
UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

**Quarterly Report Pursuant to Section 13 or 15(d) of the
Securities Exchange Act of 1934**

For the Quarterly Period Ended March 31, 2014

Commission File No. 1-13653



AMERICAN FINANCIAL GROUP, INC.

Incorporated under the Laws of Ohio

IRS Employer I.D. No. 31-1544320

301 East Fourth Street, Cincinnati, Ohio 45202
(513) 579-2121

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months, and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the Registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the Registrant was required to submit and post such files). Yes No

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

As of May 1, 2014, there were 89,519,325 shares of the Registrant's Common Stock outstanding, excluding 14.9 million shares owned by subsidiaries.

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PART I
ITEM I — FINANCIAL STATEMENTS
AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEET (UNAUDITED)
(Dollars in Millions)

	March 31, 2014	December 31, 2013
Assets:		
Cash and cash equivalents	\$ 1,876	\$ 1,639
Investments:		
Fixed maturities, available for sale at fair value (amortized cost — \$25,984 and \$25,366)	27,390	26,456
Fixed maturities, trading at fair value	297	305
Equity securities, at fair value (cost — \$1,092 and \$987)	1,297	1,179
Mortgage loans	888	781
Policy loans	235	238
Real estate and other investments	744	715
Total cash and investments	32,727	31,313
Recoverables from reinsurers	2,969	3,157
Prepaid reinsurance premiums	438	408
Agents' balances and premiums receivable	735	739
Deferred policy acquisition costs	890	975
Assets of managed investment entities	2,723	2,888
Other receivables	524	854
Variable annuity assets (separate accounts)	666	665
Other assets	913	903
Goodwill	185	185
Total assets	\$ 42,770	\$ 42,087
Liabilities and Equity:		
Unpaid losses and loss adjustment expenses	\$ 6,134	\$ 6,410
Unearned premiums	1,788	1,757
Annuity benefits accumulated	21,744	20,944
Life, accident and health reserves	2,039	2,008
Payable to reinsurers	400	508
Liabilities of managed investment entities	2,413	2,567
Long-term debt	913	913
Variable annuity liabilities (separate accounts)	666	665
Other liabilities	1,700	1,546
Total liabilities	37,797	37,318
Shareholders' equity:		
Common Stock, no par value		
— 200,000,000 shares authorized		
— 89,588,999 and 89,513,386 shares outstanding	90	90
Capital surplus	1,138	1,123
Retained earnings:		
Appropriated — managed investment entities	49	49
Unappropriated	2,842	2,777
Accumulated other comprehensive income, net of tax	677	560
Total shareholders' equity	4,796	4,599
Noncontrolling interests	177	170
Total equity	4,973	4,769
Total liabilities and equity	\$ 42,770	\$ 42,087

AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF EARNINGS (UNAUDITED)
(In Millions, Except Per Share Data)

	Three months ended March 31,	
	2014	2013
Revenues:		
Property and casualty insurance net earned premiums	\$ 754	\$ 687
Life, accident and health net earned premiums	28	30
Net investment income	361	326
Realized gains on securities (*)	19	57
Income (loss) of managed investment entities:		
Investment income	28	34
Gain (loss) on change in fair value of assets/liabilities	—	(8)
Other income	21	22
Total revenues	1,211	1,148
Costs and Expenses:		
Property and casualty insurance:		
Losses and loss adjustment expenses	429	393
Commissions and other underwriting expenses	267	251
Annuity benefits	168	134
Life, accident and health benefits	43	40
Annuity and supplemental insurance acquisition expenses	35	36
Interest charges on borrowed money	18	18
Expenses of managed investment entities	20	22
Other expenses	70	79
Total costs and expenses	1,050	973
Earnings before income taxes	161	175
Provision for income taxes	54	62
Net earnings, including noncontrolling interests	107	113
Less: Net earnings (loss) attributable to noncontrolling interests	4	(7)
Net Earnings Attributable to Shareholders	\$ 103	\$ 120
Earnings Attributable to Shareholders per Common Share:		
Basic	\$ 1.15	\$ 1.34
Diluted	\$ 1.13	\$ 1.32
Average number of Common Shares:		
Basic	89.6	89.4
Diluted	91.6	91.0
Cash dividends per Common Share	\$ 0.22	\$ 0.195
(*) Consists of the following:		
Realized gains before impairments	\$ 20	\$ 57
Losses on securities with impairment	(1)	—
Non-credit portion recognized in other comprehensive income (loss)	—	—
Impairment charges recognized in earnings	(1)	—
Total realized gains on securities	\$ 19	\$ 57

AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME (UNAUDITED)
(In Millions)

	Three months ended March 31,	
	2014	2013
Net earnings, including noncontrolling interests	\$ 107	\$ 113
Other comprehensive income (loss), net of tax:		
Net unrealized gains on securities:		
Unrealized holding gains on securities arising during the period	137	79
Reclassification adjustment for realized gains included in net earnings	(12)	(36)
Total net unrealized gains on securities	125	43
Foreign currency translation adjustments	(5)	(4)
Other comprehensive income, net of tax	120	39
Total comprehensive income, net of tax	227	152
Less: Comprehensive income (loss) attributable to noncontrolling interests	7	(6)
Comprehensive income attributable to shareholders	\$ 220	\$ 158

AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF CHANGES IN EQUITY (UNAUDITED)
(Dollars in Millions)

	Common Shares	Shareholders' Equity					Noncon- trolling Interests	Total Equity
		Common Stock and Capital Surplus	Retained Earnings		Accumulated Other Comp Inc. (Loss)	Total		
			Approp.	Unapprop.				
Balance at December 31, 2013	89,513,386	\$ 1,213	\$ 49	\$ 2,777	\$ 560	\$ 4,599	\$ 170	\$ 4,769
Net earnings	—	—	—	103	—	103	4	107
Other comprehensive income	—	—	—	—	117	117	3	120
Allocation of earnings of managed investment entities	—	—	—	—	—	—	—	—
Dividends on Common Stock	—	—	—	(19)	—	(19)	—	(19)
Shares issued:								
Exercise of stock options	323,473	11	—	—	—	11	—	11
Other benefit plans	192,525	5	—	—	—	5	—	5
Dividend reinvestment plan	3,343	—	—	—	—	—	—	—
Stock-based compensation expense	—	5	—	—	—	5	—	5
Shares acquired and retired	(419,938)	(6)	—	(18)	—	(24)	—	(24)
Shares exchanged — benefit plans	(23,790)	—	—	(1)	—	(1)	—	(1)
Balance at March 31, 2014	<u>89,588,999</u>	<u>\$ 1,228</u>	<u>\$ 49</u>	<u>\$ 2,842</u>	<u>\$ 677</u>	<u>\$ 4,796</u>	<u>\$ 177</u>	<u>\$ 4,973</u>
Balance at December 31, 2012	88,979,303	\$ 1,152	\$ 75	\$ 2,520	\$ 831	\$ 4,578	\$ 170	\$ 4,748
Net earnings	—	—	—	120	—	120	(7)	113
Other comprehensive income	—	—	—	—	38	38	1	39
Allocation of losses of managed investment entities	—	—	(11)	—	—	(11)	11	—
Dividends on Common Stock	—	—	—	(17)	—	(17)	—	(17)
Shares issued:								
Exercise of stock options	646,136	21	—	—	—	21	—	21
Other benefit plans	344,736	4	—	—	—	4	—	4
Dividend reinvestment plan	3,986	—	—	—	—	—	—	—
Stock-based compensation expense	—	4	—	—	—	4	—	4
Shares acquired and retired	(61,586)	(1)	—	(2)	—	(3)	—	(3)
Shares exchanged — benefit plans	(29,353)	—	—	(1)	—	(1)	—	(1)
Balance at March 31, 2013	<u>89,883,222</u>	<u>\$ 1,180</u>	<u>\$ 64</u>	<u>\$ 2,620</u>	<u>\$ 869</u>	<u>\$ 4,733</u>	<u>\$ 175</u>	<u>\$ 4,908</u>

AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF CASH FLOWS (UNAUDITED)
(In Millions)

	Three months ended March 31,	
	2014	2013
Operating Activities:		
Net earnings, including noncontrolling interests	\$ 107	\$ 113
Adjustments:		
Depreciation and amortization	27	35
Annuity benefits	168	134
Realized gains on investing activities	(19)	(58)
Net sales of trading securities	6	10
Deferred annuity and life policy acquisition costs	(50)	(34)
Change in:		
Reinsurance and other receivables	459	807
Other assets	(5)	(25)
Insurance claims and reserves	(226)	(597)
Payable to reinsurers	(108)	(225)
Other liabilities	(60)	85
Managed investment entities' assets/liabilities	(99)	(193)
Other operating activities, net	4	7
Net cash provided by operating activities	<u>204</u>	<u>59</u>
Investing Activities:		
Purchases of:		
Fixed maturities	(1,355)	(1,370)
Equity securities	(137)	(71)
Mortgage loans	(113)	—
Real estate, property and equipment	(14)	(28)
Business	(8)	—
Proceeds from:		
Maturities and redemptions of fixed maturities	782	675
Repayments of mortgage loans	6	23
Sales of fixed maturities	151	91
Sales of equity securities	51	58
Managed investment entities:		
Purchases of investments	(244)	(440)
Proceeds from sales and redemptions of investments	442	578
Other investing activities, net	13	14
Net cash used in investing activities	<u>(426)</u>	<u>(470)</u>
Financing Activities:		
Annuity receipts	967	624
Annuity surrenders, benefits and withdrawals	(395)	(372)
Net transfers from variable annuity assets	6	3
Reductions of long-term debt	—	(3)
Issuances of managed investment entities' liabilities	45	233
Retirement of managed investment entities' liabilities	(133)	(251)
Issuances of Common Stock	11	21
Repurchases of Common Stock	(24)	(3)
Cash dividends paid on Common Stock	(19)	(17)
Other financing activities, net	1	—
Net cash provided by financing activities	<u>459</u>	<u>235</u>
Net Change in Cash and Cash Equivalents	<u>237</u>	<u>(176)</u>
Cash and cash equivalents at beginning of period	1,639	1,705
Cash and cash equivalents at end of period	<u>\$ 1,876</u>	<u>\$ 1,529</u>

AMERICAN FINANCIAL GROUP, INC. 10-Q
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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A. Accounting Policies

Basis of Presentation The accompanying consolidated financial statements for American Financial Group, Inc. ("AFG") and its subsidiaries are unaudited; however, management believes that all adjustments (consisting only of normal recurring accruals unless otherwise disclosed herein) necessary for fair presentation have been made. The results of operations for interim periods are not necessarily indicative of results to be expected for the year. The financial statements have been prepared in accordance with the instructions to Form 10-Q and, therefore, do not include all information and footnotes necessary to be in conformity with U.S. generally accepted accounting principles.

Certain reclassifications have been made to prior periods to conform to the current year's presentation. All significant intercompany balances and transactions have been eliminated. The results of operations of companies since their formation or acquisition are included in the consolidated financial statements. Events or transactions occurring subsequent to March 31, 2014, and prior to the filing of this Form 10-Q, have been evaluated for potential recognition or disclosure herein.

The preparation of the financial statements requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Changes in circumstances could cause actual results to differ materially from those estimates.

Fair Value Measurements Accounting standards define fair value as the price that would be received to sell an asset or paid to transfer a liability (an exit price) in an orderly transaction between market participants on the measurement date. The standards establish a hierarchy of valuation techniques based on whether the assumptions that market participants would use in pricing the asset or liability ("inputs") are observable or unobservable. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect AFG's assumptions about the assumptions market participants would use in pricing the asset or liability. AFG did not have any significant nonrecurring fair value measurements of nonfinancial assets and liabilities in the first three months of 2014 or 2013.

Investments Fixed maturity and equity securities classified as "available for sale" are reported at fair value with unrealized gains and losses included in AOCI in AFG's Balance Sheet. Fixed maturity and equity securities classified as "trading" are reported at fair value with changes in unrealized holding gains or losses during the period included in net investment income. Mortgage and policy loans are carried primarily at the aggregate unpaid balance.

Premiums and discounts on fixed maturity securities are amortized using the interest method; mortgage-backed securities ("MBS") are amortized over a period based on estimated future principal payments, including prepayments. Prepayment assumptions are reviewed periodically and adjusted to reflect actual prepayments and changes in expectations.

Gains or losses on securities are determined on the specific identification basis. When a decline in the value of a specific investment is considered to be other-than-temporary at the balance sheet date, a provision for impairment is charged to earnings (included in realized gains (losses) on securities) and the cost basis of that investment is reduced. If management can assert that it does not intend to sell an impaired fixed maturity security and it is not more likely than not that it will have to sell the security before recovery of its amortized cost basis, then the other-than-temporary impairment is separated into two components: (i) the amount related to credit losses (recorded in earnings) and (ii) the amount related to all other factors (recorded in other comprehensive income). The credit-related portion of an other-than-temporary impairment is measured by comparing a security's amortized cost to the present value of its current expected cash flows discounted at its effective yield prior to the impairment charge. Both components are shown in the Statement of Earnings. If management intends to sell an impaired

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — CONTINUED

security, or it is more likely than not that it will be required to sell the security before recovery, an impairment charge to earnings is recorded to reduce the amortized cost of that security to fair value.

Derivatives Derivatives included in AFG's Balance Sheet are recorded at fair value and consist primarily of (i) components of certain fixed maturity securities (primarily interest-only MBS) and (ii) the equity-based component of certain annuity products (included in annuity benefits accumulated) and related call options (included in other investments) designed to be consistent with the characteristics of the liabilities and used to mitigate the risk embedded in those annuity products. Changes in the fair value of these derivatives are included in earnings.

Goodwill Goodwill represents the excess of cost of subsidiaries over AFG's equity in their underlying net assets. Goodwill is not amortized, but is subject to an impairment test at least annually. An entity is not required to complete the quantitative annual goodwill impairment test on a reporting unit if the entity elects to perform a qualitative analysis and determines that it is more likely than not that the reporting unit's fair value exceeds its carrying amount.

Reinsurance Amounts recoverable from reinsurers are estimated in a manner consistent with the claim liability associated with the reinsured policies. AFG's property and casualty insurance subsidiaries report as assets (i) the estimated reinsurance recoverable on paid and unpaid losses, including an estimate for losses incurred but not reported, and (ii) amounts paid or due to reinsurers applicable to the unexpired terms of policies in force. Payable to reinsurers includes ceded premiums due to reinsurers as well as ceded premiums retained by AFG's property and casualty insurance subsidiaries under contracts to fund ceded losses as they become due. AFG's insurance subsidiaries also assume reinsurance from other companies. Earnings on reinsurance assumed is recognized based on information received from ceding companies.

A subsidiary cedes life insurance policies to a third party on a funds withheld basis whereby the subsidiary retains the assets (securities) associated with the reinsurance contract. Interest is credited to the reinsurer based on the actual investment performance of the retained assets. This reinsurance contract is considered to contain an embedded derivative (that must be adjusted to fair value) because the yield on the payable is based on a specific block of the ceding company's assets, rather than the overall creditworthiness of the ceding company. AFG determined that changes in the fair value of the underlying portfolio of fixed maturity securities is an appropriate measure of the value of the embedded derivative. The securities related to this contract are classified as "trading." The adjustment to fair value on the embedded derivative offsets the investment income recorded on the adjustment to fair value of the related trading portfolio.

Deferred Policy Acquisition Costs ("DPAC") Policy acquisition costs (principally commissions, premium taxes and certain underwriting and policy issuance costs) directly related to the successful acquisition or renewal of an insurance contract are deferred. DPAC also includes capitalized costs associated with sales inducements offered to fixed annuity policyholders such as enhanced interest rates and premium and persistency bonuses.

For the property and casualty companies, DPAC is limited based upon recoverability without any consideration for anticipated investment income and is charged against income ratably over the terms of the related policies. A premium deficiency is recognized if the sum of expected claims costs, claims adjustment expenses and unamortized acquisition costs exceed the related unearned premiums. A premium deficiency is first recognized by charging any unamortized acquisition costs to expense to the extent required to eliminate the deficiency. If the premium deficiency is greater than unamortized acquisition costs, a liability is accrued for the excess deficiency and reported with unpaid losses and loss adjustment expenses.

DPAC related to annuities is deferred to the extent deemed recoverable and amortized, with interest, in relation to the present value of actual and expected gross profits on the policies. Expected gross profits consist principally of estimated future investment margin (estimated future net investment income less interest credited on policyholder funds) and surrender, mortality, and other life and annuity policy charges, less death, annuitization and guaranteed withdrawal benefits in excess of account balances and estimated future policy administration expenses. To the extent that realized gains and losses result in adjustments to the amortization of DPAC related to annuities, such adjustments are reflected as components of realized gains (losses) on securities.

DPAC related to traditional life and health insurance is amortized over the expected premium paying period of the related policies, in proportion to the ratio of annual premium revenues to total anticipated premium revenues. See "*Life, Accident and Health Reserves*" below for details on the impact of loss recognition on the accounting for traditional life and health insurance contracts.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — CONTINUED

DPAC includes the present value of future profits on business in force of annuity and life, accident and health insurance companies acquired (“PVFP”). PVFP represents the portion of the costs to acquire companies that is allocated to the value of the right to receive future cash flows from insurance contracts existing at the date of acquisition. PVFP is amortized with interest in relation to expected gross profits of the acquired policies for annuities and universal life products and in relation to the premium paying period for traditional life and health insurance products.

DPAC and certain other balance sheet amounts related to annuity, long-term care and life businesses are also adjusted, net of tax, for the change in expense that would have been recorded if the unrealized gains (losses) from securities had actually been realized. These adjustments are included in unrealized gains (losses) on marketable securities, a component of AOCI in AFG’s Balance Sheet.

Managed Investment Entities A company is considered the primary beneficiary of, and therefore must consolidate, a variable interest entity (“VIE”) based primarily on its ability to direct the activities of the VIE that most significantly impact that entity’s economic performance and the obligation to absorb losses of, or receive benefits from, the entity that could potentially be significant to the VIE.

AFG manages, and has investments in, collateralized loan obligations (“CLOs”) that are VIEs (see *Note H — “Managed Investment Entities”*). Both the management fees (payment of which is subordinate to other obligations of the CLOs) and the investments in the CLOs are considered variable interests. AFG has determined that it is the primary beneficiary of the CLOs because (i) its role as asset manager gives it the power to direct the activities that most significantly impact the economic performance of the CLOs and (ii) it has exposure to CLO losses (through its investments in the CLO debt tranches) and the right to receive benefits (through its subordinated management fees and returns on its investments), both of which could potentially be significant to the CLOs.

Because AFG has no right to use the CLO assets and no obligation to pay the CLO liabilities, the assets and liabilities of the CLOs are shown separately in AFG’s Balance Sheet (at fair value). AFG has elected the fair value option for reporting on the CLO assets and liabilities to improve the transparency of financial reporting related to the CLOs. The excess of fair value of the CLOs’ assets over the fair value of the liabilities is recorded in AFG’s Balance Sheet as appropriated retained earnings — managed investment entities, representing amounts that ultimately will inure to the benefit of the CLO debt holders.

The net gain or loss from accounting for the CLO assets and liabilities at fair value is separately presented in AFG’s Statement of Earnings. CLO earnings attributable to AFG’s shareholders represent the change in fair value of AFG’s investments in the CLOs (including distributions) and management fees earned. All other CLO earnings (losses) are not attributable to AFG’s shareholders and will ultimately inure to the benefit of the CLO debt holders. As a result, such CLO earnings (losses) are included in net earnings (loss) attributable to noncontrolling interests in AFG’s Statement of Earnings and in appropriated retained earnings — managed investment entities in the Balance Sheet. As the CLOs approach maturity (2016 to 2026), it is expected that losses attributable to noncontrolling interests will reduce appropriated retained earnings towards zero as the fair values of the assets and liabilities converge and the CLO assets are used to pay the CLO debt.

At March 31, 2014, assets and liabilities of managed investment entities included \$82 million in assets and \$67 million in liabilities of a temporary warehousing entity that was established in connection with the formation of a new CLO that is expected to close in the second or third quarter of 2014. Upon closing, all warehoused assets are expected to be transferred to the new CLO and the liabilities will be repaid.

Unpaid Losses and Loss Adjustment Expenses The net liabilities stated for unpaid claims and for expenses of investigation and adjustment of unpaid claims represent management’s best estimate and are based upon (i) the accumulation of case estimates for losses reported prior to the close of the accounting period on direct business written; (ii) estimates received from ceding reinsurers and insurance pools and associations; (iii) estimates of unreported losses (including possible development on known claims) based on past experience; (iv) estimates based on experience of expenses for investigating and adjusting claims; and (v) the current state of the law and coverage litigation. Establishing reserves for asbestos, environmental and other mass tort claims involves considerably more judgment than other types of claims due to, among other things, inconsistent court decisions, an increase in bankruptcy filings as a result of asbestos-related liabilities, novel theories of coverage, and judicial interpretations that often expand theories of recovery and broaden the scope of coverage.

Loss reserve liabilities are subject to the impact of changes in claim amounts and frequency and other factors. Changes in estimates of the liabilities for losses and loss adjustment expenses are reflected in the Statement of Earnings in the period in

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — CONTINUED

which determined. Despite the variability inherent in such estimates, management believes that the liabilities for unpaid losses and loss adjustment expenses are adequate.

Annuity Benefits Accumulated Annuity receipts and benefit payments are recorded as increases or decreases in annuity benefits accumulated rather than as revenue and expense. Increases in this liability for interest credited are charged to expense and decreases for policy charges are credited to other income.

For certain products, annuity benefits accumulated also includes reserves for accrued persistency and premium bonuses, guaranteed withdrawals and excess benefits expected to be paid on future deaths and annuitizations (“EDAR”). The liabilities for EDAR and guaranteed withdrawals are accrued for and modified using assumptions consistent with those used in determining DPAC and DPAC amortization, except that amounts are determined in relation to the present value of total expected assessments. Total expected assessments consist principally of estimated future investment margin, surrender, mortality, and other life and annuity policy charges, and unearned revenues once they are recognized as income.

Annuity benefits accumulated also includes amounts advanced from the Federal Home Loan Bank of Cincinnati.

Unearned Revenue Certain upfront policy charges on annuities are deferred as unearned revenue (included in other liabilities) and recognized in net earnings using the same assumptions and estimated gross profits used to amortize DPAC.

Life, Accident and Health Reserves Liabilities for future policy benefits under traditional life, accident and health policies are computed using the net level premium method. Computations are based on the original projections of investment yields, mortality, morbidity and surrenders and include provisions for unfavorable deviations unless a loss recognition event (premium deficiency) occurs. Claim reserves and liabilities established for accident and health claims are modified as necessary to reflect actual experience and developing trends.

For long-duration contracts (such as traditional life and long-term care policies), loss recognition occurs when, based on current expectations as of the measurement date, existing contract liabilities plus the present value of future premiums (including reasonably expected rate increases) are not expected to cover the present value of future claims payments and related settlement and maintenance costs (excluding overhead) as well as unamortized acquisition costs. If a block of business is determined to be in loss recognition, a charge is recorded in earnings in an amount equal to the excess of the present value of expected future claims costs and unamortized acquisition costs over existing reserves plus the present value of expected future premiums (with no provision for adverse deviation). The charge is recorded first to reduce unamortized acquisition costs and then as an additional reserve (if unamortized acquisition costs have been reduced to zero).

In addition, reserves for traditional life and long-term care policies are subject to adjustment for loss recognition charges that would have been recorded if the unrealized gains from securities had actually been realized. This adjustment is included in unrealized gains (losses) on marketable securities, a component of AOCI in AFG’s Balance Sheet.

Variable Annuity Assets and Liabilities Separate accounts related to variable annuities represent the fair value of deposits invested in underlying investment funds on which AFG earns a fee. Investment funds are selected and may be changed only by the policyholder, who retains all investment risk.

AFG’s variable annuity contracts contain a guaranteed minimum death benefit (“GMDB”) to be paid if the policyholder dies before the annuity payout period commences. In periods of declining equity markets, the GMDB may exceed the value of the policyholder’s account. A GMDB liability is established for future excess death benefits using assumptions together with a range of reasonably possible scenarios for investment fund performance that are consistent with DPAC capitalization and amortization assumptions.

Premium Recognition Property and casualty premiums are earned generally over the terms of the policies on a pro rata basis. Unearned premiums represent that portion of premiums written which is applicable to the unexpired terms of policies in force. On reinsurance assumed from other insurance companies or written through various underwriting organizations, unearned premiums are based on information received from such companies and organizations. For traditional life, accident and health products, premiums are recognized as revenue when legally collectible from policyholders. For interest-sensitive life and universal life products, premiums are recorded in a policyholder account, which is reflected as a liability. Revenue is recognized as amounts are assessed against the policyholder account for mortality coverage and contract expenses.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — CONTINUED

Noncontrolling Interests For Balance Sheet purposes, noncontrolling interests represents the interests of shareholders other than AFG in consolidated entities. In the Statement of Earnings, net earnings and losses attributable to noncontrolling interests represents such shareholders' interest in the earnings and losses of those entities.

Income Taxes Deferred income taxes are calculated using the liability method. Under this method, deferred income tax assets and liabilities are determined based on differences between financial reporting and tax bases and are measured using enacted tax rates. A valuation allowance is established to reduce total deferred tax assets to an amount that will more likely than not be realized.

AFG recognizes the tax benefits of uncertain tax positions only when the position is more likely than not to be sustained under examination by the appropriate taxing authority. Interest and penalties on AFG's reserve for uncertain tax positions are recognized as a component of tax expense.

Stock-Based Compensation All share-based grants are recognized as compensation expense on a straight-line basis over their vesting periods based on their calculated fair value at the date of grant. AFG uses the Black-Scholes pricing model to measure the fair value of employee stock options. See *Note K — "Shareholders' Equity"* for further information.

Benefit Plans AFG provides retirement benefits to qualified employees of participating companies through the AFG 401(k) Retirement and Savings Plan, a defined contribution plan. AFG makes all contributions to the retirement fund portion of the plan and matches a percentage of employee contributions to the savings fund. Company contributions are expensed in the year for which they are declared. AFG and many of its subsidiaries provide health care and life insurance benefits to eligible retirees. AFG also provides postemployment benefits to former or inactive employees (primarily those on disability) who were not deemed retired under other company plans. The projected future cost of providing these benefits is expensed over the period employees earn such benefits.

Earnings Per Share Although basic earnings per share only considers shares of common stock outstanding during the period, the calculation of diluted earnings per share includes the following adjustments to weighted average common shares related to stock-based compensation plans: first three months of 2014 and 2013 — 2.0 million and 1.6 million, respectively.

AFG's weighted average diluted shares outstanding excludes the following anti-dilutive potential common shares related to stock compensation plans: first three months of 2014 and 2013 — 0.6 million and 1.5 million, respectively. Adjustments to net earnings attributable to shareholders in the calculation of diluted earnings per share were nominal in the 2014 and 2013 periods.

Statement of Cash Flows For cash flow purposes, "investing activities" are defined as making and collecting loans and acquiring and disposing of debt or equity instruments and property and equipment. "Financing activities" include obtaining resources from owners and providing them with a return on their investments, borrowing money and repaying amounts borrowed. Annuity receipts, surrenders, benefits and withdrawals are also reflected as financing activities. All other activities are considered "operating." Short-term investments having original maturities of three months or less when purchased are considered to be cash equivalents for purposes of the financial statements.

B. Acquisitions

On March 27, 2014, AFG completed a renewal rights agreement with Selective Insurance Company of America to acquire Selective's pooled public entity book of business for \$8 million. At the acquisition date, this book of business had approximately \$38 million in in-force gross written premiums.

On April 1, 2014, AFG acquired Summit Holding Southeast, Inc. and its related companies ("Summit"), from Liberty Mutual Insurance using cash on hand at the parent company. AFG paid approximately \$260 million at closing, which is subject to post-closing adjustments. In addition, AFG made a capital contribution of approximately \$140 million, bringing its total capital investment in the Summit business to approximately \$400 million. Summit is based in Lakeland, Florida and is a leading provider of specialty workers' compensation solutions in the southeastern United States, with over \$500 million in net written premiums in 2013 and \$1.5 billion in assets at the closing date. Summit continues to operate under the Summit brand as a member of AFG's Great American Insurance Group.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — CONTINUED

C. Segments of Operations

AFG manages its business as four segments: (i) Property and casualty insurance, (ii) Annuity, (iii) Run-off long-term care and life and (iv) Other, which includes holding company costs and the operations attributable to the noncontrolling interests of the managed investment entities.

AFG reports its property and casualty insurance business in the following Specialty sub-segments: (i) Property and transportation, which includes physical damage and liability coverage for buses, trucks and recreational vehicles, inland and ocean marine, agricultural-related products and other property coverages, (ii) Specialty casualty, which includes primarily excess and surplus, general liability, executive liability, professional liability, umbrella and excess liability, specialty coverage in targeted markets, customized programs for small to mid-sized businesses and workers' compensation insurance, and (iii) Specialty financial, which includes risk management insurance programs for leasing and financing institutions (including collateral and lender-placed mortgage property insurance), surety and fidelity products and trade credit insurance. AFG's annuity business markets traditional fixed and fixed-indexed annuities in the retail, financial institutions and education markets. AFG's reportable segments and their components were determined based primarily upon similar economic characteristics, products and services.

The following tables (in millions) show AFG's revenues and earnings before income taxes by segment and sub-segment.

	Three months ended March 31,	
	2014	2013
Revenues		
Property and casualty insurance:		
Premiums earned:		
Specialty		
Property and transportation	\$ 301	\$ 293
Specialty casualty	313	259
Specialty financial	117	116
Other specialty	23	19
Total premiums earned	754	687
Net investment income	67	66
Other income	2	3
Total property and casualty insurance	823	756
Annuity:		
Net investment income	275	248
Other income	18	14
Total annuity	293	262
Run-off long-term care and life	51	50
Other	25	23
Total revenues before realized gains	1,192	1,091
Realized gains on securities	19	57
Total revenues	\$ 1,211	\$ 1,148

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — CONTINUED

	Three months ended March 31,	
	2014	2013
Earnings Before Income Taxes		
Property and casualty insurance:		
Underwriting:		
Specialty		
Property and transportation	\$ 6	\$ 10
Specialty casualty	38	19
Specialty financial	10	13
Other specialty	5	6
Other lines	(1)	(5)
Total underwriting	58	43
Investment and other income, net	54	56
Total property and casualty insurance	112	99
Annuity	73	76
Run-off long-term care and life	(2)	(1)
Other (a)	(41)	(56)
Total earnings before realized gains and income taxes	142	118
Realized gains on securities	19	57
Total earnings before income taxes	\$ 161	\$ 175

- (a) Includes holding company expenses and earnings (losses) of managed investment entities attributable to noncontrolling interests (earnings of less than \$1 million for the first three months of 2014 and losses of \$11 million for the first three months of 2013).

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — CONTINUED

D. Fair Value Measurements

Accounting standards for measuring fair value are based on inputs used in estimating fair value. The three levels of the hierarchy are as follows:

Level 1 — Quoted prices for identical assets or liabilities in active markets (markets in which transactions occur with sufficient frequency and volume to provide pricing information on an ongoing basis). AFG's Level 1 financial instruments consist primarily of publicly traded equity securities and highly liquid government bonds for which quoted market prices in active markets are available and short-term investments of managed investment entities.

Level 2 — Quoted prices for similar instruments in active markets; quoted prices for identical or similar assets or liabilities in inactive markets (markets in which there are few transactions, the prices are not current, price quotations vary substantially over time or among market makers, or in which little information is released publicly); and valuations based on other significant inputs that are observable in active markets. AFG's Level 2 financial instruments include separate account assets, corporate and municipal fixed maturity securities, mortgage-backed securities ("MBS") and investments of managed investment entities priced using observable inputs. Level 2 inputs include benchmark yields, reported trades, corroborated broker/dealer quotes, issuer spreads and benchmark securities. When non-binding broker quotes can be corroborated by comparison to similar securities priced using observable inputs, they are classified as Level 2.

Level 3 — Valuations derived from market valuation techniques generally consistent with those used to estimate the fair values of Level 2 financial instruments in which one or more significant inputs are unobservable or when the market for a security exhibits significantly less liquidity relative to markets supporting Level 2 fair value measurements. The unobservable inputs may include management's own assumptions about the assumptions market participants would use based on the best information available in the circumstances. AFG's Level 3 is comprised of financial instruments, including liabilities of managed investment entities, whose fair value is estimated based on non-binding broker quotes or internally developed using significant inputs not based on, or corroborated by, observable market information.

AFG's management is responsible for the valuation process and uses data from outside sources (including nationally recognized pricing services and broker/dealers) in establishing fair value. AFG's internal investment professionals are a group of approximately 20 analysts whose primary responsibility is to manage AFG's investment portfolio. These professionals monitor individual investments as well as overall industries and are active in the financial markets on a daily basis. The group is led by AFG's chief investment officer, who reports directly to one of AFG's Co-CEOs. Valuation techniques utilized by pricing services and prices obtained from external sources are reviewed by AFG's internal investment professionals who are familiar with the securities being priced and the markets in which they trade to ensure the fair value determination is representative of an exit price. To validate the appropriateness of the prices obtained, these investment managers consider widely published indices (as benchmarks), recent trades, changes in interest rates, general economic conditions and the credit quality of the specific issuers. In addition, the Company communicates directly with the pricing service regarding the methods and assumptions used in pricing, including verifying, on a test basis, the inputs used by the service to value specific securities.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — CONTINUED

Assets and liabilities measured and carried at fair value in the financial statements are summarized below (in millions):

	Level 1	Level 2	Level 3	Total
March 31, 2014				
Assets:				
Available for sale (“AFS”) fixed maturities:				
U.S. Government and government agencies	\$ 152	\$ 154	\$ 15	\$ 321
States, municipalities and political subdivisions	—	5,662	61	5,723
Foreign government	—	193	—	193
Residential MBS	—	4,309	272	4,581
Commercial MBS	—	2,591	28	2,619
Asset-backed securities (“ABS”)	—	2,554	206	2,760
Corporate and other	30	10,841	322	11,193
Total AFS fixed maturities	182	26,304	904	27,390
Trading fixed maturities	—	297	—	297
Equity securities	1,059	197	41	1,297
Assets of managed investment entities (“MIE”)	267	2,427	29	2,723
Variable annuity assets (separate accounts) (a)	—	666	—	666
Other investments — derivatives	—	288	—	288
Total assets accounted for at fair value	\$ 1,508	\$ 30,179	\$ 974	\$ 32,661
Liabilities:				
Liabilities of managed investment entities	\$ 91	\$ —	\$ 2,322	\$ 2,413
Derivatives in annuity benefits accumulated	—	—	904	904
Other liabilities — derivatives	—	12	—	12
Total liabilities accounted for at fair value	\$ 91	\$ 12	\$ 3,226	\$ 3,329
December 31, 2013				
Assets:				
Available for sale fixed maturities:				
U.S. Government and government agencies	\$ 147	\$ 152	\$ 15	\$ 314
States, municipalities and political subdivisions	—	5,311	61	5,372
Foreign government	—	208	—	208
Residential MBS	—	3,994	316	4,310
Commercial MBS	—	2,696	28	2,724
Asset-backed securities	—	2,418	75	2,493
Corporate and other	28	10,672	335	11,035
Total AFS fixed maturities	175	25,451	830	26,456
Trading fixed maturities	—	305	—	305
Equity securities	1,023	125	31	1,179
Assets of managed investment entities	266	2,592	30	2,888
Variable annuity assets (separate accounts) (a)	—	665	—	665
Other investments — derivatives	—	274	—	274
Total assets accounted for at fair value	\$ 1,464	\$ 29,412	\$ 891	\$ 31,767
Liabilities:				
Liabilities of managed investment entities	\$ 156	\$ —	\$ 2,411	\$ 2,567
Derivatives in annuity benefits accumulated	—	—	804	804
Other liabilities — derivatives	—	10	—	10
Total liabilities accounted for at fair value	\$ 156	\$ 10	\$ 3,215	\$ 3,381

(a) Variable annuity liabilities equal the fair value of variable annuity assets.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — CONTINUED

During the first three months of 2014, eight perpetual preferred stocks with an aggregate fair value of \$55 million were transferred from Level 1 to Level 2 due to insufficient trade data to warrant classification in Level 1. During the first three months of 2014 and 2013, there were no transfers from Level 2 to Level 1. Approximately 3% of the total assets carried at fair value on March 31, 2014, were Level 3 assets. Approximately 85% (\$833 million) of the Level 3 assets were priced using non-binding broker quotes, for which there is a lack of transparency as to the inputs used to determine fair value. Details as to the quantitative inputs are neither provided by the brokers nor otherwise reasonably obtainable by AFG. Since internally developed Level 3 asset fair values represent less than one-half of 1% of the total assets measured at fair value and less than 3% of AFG's shareholders' equity, changes in unobservable inputs used to determine internally developed fair values would not have a material impact on AFG's financial position.

The fair values of the liabilities of managed investment entities were determined using primarily non-binding broker quotes, which were reviewed by AFG's investment professionals. AFG's investment professionals are familiar with the cash flow models used by the brokers to determine the fair value of these liabilities and review the broker quotes based on their knowledge of the CLO market and the market for the underlying assets. Their review includes consideration of expected reinvestment, default and recovery rates on the assets supporting the CLO liabilities, as well as surveying general CLO liability fair values and analysis provided by third parties.

The only significant Level 3 assets or liabilities carried at fair value in the financial statements that were not measured using broker quotes are the derivatives embedded in AFG's fixed-indexed annuity liabilities, which are measured using a discounted cash flow approach and had a fair value of \$904 million at March 31, 2014. The following table presents information about the unobservable inputs used by management in determining fair value of these embedded derivatives. See Note F — "Derivatives."

Unobservable Input	Range
Adjustment for insurance subsidiary's credit risk	0.40% – 1.60% over the risk free rate
Risk margin for uncertainty in cash flows	0.3% reduction in the discount rate
Surrenders	4% – 16% of indexed account value
Partial surrenders	2% – 6% of indexed account value
Annuitizations	1% – 2% of indexed account value
Deaths	1.5% – 2.5% of indexed account value
Budgeted option costs	2.5% – 4.0% of indexed account value

The range of adjustments for insurance subsidiary's credit risk reflects credit spread variations across the yield curve. The range of projected surrender rates reflects the specific surrender charges and other features of AFG's individual fixed-indexed annuity products with an expected range of 6% to 12% in the majority of future calendar years (4% to 16% over all periods). Increasing the budgeted option cost or risk margin for uncertainty in cash flows assumptions in the table above would increase the fair value of the fixed-indexed annuity embedded derivatives, while increasing any of the other unobservable inputs in the table above would decrease the fair value of the embedded derivatives.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — CONTINUED

Changes in balances of Level 3 financial assets and liabilities carried at fair value during the first three months of 2014 and 2013 are presented below (in millions). The transfers into and out of Level 3 were due to changes in the availability of market observable inputs. All transfers are reflected in the table at fair value as of the end of the reporting period.

	Balance at December 31, 2013	Total realized/unrealized gains (losses) included in		Purchases and issuances	Sales and settlements	Transfer into Level 3	Transfer out of Level 3	Balance at March 31, 2014
		Net income	Other comprehensive income (loss)					
AFS fixed maturities:								
U.S. government agency	\$ 15	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —	\$ 15
State and municipal	61	—	—	—	—	—	—	61
Residential MBS	316	1	4	—	(8)	32	(73)	272
Commercial MBS	28	—	—	—	—	—	—	28
Asset-backed securities	75	—	1	50	(1)	81	—	206
Corporate and other	335	1	3	1	(16)	—	(2)	322
Equity securities	31	1	2	30	(9)	—	(14)	41
Assets of MIE	30	(1)	—	—	—	—	—	29
Liabilities of MIE (*)	(2,411)	1	—	(45)	133	—	—	(2,322)
Embedded derivatives	(804)	(54)	—	(55)	9	—	—	(904)

(*) Total realized/unrealized loss included in net income includes gains of \$4 million related to liabilities outstanding as of March 31, 2014. See Note H — “Managed Investment Entities.”

	Balance at December 31, 2012	Total realized/unrealized gains (losses) included in		Purchases and issuances	Sales and settlements	Transfer into Level 3	Transfer out of Level 3	Balance at March 31, 2013
		Net income	Other comprehensive income (loss)					
AFS fixed maturities:								
U.S. government agency	\$ 20	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —	\$ 20
State and municipal	58	—	—	—	—	—	(4)	54
Residential MBS	371	2	6	6	(12)	16	(35)	354
Commercial MBS	22	1	—	—	—	7	—	30
Asset-backed securities	253	1	—	12	(6)	—	(15)	245
Corporate and other	236	—	—	10	(2)	—	—	244
Equity securities	37	—	3	9	—	—	—	49
Assets of MIE	40	(4)	—	—	—	—	(6)	30
Liabilities of MIE (*)	(2,745)	(25)	—	—	250	—	19	(2,501)
Embedded derivatives	(465)	(80)	—	(17)	7	—	—	(555)

(*) Total realized/unrealized loss included in net income includes losses of \$18 million related to liabilities outstanding as of March 31, 2013. See Note H — “Managed Investment Entities.”

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — CONTINUED

Fair Value of Financial Instruments The carrying value and fair value of financial instruments that are not carried at fair value in the financial statements are summarized below (in millions):

	Carrying Value	Fair Value	Level 1	Level 2	Level 3
March 31, 2014					
Financial assets:					
Cash and cash equivalents	\$ 1,876	\$ 1,876	\$ 1,876	\$ —	\$ —
Mortgage loans	888	886	—	—	886
Policy loans	235	235	—	—	235
Total financial assets not accounted for at fair value	\$ 2,999	\$ 2,997	\$ 1,876	\$ —	\$ 1,121
Financial liabilities:					
Annuity benefits accumulated (*)	\$ 21,542	\$ 20,860	\$ —	\$ —	\$ 20,860
Long-term debt	913	1,018	—	942	76
Total financial liabilities not accounted for at fair value	\$ 22,455	\$ 21,878	\$ —	\$ 942	\$ 20,936
December 31, 2013					
Financial assets:					
Cash and cash equivalents	\$ 1,639	\$ 1,639	\$ 1,639	\$ —	\$ —
Mortgage loans	781	779	—	—	779
Policy loans	238	238	—	—	238
Total financial assets not accounted for at fair value	\$ 2,658	\$ 2,656	\$ 1,639	\$ —	\$ 1,017
Financial liabilities:					
Annuity benefits accumulated (*)	\$ 20,741	\$ 19,959	\$ —	\$ —	\$ 19,959
Long-term debt	913	985	—	909	76
Total financial liabilities not accounted for at fair value	\$ 21,654	\$ 20,944	\$ —	\$ 909	\$ 20,035

(*) Excludes life contingent annuities in the payout phase.

The carrying amount of cash and cash equivalents approximates fair value. Fair values for mortgage loans are estimated by discounting the future contractual cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings. The fair value of policy loans is estimated to approximate carrying value; policy loans have no defined maturity dates and are inseparable from insurance contracts. The fair value of annuity benefits was estimated based on expected cash flows discounted using forward interest rates adjusted for the Company's credit risk and includes the impact of maintenance expenses and capital costs. Fair values of long-term debt are based primarily on quoted market prices.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — CONTINUED

E. Investments

Available for sale fixed maturities and equity securities at March 31, 2014, and December 31, 2013, consisted of the following (in millions):

	March 31, 2014				December 31, 2013			
	Amortized Cost	Fair Value	Gross Unrealized		Amortized Cost	Fair Value	Gross Unrealized	
			Gains	Losses			Gains	Losses
Fixed maturities:								
U.S. Government and government agencies	\$ 316	\$ 321	\$ 8	\$ (3)	\$ 310	\$ 314	\$ 7	\$ (3)
States, municipalities and political subdivisions	5,579	5,723	214	(70)	5,360	5,372	156	(144)
Foreign government	184	193	9	—	198	208	10	—
Residential MBS	4,193	4,581	412	(24)	3,947	4,310	391	(28)
Commercial MBS	2,435	2,619	185	(1)	2,535	2,724	192	(3)
Asset-backed securities	2,737	2,760	39	(16)	2,477	2,493	35	(19)
Corporate and other	10,540	11,193	702	(49)	10,539	11,035	604	(108)
Total fixed maturities	\$ 25,984	\$ 27,390	\$ 1,569	\$ (163)	\$ 25,366	\$ 26,456	\$ 1,395	\$ (305)
Common stocks	\$ 801	\$ 996	\$ 207	\$ (12)	\$ 721	\$ 914	\$ 209	\$ (16)
Perpetual preferred stocks	\$ 291	\$ 301	\$ 15	\$ (5)	\$ 266	\$ 265	\$ 9	\$ (10)

The non-credit related portion of other-than-temporary impairment charges is included in other comprehensive income. Cumulative non-credit charges taken for securities still owned at March 31, 2014 and December 31, 2013, respectively, were \$224 million and \$229 million. Gross unrealized gains on such securities at March 31, 2014 and December 31, 2013 were \$153 million and \$150 million, respectively. Gross unrealized losses on such securities at March 31, 2014 and December 31, 2013 were \$11 million and \$13 million, respectively. These amounts represent the non-credit other-than-temporary impairment charges recorded in AOCI adjusted for subsequent changes in fair values and nearly all relate to residential MBS.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — CONTINUED

The following tables show gross unrealized losses (in millions) on fixed maturities and equity securities by investment category and length of time that individual securities have been in a continuous unrealized loss position at March 31, 2014 and December 31, 2013.

	Less Than Twelve Months			Twelve Months or More		
	Unrealized Loss	Fair Value	Fair Value as % of Cost	Unrealized Loss	Fair Value	Fair Value as % of Cost
March 31, 2014						
Fixed maturities:						
U.S. Government and government agencies	\$ (3)	\$ 38	93%	\$ —	\$ —	—%
States, municipalities and political subdivisions	(64)	1,523	96%	(6)	90	94%
Residential MBS	(8)	494	98%	(16)	214	93%
Commercial MBS	(1)	48	98%	—	2	100%
Asset-backed securities	(14)	1,101	99%	(2)	44	96%
Corporate and other	(44)	1,506	97%	(5)	86	95%
Total fixed maturities	\$ (134)	\$ 4,710	97%	\$ (29)	\$ 436	94%
Common stocks	\$ (12)	\$ 166	93%	\$ —	\$ —	—%
Perpetual preferred stocks	\$ (4)	\$ 90	96%	\$ (1)	\$ 6	86%

December 31, 2013

Fixed maturities:						
U.S. Government and government agencies	\$ (3)	\$ 60	95%	\$ —	\$ —	—%
States, municipalities and political subdivisions	(135)	2,219	94%	(9)	73	89%
Residential MBS	(9)	553	98%	(19)	212	92%
Commercial MBS	(3)	106	97%	—	2	100%
Asset-backed securities	(18)	1,310	99%	(1)	28	97%
Corporate and other	(101)	2,634	96%	(7)	85	92%
Total fixed maturities	\$ (269)	\$ 6,882	96%	\$ (36)	\$ 400	92%
Common stocks	\$ (16)	\$ 158	91%	\$ —	\$ —	—%
Perpetual preferred stocks	\$ (6)	\$ 91	94%	\$ (4)	\$ 20	83%

At March 31, 2014, the gross unrealized losses on fixed maturities of \$163 million relate to approximately 825 securities. Investment grade securities (as determined by nationally recognized rating agencies) represented approximately 83% of the gross unrealized loss and 88% of the fair value.

AFG analyzes its MBS securities for other-than-temporary impairment each quarter based upon expected future cash flows. Management estimates expected future cash flows based upon its knowledge of the MBS market, cash flow projections (which reflect loan to collateral values, subordination, vintage and geographic concentration) received from independent sources, implied cash flows inherent in security ratings and analysis of historical payment data. In the first three months of 2014, AFG recorded less than \$1 million in other-than-temporary impairment charges related to its residential MBS.

Management believes AFG will recover its cost basis in the securities with unrealized losses and that AFG has the ability to hold the securities until they recover in value and had no intent to sell them at March 31, 2014.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — CONTINUED

A progression of the credit portion of other-than-temporary impairments on fixed maturity securities for which the non-credit portion of an impairment has been recognized in other comprehensive income is shown below (in millions).

	2014	2013
Balance at January 1	\$ 194	\$ 192
Additional credit impairments on:		
Previously impaired securities	—	—
Securities without prior impairments	—	—
Reductions due to sales or redemptions	(17)	(1)
Balance at March 31	<u>\$ 177</u>	<u>\$ 191</u>

The table below sets forth the scheduled maturities of available for sale fixed maturities as of March 31, 2014 (in millions). Securities with sinking funds are reported at average maturity. Actual maturities may differ from contractual maturities because certain securities may be called or prepaid by the issuers.

<u>Maturity</u>	Amortized	Fair Value	
	Cost	Amount	%
One year or less	\$ 904	\$ 922	3%
After one year through five years	4,672	5,037	19%
After five years through ten years	7,383	7,714	28%
After ten years	3,660	3,757	14%
	16,619	17,430	64%
ABS (average life of approximately 5 years)	2,737	2,760	10%
MBS (average life of approximately 4-1/2 years)	6,628	7,200	26%
Total	<u>\$ 25,984</u>	<u>\$ 27,390</u>	100%

Certain risks are inherent in connection with fixed maturity securities, including loss upon default, price volatility in reaction to changes in interest rates, and general market factors and risks associated with reinvestment of proceeds due to prepayments or redemptions in a period of declining interest rates.

There were no investments in individual issuers that exceeded 10% of Shareholders' Equity at March 31, 2014 or December 31, 2013.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — CONTINUED

Net Unrealized Gain on Marketable Securities In addition to adjusting equity securities and fixed maturity securities classified as “available for sale” to fair value, GAAP requires that deferred policy acquisition costs and certain other balance sheet amounts related to annuity, long-term care and life businesses be adjusted to the extent that unrealized gains and losses from securities would result in adjustments to those balances had the unrealized gains or losses actually been realized. The following table shows (in millions) the components of the net unrealized gain on securities that is included in AOCI in AFG’s Balance Sheet.

	Pretax	Deferred Tax and Amounts Attributable to Noncontrolling Interests	Net
March 31, 2014			
Unrealized gain on:			
Fixed maturities - annuity segment (*)	\$ 963	\$ (337)	\$ 626
Fixed maturities - all other	443	(163)	280
Equity securities	205	(76)	129
Deferred policy acquisition costs - annuity segment	(450)	157	(293)
Annuity benefits accumulated	(97)	34	(63)
Life, accident and health reserves	(20)	7	(13)
Unearned revenue	29	(10)	19
	<u>\$ 1,073</u>	<u>\$ (388)</u>	<u>\$ 685</u>

December 31, 2013

Unrealized gain on:			
Fixed maturities - annuity segment (*)	\$ 729	\$ (255)	\$ 474
Fixed maturities - all other	361	(133)	228
Equity securities	192	(70)	122
Deferred policy acquisition costs - annuity segment	(345)	121	(224)
Annuity benefits accumulated	(71)	25	(46)
Life, accident and health reserves	(8)	3	(5)
Unearned revenue	22	(8)	14
	<u>\$ 880</u>	<u>\$ (317)</u>	<u>\$ 563</u>

(*) Unrealized gains on fixed maturity investments supporting AFG’s annuity benefits accumulated.

Net Investment Income The following table shows (in millions) investment income earned and investment expenses incurred.

	Three months ended March 31,	
	2014	2013
Investment income:		
Fixed maturities	\$ 327	\$ 302
Equity securities	16	12
Equity in earnings of partnerships and similar investments	6	—
Other	17	16
Gross investment income	366	330
Investment expenses	(5)	(4)
Net investment income	<u>\$ 361</u>	<u>\$ 326</u>

Equity in the earnings of partnerships has not been material and was included in realized gains (losses) on securities prior to 2014.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — CONTINUED

Realized gains (losses) and changes in unrealized appreciation (depreciation) related to fixed maturity and equity security investments are summarized as follows (in millions):

	Fixed Maturities	Equity Securities	Mortgage Loans and Other Investments	Other (a)	Tax Effects	Noncontrolling Interests	Total
Three months ended March 31, 2014							
Realized before impairments	\$ 13	\$ 6	\$ 1	\$ —	\$ (7)	\$ —	\$ 13
Realized — impairments	(1)	—	—	—	—	—	(1)
Change in unrealized	316	13	—	(136)	(68)	(3)	122
Three months ended March 31, 2013							
Realized before impairments	\$ 19	\$ 38	\$ 1	\$ (1)	\$ (20)	\$ (1)	\$ 36
Realized — impairments	—	—	—	—	—	—	—
Change in unrealized	(15)	67	—	14	(23)	(1)	42

(a) Primarily adjustments to deferred policy acquisition costs and reserves related to annuities and long-term care business.

Gross realized gains and losses (excluding impairment writedowns and mark-to-market of derivatives) on available for sale fixed maturity and equity security investment transactions included in the Statement of Cash Flows consisted of the following (in millions):

	Three months ended March 31,	
	2014	2013
Fixed maturities:		
Gross gains	\$ 11	\$ 17
Gross losses	(1)	—
Equity securities:		
Gross gains	8	37
Gross losses	—	—

F. Derivatives

As discussed under “*Derivatives*” in Note A — “*Accounting Policies*” to the financial statements, AFG uses derivatives in certain areas of its operations. AFG’s derivatives do not qualify for hedge accounting under GAAP; changes in the fair value of derivatives are included in earnings.

The following derivatives are included in AFG’s Balance Sheet at fair value (in millions):

Derivative	Balance Sheet Line	March 31, 2014		December 31, 2013	
		Asset	Liability	Asset	Liability
MBS with embedded derivatives	Fixed maturities	\$ 162	\$ —	\$ 140	\$ —
Public company warrants	Equity securities	17	—	19	—
Interest rate swaptions	Other investments	1	—	2	—
Fixed-indexed annuities (embedded derivative)	Annuity benefits accumulated	—	904	—	804
Equity index call options	Other investments	287	—	272	—
Reinsurance contracts (embedded derivative)	Other liabilities	—	12	—	10
		<u>\$ 467</u>	<u>\$ 916</u>	<u>\$ 433</u>	<u>\$ 814</u>

The MBS with embedded derivatives consist primarily of interest-only MBS with interest rates that float inversely with short-term rates. AFG records the entire change in the fair value of these securities in earnings. These investments are part of AFG’s overall investment strategy and represent a small component of AFG’s overall investment portfolio.

Warrants to purchase shares of publicly traded companies, which represent a small component of AFG’s overall investment portfolio, are considered to be derivatives that must be marked to market through earnings.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — CONTINUED

AFG has \$200 million notional amount of pay-fixed interest rate swaptions (options to enter into pay-fixed/receive floating interest rate swaps at future dates expiring in 2015) outstanding at March 31, 2014, which are used to mitigate interest rate risk in its annuity operations. AFG paid \$4 million to purchase these swaptions, which represents its maximum potential economic loss over the life of the contracts.

AFG's fixed-indexed annuities, which represented approximately one-half of annuity benefits accumulated at March 31, 2014, provide policyholders with a crediting rate tied, in part, to the performance of an existing stock market index. AFG attempts to mitigate the risk in the index-based component of these products through the purchase of call options on the appropriate index. AFG receives collateral from its counterparties to support its purchased call option assets. This collateral (\$249 million at March 31, 2014) is included in other assets in AFG's Balance Sheet with an offsetting liability to return the collateral, which is included in other liabilities. AFG's strategy is designed so that an increase in the liabilities, due to an increase in the market index, will be generally offset by unrealized and realized gains on the call options purchased by AFG. Both the index-based component of the annuities and the related call options are considered derivatives. Fluctuations in interest rates and the stock market, among other factors, can cause volatility in the periodic measurement of fair value of the embedded derivative that management believes can be inconsistent with the long-term economics of these products.

As discussed under "Reinsurance" in Note A to the financial statements, certain reinsurance contracts are considered to contain embedded derivatives.

The following table summarizes the gain (loss) included in the Statement of Earnings for changes in the fair value of these derivatives for the first three months of 2014 and 2013 (in millions):

Derivative	Statement of Earnings Line	Three months ended March 31,	
		2014	2013
MBS with embedded derivatives	Realized gains on securities	\$ 3	\$ 2
Public company warrants	Realized gains on securities	(2)	2
Interest rate swaptions	Realized gains on securities	(1)	—
Fixed-indexed annuities (embedded derivative)	Annuity benefits	(54)	(80)
Equity index call options	Annuity benefits	30	77
Reinsurance contracts (embedded derivative)	Net investment income	(2)	1
		<u>\$ (26)</u>	<u>\$ 2</u>

G. Deferred Policy Acquisition Costs

A progression of deferred policy acquisition costs is presented below (in millions):

	P&C Deferred Costs	Annuity and Run-off Long-term Care and Life					Consolidated Total
		Deferred Costs	Sales Inducements	PVFP	Unrealized	Total	
Balance at December 31, 2013	\$ 211	\$ 875	\$ 149	\$ 85	\$ (345)	\$ 764	\$ 975
Additions	124	50	4	—	—	54	178
Periodic amortization	(121)	(27)	(7)	(3)	—	(37)	(158)
Change in unrealized	—	—	—	—	(105)	(105)	(105)
Balance at March 31, 2014	<u>\$ 214</u>	<u>\$ 898</u>	<u>\$ 146</u>	<u>\$ 82</u>	<u>\$ (450)</u>	<u>\$ 676</u>	<u>\$ 890</u>
Balance at December 31, 2012	\$ 204	\$ 787	\$ 170	\$ 99	\$ (710)	\$ 346	\$ 550
Additions	119	34	2	—	—	36	155
Amortization:							
Periodic amortization	(120)	(27)	(7)	(4)	—	(38)	(158)
Included in realized gains	—	(1)	—	—	—	(1)	(1)
Change in unrealized	—	—	—	—	19	19	19
Balance at March 31, 2013	<u>\$ 203</u>	<u>\$ 793</u>	<u>\$ 165</u>	<u>\$ 95</u>	<u>\$ (691)</u>	<u>\$ 362</u>	<u>\$ 565</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — CONTINUED

The present value of future profits (“PVFP”) amounts in the table above are net of \$201 million and \$198 million of accumulated amortization at March 31, 2014 and December 31, 2013, respectively.

H. Managed Investment Entities

AFG is the investment manager and its subsidiaries have investments ranging from 7.5% to 51.2% of the most subordinate debt tranche of eleven collateralized loan obligation entities or “CLOs,” which are considered variable interest entities. AFG’s subsidiaries also own portions of the senior debt tranches of certain of these CLOs. Upon formation between 2004 and 2013, these entities issued securities in various senior and subordinate classes and invested the proceeds primarily in secured bank loans, which serve as collateral for the debt securities issued by each particular CLO. None of the collateral was purchased from AFG. AFG’s investments in the subordinate debt tranches of these entities receive residual income from the CLOs only after the CLOs pay expenses (including management fees to AFG), and interest on and returns of capital to senior levels of debt securities. There are no contractual requirements for AFG to provide additional funding for these entities. AFG has not provided and does not intend to provide any financial support to these entities.

AFG’s maximum exposure to economic loss on its CLOs is limited to its investment in the CLOs, which had an aggregate fair value of \$260 million (including \$101 million invested in the most subordinate debt tranches) at March 31, 2014, and \$271 million at December 31, 2013.

During the first three months of 2014 and 2013, AFG subsidiaries purchased \$3 million and \$70 million face amount of senior debt tranches of existing CLOs for \$3 million and \$67 million, respectively. During these periods, AFG subsidiaries also received redemption proceeds of \$29 million and \$18 million, respectively, from its CLO investments.

The revenues and expenses of the CLOs are separately identified in AFG’s Statement of Earnings, after the elimination of management fees and earnings attributable to shareholders of AFG as measured by the change in the fair value of AFG’s investments in the CLOs. Selected financial information related to the CLOs is shown below (in millions):

	Three months ended March 31,	
	2014	2013
Gains (losses) on change in fair value of assets/liabilities (a):		
Assets	\$ (1)	\$ 17
Liabilities	1	(25)
Management fees paid to AFG	3	4
CLO earnings (losses) attributable to (b):		
AFG shareholders	5	11
Noncontrolling interests	—	(11)

(a) Included in Revenues in AFG’s Statement of Earnings.

(b) Included in Earnings before income taxes in AFG’s Statement of Earnings.

The aggregate unpaid principal balance of the CLOs’ fixed maturity investments exceeded the fair value of the investments by \$14 million and \$15 million at March 31, 2014 and December 31, 2013. The aggregate unpaid principal balance of the CLOs’ debt exceeded its fair value by \$109 million at both of those dates. The CLO assets include \$2 million and \$1 million in loans at March 31, 2014 and December 31, 2013, respectively, for which the CLOs are not accruing interest because the loans are in default (aggregate unpaid principal balance of \$6 million at both of those dates).

I. Goodwill and Other Intangibles

There were no changes in the goodwill balance of \$185 million during the first three months of 2014. Included in other assets in AFG’s Balance Sheet is \$19 million at March 31, 2014 and \$14 million at December 31, 2013 in amortizable intangible assets related to property and casualty insurance acquisitions. Both of these amounts are net of accumulated amortization of \$75 million. The increase in amortizable intangible assets in the first three months of 2014 reflects a renewal rights intangible asset established in connection with the acquisition of a small property and casualty book of business in the first quarter of 2014. Amortization of these intangibles was \$3 million and \$4 million in the first three months of 2014 and 2013, respectively. Other assets also include \$8 million in non-amortizable intangible assets related to property and casualty insurance acquisitions.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — CONTINUED

J. Long-Term Debt

The carrying value of long-term debt consisted of the following (in millions):

	March 31, 2014	December 31, 2013
Direct obligations of AFG:		
9-7/8% Senior Notes due June 2019	\$ 350	\$ 350
6-3/8% Senior Notes due June 2042	230	230
5-3/4% Senior Notes due August 2042	125	125
7% Senior Notes due September 2050	132	132
Other	3	3
	<u>840</u>	<u>840</u>
Subsidiaries:		
Notes payable secured by real estate due 2014 through 2016	61	61
National Interstate bank credit facility	12	12
	<u>73</u>	<u>73</u>
	<u>\$ 913</u>	<u>\$ 913</u>

Scheduled principal payments on debt for the balance of 2014 and the subsequent five years were as follows: 2014 — \$2 million; 2015 — \$14 million; 2016 — \$45 million; 2017 — \$12 million; 2018 — none and 2019 — \$350 million.

As shown below (in millions), the majority of AFG's long-term debt is unsecured obligations of the holding company and its subsidiaries:

	March 31, 2014	December 31, 2013
Unsecured obligations	\$ 852	\$ 852
Obligations secured by real estate	61	61
	<u>\$ 913</u>	<u>\$ 913</u>

AFG can borrow up to \$500 million under its revolving credit facility which expires in December 2016. Amounts borrowed under this agreement bear interest at rates ranging from 1.00% to 1.875% (currently 1.375%) over LIBOR based on AFG's credit rating. No amounts were borrowed under this facility at March 31, 2014 or December 31, 2013.

National Interstate can borrow up to \$100 million under its unsecured credit agreement, which expires in November 2017. At March 31, 2014, there was \$12 million outstanding under this agreement, bearing interest at 1.07% (two-month LIBOR plus 0.875%).

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — CONTINUED

K. Shareholders' Equity

AFG is authorized to issue 12.5 million shares of Voting Preferred Stock and 12.5 million shares of Nonvoting Preferred Stock, each without par value.

Accumulated Other Comprehensive Income, Net of Tax ("AOCI") Comprehensive income is defined as all changes in Shareholders' Equity except those arising from transactions with shareholders. Comprehensive income includes net earnings and other comprehensive income, which consists primarily of changes in net unrealized gains or losses on available for sale securities. The progression of the components of accumulated other comprehensive income follows (in millions):

	AOCI Beginning Balance	Other Comprehensive Income					AOCI Ending Balance
		Pretax	Tax	Net of tax	Attributable to noncontrolling interests	Attributable to shareholders	
Three months ended March 31, 2014							
Net unrealized gains on securities:							
Unrealized holding gains (losses) on securities arising during the period		\$ 211	\$ (74)	\$ 137	\$ (3)	\$ 134	
Reclassification adjustment for realized gains (losses) included in net earnings (a)		(18)	6	(12)	—	(12)	
Total net unrealized gains on securities (b)	\$ 563	193	(68)	125	(3)	122	\$ 685
Foreign currency translation adjustments	1	(5)	—	(5)	—	(5)	(4)
Pension and other postretirement plans adjustments	(4)	—	—	—	—	—	(4)
Total	\$ 560	\$ 188	\$ (68)	\$ 120	\$ (3)	\$ 117	\$ 677
Three months ended March 31, 2013							
Net unrealized gains on securities:							
Unrealized holding gains (losses) on securities arising during the period		\$ 122	\$ (43)	\$ 79	\$ (1)	\$ 78	
Reclassification adjustment for realized gains (losses) included in net earnings (a)		(56)	20	(36)	—	(36)	
Total net unrealized gains on securities	\$ 823	66	(23)	43	(1)	42	\$ 865
Foreign currency translation adjustments	14	(4)	—	(4)	—	(4)	10
Pension and other postretirement plans adjustments	(6)	—	—	—	—	—	(6)
Total	\$ 831	\$ 62	\$ (23)	\$ 39	\$ (1)	\$ 38	\$ 869

(a) The reclassification adjustment out of net unrealized gains on securities affected the following lines in AFG's Consolidated Statement of Earnings:

OCI component	Affected line in the Consolidated Statement of Earnings
Pretax	Realized gains on securities
Tax	Provision for income taxes
Attributable to noncontrolling interests	Net earnings (loss) attributable to noncontrolling interests

(b) Includes net unrealized gains of \$58 million at March 31, 2014 compared to \$54 million at December 31, 2013 related to securities for which only the credit portion of an other-than-temporary impairment has been recorded in earnings.

Stock Incentive Plans Under AFG's stock incentive plans, employees of AFG and its subsidiaries are eligible to receive equity awards in the form of stock options, stock appreciation rights, restricted stock awards, restricted stock units and stock awards. In the first three months of 2014, AFG issued 102,330 shares of restricted Common Stock (fair value of \$56.44 per share) and granted stock options for 1.0 million shares of Common Stock (at an average exercise price of \$56.44) under the Stock Incentive Plan. In addition, AFG issued 84,036 shares of Common Stock (fair value of \$57.16 per share) in the first quarter of 2014 under the Equity Bonus Plan.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — CONTINUED

AFG uses the Black-Scholes option pricing model to calculate the fair value of its option grants. The expected dividend yield is based on AFG's current dividend rate. To determine expected volatility, AFG considers its daily historical volatility as well as implied volatility on traded options. The expected term was estimated based on historical exercise patterns and post vesting cancellations. The risk-free rate for periods associated with the expected term is based upon the U.S. Treasury yield curve in effect on the grant date.

	Three months ended March 31,	
	2014	2013
Exercise price	\$ 56.44	\$ 44.01
Expected dividend yield	1.6%	1.8%
Expected volatility	26%	39%
Expected term (in years)	7.25	7.25
Risk-free rate	2.20%	1.36%
Grant date fair value	\$ 14.65	\$ 15.10

Total compensation expense related to stock incentive plans of AFG and its subsidiaries was \$7 million and \$13 million, respectively, in the first three months of 2014 and 2013.

L. Income Taxes

The following is a reconciliation of income taxes at the statutory rate of 35% to the provision for income taxes as shown in the Statement of Earnings (in millions):

	Three months ended March 31,			
	2014		2013	
	Amount	% of EBT	Amount	% of EBT
Earnings before income taxes ("EBT")	\$ 161		\$ 175	
Income taxes at statutory rate	\$ 56	35%	\$ 61	35%
Effect of:				
Tax exempt interest	(5)	(3%)	(5)	(3%)
Losses of managed investment entities	—	—%	4	2%
Subsidiaries not in AFG's tax return	1	1%	1	—%
Other	2	1%	1	1%
Provision for income taxes as shown in the Statement of Earnings	\$ 54	34%	\$ 62	35%

During the first three months of 2014, there were no material changes to AFG's liability for uncertain tax positions, which relate to the timing of investment income and the deductibility of certain financing expenses. As discussed in *Note L — "Income Taxes,"* in AFG's 2013 Form 10-K, AFG believes it is reasonably possible that its liability for uncertain tax positions may be reduced by up to \$19 million due to a settlement with the IRS that is expected to become final in 2014. The majority of the reduction in this liability would result in offsetting adjustments to AFG's deferred tax liability. Accordingly, the resolution of these items will not have a material impact on AFG's effective tax rate.

M. Contingencies

There have been no significant changes to the matters discussed and referred to in *Note M — "Contingencies"* of AFG's 2013 Form 10-K, which covers property and casualty insurance reserves for claims related to environmental exposures, asbestos and other mass tort claims, as well as environmental and occupational injury and disease claims of former subsidiary railroad and manufacturing operations.

Management's Discussion and Analysis of Financial Condition and Results of Operations**INDEX TO MD&A**

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FORWARD-LOOKING STATEMENTS

The Private Securities Litigation Reform Act of 1995 provides a safe harbor for forward-looking statements. Some of the forward-looking statements can be identified by the use of words such as “anticipates”, “believes”, “expects”, “projects”, “estimates”, “intends”, “plans”, “seeks”, “could”, “may”, “should”, “will” or the negative version of those words or other comparable terminology. Such forward-looking statements include statements relating to: expectations concerning market and other conditions and their effect on future premiums, revenues, earnings and investment activities; recoverability of asset values; expected losses and the adequacy of reserves for long-term care, asbestos, environmental pollution and mass tort claims; rate changes; and improved loss experience.

Actual results and/or financial condition could differ materially from those contained in or implied by such forward-looking statements for a variety of reasons including but not limited to:

- changes in financial, political and economic conditions, including changes in interest and inflation rates, currency fluctuations and extended economic recessions or expansions in the U.S. and/or abroad;
- performance of securities markets;
- AFG's ability to estimate accurately the likelihood, magnitude and timing of any losses in connection with investments in the non-agency residential mortgage market;
- new legislation or declines in credit quality or credit ratings that could have a material impact on the valuation of securities in AFG's investment portfolio;
- the availability of capital;
- regulatory actions (including changes in statutory accounting rules);
- changes in the legal environment affecting AFG or its customers;
- tax law and accounting changes;
- levels of natural catastrophes and severe weather, terrorist activities (including any nuclear, biological, chemical or radiological events), incidents of war or losses resulting from civil unrest and other major losses;
- development of insurance loss reserves and establishment of other reserves, particularly with respect to amounts associated with asbestos and environmental claims and AFG's run-off long-term care business;
- availability of reinsurance and ability of reinsurers to pay their obligations;
- trends in persistency, mortality and morbidity;
- competitive pressures, including those in the annuity distribution channels;
- the ability to obtain adequate rates and policy terms; and
- changes in AFG's credit ratings or the financial strength ratings assigned by major ratings agencies to AFG's operating subsidiaries.

The forward-looking statements herein are made only as of the date of this report. The Company assumes no obligation to publicly update any forward-looking statements.

Management's Discussion and Analysis of Financial Condition and Results of Operations — Continued**OVERVIEW****Financial Condition**

AFG is organized as a holding company with almost all of its operations being conducted by subsidiaries. AFG, however, has continuing cash needs for administrative expenses, the payment of principal and interest on borrowings, shareholder dividends, and taxes. Therefore, certain analyses are most meaningfully presented on a parent only basis while others are best done on a total enterprise basis. In addition, because most of its businesses are financial in nature, AFG does not prepare its consolidated financial statements using a current-noncurrent format. Consequently, certain traditional ratios and financial analysis tests are not meaningful.

Results of Operations

Through the operations of its subsidiaries, AFG is engaged primarily in property and casualty insurance, focusing on specialized commercial products for businesses and in the sale of fixed and fixed-indexed annuities in the retail, financial institutions and education markets.

Net earnings attributable to AFG's shareholders for the first three months of 2014 were \$103 million (\$1.13 per share, diluted) compared to \$120 million (\$1.32 per share, diluted) for the comparable 2013 period. Higher underwriting profits in the property and casualty insurance segment were more than offset by lower realized gains on securities and slightly lower earnings in the annuity segment.

CRITICAL ACCOUNTING POLICIES

Significant accounting policies are summarized in *Note A — "Accounting Policies"* to the financial statements. The preparation of financial statements in conformity with U.S. generally accepted accounting principles ("GAAP") requires management to make estimates and assumptions that can have a significant effect on amounts reported in the financial statements. As more information becomes known, these estimates and assumptions change and, thus, impact amounts reported in the future. The areas where management believes the degree of judgment required to determine amounts recorded in the financial statements make accounting policies critical are as follows:

- the establishment of insurance reserves, especially asbestos and environmental-related reserves and reserves for AFG's closed block of long-term care insurance,
- the recoverability of reinsurance,
- the recoverability of deferred acquisition costs,
- the establishment of asbestos and environmental reserves of former railroad and manufacturing operations, and
- the valuation of investments, including the determination of "other-than-temporary" impairments.

For a discussion of these policies, see *Management's Discussion and Analysis — "Critical Accounting Policies"* in AFG's 2013 Form 10-K.

LIQUIDITY AND CAPITAL RESOURCES

Ratios AFG's debt to total capital ratio on a consolidated basis is shown below (dollars in millions):

	March 31, 2014	December 31,	
		2013	2012
Long-term debt	\$ 913	\$ 913	\$ 953
Total capital	5,281	5,192	4,907
Ratio of debt to total capital:			
Including debt secured by real estate	17.3%	17.6%	19.4%
Excluding debt secured by real estate	16.3%	16.6%	18.4%

The ratio of debt to total capital is a non-GAAP measure that management believes is useful for investors, analysts and independent ratings agencies to evaluate AFG's financial strength and liquidity and to provide insight into how AFG finances

Management's Discussion and Analysis of Financial Condition and Results of Operations — Continued

its operations. The ratio is calculated by dividing AFG's long-term debt by its total capital, which includes long-term debt, noncontrolling interests and shareholders' equity (excluding unrealized gains (losses) related to fixed maturity investments and appropriated retained earnings related to managed investment entities).

AFG's ratio of earnings to fixed charges, including annuity benefits as a fixed charge, was 1.81 for the three months ended March 31, 2014 and 2.15 for the year ended December 31, 2013. Excluding annuity benefits, this ratio was 7.74 and 8.86, respectively. Although the ratio excluding annuity benefits is not required or encouraged to be disclosed under Securities and Exchange Commission rules, it is presented because interest credited to annuity policyholder accounts is not always considered a borrowing cost for an insurance company.

Condensed Consolidated Cash Flows AFG's principal sources of cash include insurance premiums, income from its investment portfolio and proceeds from the maturities, redemptions and sales of investments. Insurance premiums in excess of acquisition expenses and operating costs are invested until they are needed to meet policyholder obligations or made available to the parent company through dividends to cover debt obligations and corporate expenses, and to provide returns to shareholders through share repurchases and dividends. AFG's cash flows from operating, investing and financing activities as detailed in its Consolidated Statement of Cash Flows are shown below (in millions):

	Three months ended March 31,	
	2014	2013
Net cash provided by operating activities	\$ 204	\$ 59
Net cash used in investing activities	(426)	(470)
Net cash provided by financing activities	459	235
Net change in cash and cash equivalents	\$ 237	\$ (176)

Net Cash Provided by Operating Activities AFG's property and casualty insurance operations typically produce positive net operating cash flows as premiums collected and investment income exceed policy acquisition costs, claims payments and operating expenses. AFG's net cash provided by operating activities is impacted by the level and timing of property and casualty premiums, claim and expense payments and recoveries from reinsurers. AFG's annuity operations typically produce positive net operating cash flows as investment income exceeds acquisition costs and operating expenses. Interest credited on annuity policyholder funds is a non-cash increase in AFG's annuity benefits accumulated liability and annuity premiums, benefits and withdrawals are considered financing activities due to the deposit-type nature of annuities. Net cash provided by operating activities was \$204 million for the first three months of 2014 compared to \$59 million in the first three months of 2013, an increase of \$145 million. The \$145 million increase in net cash provided by operating activities is due primarily to the timing of claims payments and reinsurance recoveries in the property and casualty insurance operations.

Net Cash Used in Investing Activities AFG's investing activities consist primarily of the investment of funds provided by its property and casualty and annuity products. Net cash used in investing activities was \$426 million for the first three months of 2014 compared to \$470 million in the first three months of 2013, a decrease of \$44 million. The \$323 million increase in net cash flows from annuity policyholders in the first three months of 2014 as compared to the 2013 period (discussed below under net cash provided by financing activities) increased the amount of cash available for investment in the first three months of 2014 compared to the 2013 period. However, cash on hand in the annuity and run-off long-term care and life segments increased by \$243 million during the first three months of 2014 as net cash flows from annuity policyholders outpaced the investment of the funds received. The change in net cash used in investing activities also reflects the impact of investing the property and casualty segment's cash flows from operating activities, which were higher in the first three months of 2014 as compared to the 2013 period. Investing activities also include the purchase and disposal of managed investment entity investments (collateralized loan obligations), which are presented separately in AFG's Balance Sheet. Net investment activity in the managed investment entities was a \$198 million source of cash in the first three months of 2014 compared to a \$138 million source of cash in the 2013 period. See *Note A — "Accounting Policies — Managed Investment Entities"* and *Note H — "Managed Investment Entities"* to the financial statements.

Net Cash Provided by Financing Activities AFG's financing activities consist primarily of transactions with annuity policyholders, issuances and retirements of long-term debt, repurchases of common stock and dividend payments. Net cash provided by financing activities was \$459 million for the first three months of 2014 compared to \$235 million in the first three months of 2013, an increase of \$224 million. Annuity receipts exceeded annuity surrenders, benefits, withdrawals and transfers by \$578 million in the first three months of 2014 compared to \$255 million in the first three months of 2013, resulting in a

Management's Discussion and Analysis of Financial Condition and Results of Operations — Continued

\$323 million increase in net cash provided by financing activities in the 2014 period compared to the 2013 period. During the first three months of 2014, AFG repurchased \$24 million of its Common Stock compared to \$3 million repurchased in the first three months of 2013, which accounted for a \$21 million decrease in net cash provided by financing activities in the 2014 period compared to the 2013 period. Financing activities also include the issuance and retirement of managed investment entity liabilities, which are nonrecourse to AFG and presented separately in AFG's Balance Sheet. The retirement of managed investment entity liabilities exceed issuances by \$88 million in the first three months of 2014 compared to \$18 million in the first three months of 2013, representing a \$70 million decrease in net cash provided by financing activities in the 2014 period compared to the 2013 period. See *Managed Investment Entities* in Note A — "Accounting Policies" and Note H — "Managed Investment Entities" to the financial statements.

Parent and Subsidiary Liquidity

Parent Holding Company Liquidity Management believes AFG has sufficient resources to meet its liquidity requirements. If funds generated from operations, including dividends, tax payments and borrowings from subsidiaries, are insufficient to meet fixed charges in any period, AFG would be required to utilize parent company cash and marketable securities or to generate cash through borrowings, sales of other assets, or similar transactions.

AFG can borrow up to \$500 million under its revolving credit facility which expires in December 2016. Amounts borrowed under this agreement bear interest at rates ranging from 1.00% to 1.875% (currently 1.375%) over LIBOR based on AFG's credit rating. There were no borrowings under the agreement, or under any other parent company short-term borrowing arrangements, during 2013 or the first three months of 2014.

In April 2014, AFG completed the previously announced purchase of Summit Holding Southeast, Inc. and its related companies ("Summit") from Liberty Mutual Insurance using cash on hand at the parent company. AFG paid Liberty Mutual Insurance approximately \$260 million at closing. In addition, AFG made a capital contribution of approximately \$140 million, bringing its capital investment in the Summit business to approximately \$400 million, pending post-closing adjustments. Summit's results of operations will be included in AFG's consolidated results commencing with the beginning of the 2014 second quarter.

During the first three months of 2014, AFG repurchased 419,938 shares of its Common Stock for \$24 million. In April 2014, AFG repurchased 151,266 additional shares of its Common Stock for \$8 million. During 2013, AFG repurchased 1.4 million shares of its Common Stock for \$70 million.

Under tax allocation agreements with AFG, its 80%-owned U.S. subsidiaries generally pay taxes to (or recover taxes from) AFG based on each subsidiary's contribution to amounts due under AFG's consolidated tax return.

Subsidiary Liquidity Great American Life Insurance Company ("GALIC"), a wholly-owned annuity subsidiary, is a member of the Federal Home Loan Bank of Cincinnati ("FHLB"). The FHLB makes advances and provides other banking services to member institutions, which provides the annuity operations with a substantial additional source of liquidity. These advances further the FHLB's mission of improving access to housing by increasing liquidity in the residential mortgage-backed securities market. At March 31, 2014, GALIC had \$440 million in outstanding advances from the FHLB (included in annuity benefits accumulated), bearing interest at rates ranging from 0.02% to 0.23% over LIBOR (average rate of 0.31% at March 31, 2014). While these advances must be repaid between 2016 and 2018, GALIC has the option to prepay all or a portion of the advances. GALIC has invested the proceeds from the advances in fixed maturity securities for the purpose of earning a spread over the interest payments due to the FHLB.

National Interstate Corporation, a 51%-owned property and casualty insurance subsidiary, can borrow up to \$100 million under its unsecured credit agreement, which expires in November 2017. There was \$12 million borrowed under this agreement at March 31, 2014, bearing interest at 1.07% (two-month LIBOR plus 0.875%).

The liquidity requirements of AFG's insurance subsidiaries relate primarily to the liabilities associated with their products as well as operating costs and expenses, payments of dividends and taxes to AFG and contributions of capital to their subsidiaries. Historically, cash flows from premiums and investment income have generally provided more than sufficient funds to meet these requirements. Funds received in excess of cash requirements are generally invested in additional marketable securities. In addition, the insurance subsidiaries generally hold a significant amount of highly liquid, short-term investments.

The excess cash flow of AFG's property and casualty group allows it to extend the duration of its investment portfolio somewhat beyond that of its claim reserves.

Management's Discussion and Analysis of Financial Condition and Results of Operations — Continued

In the annuity business, where profitability is largely dependent on earning a “spread” between invested assets and annuity liabilities, the duration of investments is generally maintained close to that of liabilities. In a rising interest rate environment, significant protection from withdrawals exists in the form of temporary and permanent surrender charges on AFG’s annuity products. With declining rates, AFG receives some protection (from spread compression) due to the ability to lower crediting rates, subject to contractually guaranteed minimum interest rates (“GMIRs”). AFG began selling policies with GMIRs below 2% in 2003; almost all new business since late 2010 has been issued with a 1% GMIR. At March 31, 2014, AFG could reduce the average crediting rate of its \$16 billion of traditional fixed and fixed-indexed deferred annuities without guaranteed withdrawal benefits by approximately 51 basis points (on a weighted average basis).

AFG believes its insurance subsidiaries maintain sufficient liquidity to pay claims and benefits and operating expenses. In addition, these subsidiaries have sufficient capital to meet commitments in the event of unforeseen events such as reserve deficiencies, inadequate premium rates or reinsurer insolvencies. Nonetheless, changes in statutory accounting rules, significant declines in the fair value of the insurance subsidiaries’ investment portfolios or significant ratings downgrades on these investments, could create a need for additional capital.

Supplemental Catastrophe Reinsurance On March 31, 2014, AFG’s property and casualty insurance operations entered into a reinsurance agreement to obtain additional catastrophe protection through a catastrophe bond structure with Riverfront Re Ltd. (“Riverfront”). The reinsurance agreement provides supplemental reinsurance coverage up to \$95 million (fully collateralized) for catastrophe losses in excess of \$100 million occurring during the period from April 1, 2014 through December 31, 2016. In connection with the reinsurance agreement, Riverfront issued notes to unrelated investors for the full \$95 million of coverage provided under the reinsurance agreement. At the time of the agreement, AFG concluded that Riverfront is a variable interest entity, but that it does not have a variable interest in the entity because the variability in Riverfront’s results is expected to be absorbed entirely by the investors in Riverfront. Accordingly, Riverfront is not consolidated in AFG’s financial statements and the reinsurance agreement is accounted for as ceded reinsurance. AFG’s cost for this coverage will be approximately \$5 million per year.

Investments AFG’s investment portfolio at March 31, 2014, contained \$27.39 billion in fixed maturity securities classified as available for sale and \$1.30 billion in equity securities, all carried at fair value with unrealized gains and losses included in a separate component of shareholders’ equity on an after-tax basis. In addition, \$297 million in fixed maturities were classified as trading with changes in unrealized holding gains or losses included in net investment income.

Fair values for AFG’s portfolio are determined by AFG’s internal investment professionals using data from nationally recognized pricing services as well as non-binding broker quotes. Fair values of equity securities are generally based on closing prices obtained from the pricing services. For mortgage-backed securities (“MBS”), which comprise approximately 26% of AFG’s fixed maturities, prices for each security are generally obtained from both pricing services and broker quotes. For the remainder of AFG’s fixed maturity portfolio, approximately 85% are priced using pricing services and the balance is priced primarily by using non-binding broker quotes. When prices obtained for the same security vary, AFG’s internal investment professionals select the price they believe is most indicative of an exit price.

The pricing services use a variety of observable inputs to estimate fair value of fixed maturities that do not trade on a daily basis. Based upon information provided by the pricing services, these inputs include, but are not limited to, recent reported trades, benchmark yields, issuer spreads, bids or offers, reference data, and measures of volatility. Included in the pricing of MBS are estimates of the rate of future prepayments and defaults of principal over the remaining life of the underlying collateral. Due to the lack of transparency in the process that brokers use to develop prices, valuations that are based on brokers’ prices are classified as Level 3 in the GAAP hierarchy unless the price can be corroborated, for example, by comparison to similar securities priced using observable inputs.

Valuation techniques utilized by pricing services and prices obtained from external sources are reviewed by AFG’s internal investment professionals who are familiar with the securities being priced and the markets in which they trade to ensure the fair value determination is representative of an exit price. To validate the appropriateness of the prices obtained, these investment managers consider widely published indices (as benchmarks), recent trades, changes in interest rates, general economic conditions and the credit quality of the specific issuers. In addition, AFG communicates directly with pricing services regarding the methods and assumptions used in pricing, including verifying, on a test basis, the inputs used by the services to value specific securities.

Management's Discussion and Analysis of Financial Condition and Results of Operations — Continued

In general, the fair value of AFG's fixed maturity investments is inversely correlated to changes in interest rates. The following table demonstrates the sensitivity of such fair values to reasonably likely changes in interest rates by illustrating the estimated effect on AFG's fixed maturity portfolio that an immediate increase of 100 basis points in the interest rate yield curve would have at March 31, 2014 (dollars in millions). Effects of increases or decreases from the 100 basis points illustrated would be approximately proportional.

Fair value of fixed maturity portfolio	\$	27,687
Pretax impact on fair value of 100 bps increase in interest rates	\$	(1,246)
Pretax impact as % of total fixed maturity portfolio		(4.5%)

Approximately 86% of the fixed maturities held by AFG at March 31, 2014, were rated "investment grade" (credit rating of AAA to BBB) by nationally recognized rating agencies. Investment grade securities generally bear lower yields and lower degrees of risk than those that are unrated and non-investment grade. Management believes that the high quality investment portfolio should generate a stable and predictable investment return.

MBS are subject to significant prepayment risk due to the fact that, in periods of declining interest rates, mortgages may be repaid more rapidly than scheduled as borrowers refinance higher rate mortgages to take advantage of lower rates. Although interest rates have been low for the last few years, tighter lending standards have resulted in fewer buyers being able to refinance the mortgages underlying much of AFG's non-agency residential MBS portfolio.

Summarized information for AFG's MBS (including those classified as trading) at March 31, 2014, is shown (dollars in millions) in the table below. Agency-backed securities are those issued by a U.S. government-backed agency; Alt-A mortgages are those with risk profiles between prime and subprime. The majority of the Alt-A securities and substantially all of the subprime securities are backed by fixed-rate mortgages. The average life of the residential and commercial MBS is approximately 5 years and 4 years, respectively.

Collateral type	Amortized Cost	Fair Value	Fair Value as % of Cost	Unrealized Gain (Loss)	% Rated Investment Grade
Residential:					
Agency-backed	\$ 310	\$ 315	102%	\$ 5	100%
Non-agency prime	1,996	2,209	111%	213	44%
Alt-A	989	1,091	110%	102	22%
Subprime	908	976	107%	68	17%
Commercial	2,442	2,626	108%	184	100%
	<u>\$ 6,645</u>	<u>\$ 7,217</u>	109%	<u>\$ 572</u>	60%

The National Association of Insurance Commissioners ("NAIC") assigns creditworthiness designations on a scale of 1 to 6 with 1 being the highest quality and 6 being the lowest quality. The NAIC retains third-party investment management firms to assist in the determination of appropriate NAIC designations for mortgage-backed securities based not only on the probability of loss (which is the primary basis of ratings by the major ratings firms), but also on the severity of loss and statutory carrying value. At March 31, 2014, 97% (based on statutory carrying value of \$6.52 billion) of AFG's MBS securities had a NAIC designation of 1 or 2.

Municipal bonds represented approximately 21% of AFG's fixed maturity portfolio at March 31, 2014. AFG's municipal bond portfolio is high quality, with 99% of the securities rated investment grade at that date. The portfolio is well diversified across the states of issuance and individual issuers. At March 31, 2014, approximately 73% of the municipal bond portfolio was held in revenue bonds, with the remainder held in general obligation bonds. General obligation securities of California, Illinois, Michigan, New Jersey, New York and Puerto Rico collectively represented approximately 1% of this portfolio.

Management's Discussion and Analysis of Financial Condition and Results of Operations — Continued

Summarized information for the unrealized gains and losses recorded in AFG's Balance Sheet at March 31, 2014, is shown in the following table (dollars in millions). Approximately \$612 million of available for sale fixed maturity securities and \$87 million of equity securities had no unrealized gains or losses at March 31, 2014.

	Securities With Unrealized Gains	Securities With Unrealized Losses
Available for Sale Fixed Maturities		
Fair value of securities	\$ 21,632	\$ 5,146
Amortized cost of securities	\$ 20,063	\$ 5,309
Gross unrealized gain (loss)	\$ 1,569	\$ (163)
Fair value as % of amortized cost	108%	97%
Number of security positions	3,944	824
Number individually exceeding \$2 million gain or loss	128	1
Concentration of gains (losses) by type or industry (exceeding 5% of unrealized):		
States and municipalities	\$ 214	\$ (70)
Mortgage-backed securities	597	(25)
Banks, savings and credit institutions	125	(8)
Asset-backed securities	39	(16)
Gas and electric services	121	(2)
Percentage rated investment grade	85%	88%
Equity Securities		
Fair value of securities	\$ 948	\$ 262
Cost of securities	\$ 726	\$ 279
Gross unrealized gain (loss)	\$ 222	\$ (17)
Fair value as % of cost	131%	94%
Number of security positions	182	37
Number individually exceeding \$2 million gain or loss	38	1

The table below sets forth the scheduled maturities of AFG's available for sale fixed maturity securities at March 31, 2014, based on their fair values. Securities with sinking funds are reported at average maturity. Actual maturities may differ from contractual maturities because certain securities may be called or prepaid by the issuers.

	Securities With Unrealized Gains	Securities With Unrealized Losses
Maturity		
One year or less	4%	—%
After one year through five years	22%	6%
After five years through ten years	28%	31%
After ten years	11%	26%
	65%	63%
Asset-backed securities (average life of approximately 5 years)	6%	22%
Mortgage-backed securities (average life of approximately 4-1/2 years)	29%	15%
	100%	100%

Management's Discussion and Analysis of Financial Condition and Results of Operations — Continued

The table below (dollars in millions) summarizes the unrealized gains and losses on fixed maturity securities by dollar amount:

	Aggregate Fair Value	Aggregate Unrealized Gain (Loss)	Fair Value as % of Cost Basis
Fixed Maturities at March 31, 2014			
Securities with unrealized gains:			
Exceeding \$500,000 (959 securities)	\$ 10,913	\$ 1,120	111%
\$500,000 or less (2,985 securities)	10,719	449	104%
	<u>\$ 21,632</u>	<u>\$ 1,569</u>	108%
Securities with unrealized losses:			
Exceeding \$500,000 (80 securities)	\$ 1,133	\$ (75)	94%
\$500,000 or less (744 securities)	4,013	(88)	98%
	<u>\$ 5,146</u>	<u>\$ (163)</u>	97%

The following table summarizes (dollars in millions) the unrealized loss for all securities with unrealized losses by issuer quality and length of time those securities have been in an unrealized loss position:

	Aggregate Fair Value	Aggregate Unrealized Loss	Fair Value as % of Cost Basis
Securities with Unrealized Losses at March 31, 2014			
Investment grade fixed maturities with losses for:			
Less than one year (607 securities)	\$ 4,249	\$ (122)	97%
One year or longer (56 securities)	267	(13)	95%
	<u>\$ 4,516</u>	<u>\$ (135)</u>	97%
Non-investment grade fixed maturities with losses for:			
Less than one year (77 securities)	\$ 461	\$ (12)	97%
One year or longer (84 securities)	169	(16)	91%
	<u>\$ 630</u>	<u>\$ (28)</u>	96%
Common equity securities with losses for:			
Less than one year (21 securities)	\$ 166	\$ (12)	93%
One year or longer (none)	—	—	—%
	<u>\$ 166</u>	<u>\$ (12)</u>	93%
Perpetual preferred equity securities with losses for:			
Less than one year (15 securities)	\$ 90	\$ (4)	96%
One year or longer (1 security)	6	(1)	86%
	<u>\$ 96</u>	<u>\$ (5)</u>	95%

When a decline in the value of a specific investment is considered to be “other-than-temporary,” a provision for impairment is charged to earnings (accounted for as a realized loss) and the cost basis of that investment is reduced by the amount of the charge. The determination of whether unrealized losses are “other-than-temporary” requires judgment based on subjective as well as objective factors as detailed in AFG’s 2013 Form 10-K under *Management’s Discussion and Analysis — “Investments.”*

Based on its analysis, management believes AFG will recover its cost basis in the securities with unrealized losses and that AFG has the ability to hold the securities until they recover in value and had no intent to sell them at March 31, 2014. Although AFG has the ability to continue holding its investments with unrealized losses, its intent to hold them may change due to deterioration in the issuers’ creditworthiness, decisions to lessen exposure to a particular issuer or industry, asset/liability management decisions, market movements, changes in views about appropriate asset allocation or the desire to offset taxable realized gains. Should AFG’s ability or intent change with regard to a particular security, a charge for impairment would likely be required. While it is not possible to accurately predict if or when a specific security will become impaired, charges for other-than-temporary impairment could be material to results of operations in future periods. Significant declines in the fair value of AFG’s investment portfolio could have a significant adverse effect on AFG’s liquidity.

Management's Discussion and Analysis of Financial Condition and Results of Operations — Continued

Uncertainties Management believes that the areas posing the greatest risk of material loss are the adequacy of its insurance reserves and contingencies arising out of its former railroad and manufacturing operations. See *Management's Discussion and Analysis — "Uncertainties"* in AFG's 2013 Form 10-K.

MANAGED INVESTMENT ENTITIES

Accounting standards require AFG to consolidate its investments in collateralized loan obligation ("CLO") entities that it manages and owns an interest in (in the form of debt). See *Note A — "Accounting Policies — Managed Investment Entities"* and *Note H — "Managed Investment Entities"* to the financial statements. The effect of consolidating these entities is shown in the tables below (in millions). The "Before CLO Consolidation" columns include AFG's investment and earnings in the CLOs on an unconsolidated basis.

Management's Discussion and Analysis of Financial Condition and Results of Operations — Continued
CONDENSED CONSOLIDATING BALANCE SHEET

	Before CLO Consolidation	Managed Investment Entities	Consol. Entries		Consolidated As Reported
March 31, 2014					
Assets:					
Cash and investments	\$ 32,987	\$ —	\$ (260)	(a)	\$ 32,727
Assets of managed investment entities	—	2,723	—		2,723
Other assets	7,321	—	(1)	(a)	7,320
Total assets	<u>\$ 40,308</u>	<u>\$ 2,723</u>	<u>\$ (261)</u>		<u>\$ 42,770</u>
Liabilities:					
Unpaid losses and loss adjustment expenses and unearned premiums	\$ 7,922	\$ —	\$ —		\$ 7,922
Annuity, life, accident and health benefits and reserves	23,783	—	—		23,783
Liabilities of managed investment entities	—	2,659	(246)	(a)	2,413
Long-term debt and other liabilities	3,679	—	—		3,679
Total liabilities	<u>35,384</u>	<u>2,659</u>	<u>(246)</u>		<u>37,797</u>
Shareholders' equity:					
Common Stock and Capital surplus	1,228	15	(15)		1,228
Retained earnings:					
Appropriated — managed investment entities	—	49	—		49
Unappropriated	2,842	—	—		2,842
Accumulated other comprehensive income, net of tax	677	—	—		677
Total shareholders' equity	<u>4,747</u>	<u>64</u>	<u>(15)</u>		<u>4,796</u>
Noncontrolling interests					
	177	—	—		177
Total equity	<u>4,924</u>	<u>64</u>	<u>(15)</u>		<u>4,973</u>
Total liabilities and equity	<u>\$ 40,308</u>	<u>\$ 2,723</u>	<u>\$ (261)</u>		<u>\$ 42,770</u>
December 31, 2013					
Assets:					
Cash and investments	\$ 31,584	\$ —	\$ (271)	(a)	\$ 31,313
Assets of managed investment entities	—	2,888	—		2,888
Other assets	7,887	—	(1)	(a)	7,886
Total assets	<u>\$ 39,471</u>	<u>\$ 2,888</u>	<u>\$ (272)</u>		<u>\$ 42,087</u>
Liabilities:					
Unpaid losses and loss adjustment expenses and unearned premiums	\$ 8,167	\$ —	\$ —		\$ 8,167
Annuity, life, accident and health benefits and reserves	22,952	—	—		22,952
Liabilities of managed investment entities	—	2,839	(272)	(a)	2,567
Long-term debt and other liabilities	3,632	—	—		3,632
Total liabilities	<u>34,751</u>	<u>2,839</u>	<u>(272)</u>		<u>37,318</u>
Shareholders' equity:					
Common Stock and Capital surplus	1,213	—	—		1,213
Retained earnings:					
Appropriated — managed investment entities	—	49	—		49
Unappropriated	2,777	—	—		2,777
Accumulated other comprehensive income, net of tax	560	—	—		560
Total shareholders' equity	<u>4,550</u>	<u>49</u>	<u>—</u>		<u>4,599</u>
Noncontrolling interests					
	170	—	—		170
Total equity	<u>4,720</u>	<u>49</u>	<u>—</u>		<u>4,769</u>
Total liabilities and equity	<u>\$ 39,471</u>	<u>\$ 2,888</u>	<u>\$ (272)</u>		<u>\$ 42,087</u>

(a) Elimination of the fair value of AFG's investment in CLOs and related accrued interest.

Management's Discussion and Analysis of Financial Condition and Results of Operations — Continued
CONDENSED CONSOLIDATING STATEMENT OF EARNINGS

	Before CLO Consolidation (a)	Managed Investment Entities	Consol. Entries	Consolidated As Reported
Three months ended March 31, 2014				
Revenues:				
Insurance net earned premiums	\$ 782	\$ —	\$ —	\$ 782
Net investment income	366	—	(5) (b)	361
Realized gains on securities	19	—	—	19
Income (loss) of managed investment entities:				
Investment income	—	28	—	28
Gain (loss) on change in fair value of assets/liabilities	—	1	(1) (b)	—
Other income	24	—	(3) (c)	21
Total revenues	1,191	29	(9)	1,211
Costs and Expenses:				
Insurance benefits and expenses	942	—	—	942
Expenses of managed investment entities	—	29	(9) (b)(c)	20
Interest charges on borrowed money and other expenses	88	—	—	88
Total costs and expenses	1,030	29	(9)	1,050
Earnings before income taxes	161	—	—	161
Provision for income taxes	54	—	—	54
Net earnings, including noncontrolling interests	107	—	—	107
Less: Net earnings (loss) attributable to noncontrolling interests	4	—	— (d)	4
Net earnings attributable to shareholders	\$ 103	\$ —	\$ —	\$ 103
Three months ended March 31, 2013				
Revenues:				
Insurance net earned premiums	\$ 717	\$ —	\$ —	\$ 717
Net investment income	337	—	(11) (b)	326
Realized gains on securities	57	—	—	57
Income (loss) of managed investment entities:				
Investment income	—	34	—	34
Gain (loss) on change in fair value of assets/liabilities	—	(10)	2 (b)	(8)
Other income	26	—	(4) (c)	22
Total revenues	1,137	24	(13)	1,148
Costs and Expenses:				
Insurance benefits and expenses	854	—	—	854
Expenses of managed investment entities	—	32	(10) (b)(c)	22
Interest charges on borrowed money and other expenses	97	—	—	97
Total costs and expenses	951	32	(10)	973
Earnings before income taxes	186	(8)	(3)	175
Provision for income taxes	62	—	—	62
Net earnings, including noncontrolling interests	124	(8)	(3)	113
Less: Net earnings (loss) attributable to noncontrolling interests	4	—	(11) (d)	(7)
Net earnings attributable to shareholders	\$ 120	\$ (8)	\$ 8	\$ 120

(a) Includes \$5 million and \$11 million for the first three months of 2014 and 2013, respectively, in net investment income representing the change in fair value of AFG's CLO investments plus \$3 million and \$4 million in the first three months of 2014 and 2013, respectively, in CLO management fees earned.

(b) Elimination of the change in fair value of AFG's investments in the CLOs, including \$6 million in each period in distributions recorded as interest expense by the CLOs.

(c) Elimination of management fees earned by AFG.

(d) Allocate earnings (losses) of CLOs attributable to other debt holders to noncontrolling interests.

Management's Discussion and Analysis of Financial Condition and Results of Operations — Continued**RESULTS OF OPERATIONS**

General Results of operations as shown in the accompanying financial statements are prepared in accordance with GAAP.

AFG's net earnings attributable to shareholders, determined in accordance with GAAP, include certain items that may not be indicative of its ongoing core operations. The following table identifies such items and reconciles net earnings attributable to shareholders to core net operating earnings, a non-GAAP financial measure that AFG believes is a useful tool for investors and analysts in analyzing ongoing operating trends (in millions, except per share amounts):

	Three months ended March 31,	
	2014	2013
Core net operating earnings	\$ 91	\$ 84
Realized gains on securities (*)	12	36
Net earnings attributable to shareholders	\$ 103	\$ 120
Diluted per share amounts:		
Core net operating earnings	\$ 1.00	\$ 0.92
Realized gains on securities	0.13	0.40
Net earnings attributable to shareholders	\$ 1.13	\$ 1.32

(*) Realized gains on securities are shown net of taxes of \$7 million in the first quarter of 2014 and \$20 million in the first quarter of 2013. In addition, realized gains on securities are shown net of noncontrolling interests of \$1 million in the first quarter of 2013.

Net earnings attributable to shareholders decreased \$17 million in the first three months of 2014 compared to the same period in 2013 due primarily to lower realized gains on securities and slightly lower earnings in the annuity segment, partially offset by higher underwriting profits in the property and casualty insurance segment.

Core net operating earnings increased \$7 million in the first three months of 2014 compared to the same period in 2013 due primarily to higher underwriting profits in the property and casualty insurance segment, partially offset by slightly lower earnings in the annuity segment.

Management's Discussion and Analysis of Financial Condition and Results of Operations — Continued

Segmented Statement of Earnings AFG reports its business as four segments: (i) Property and casualty insurance (“P&C”), (ii) Annuity, (iii) Run-off long-term care and life and (iv) Other, which includes holding company costs and operations attributable to the noncontrolling interests of the managed investment entities (“MIEs”).

AFG’s net earnings attributable to shareholders, determined in accordance with GAAP, include certain items that may not be indicative of its ongoing core operations. The following tables for the quarters ended March 31, 2014 and 2013 identify such items by segment and reconcile net earnings attributable to shareholders to core net operating earnings, a non-GAAP financial measure that AFG believes is a useful tool for investors and analysts in analyzing ongoing operating trends (in millions):

	P&C	Annuity	Run-off long-term care and life	Other		Total	Non-core reclass	GAAP Total
				Consol. MIEs	Holding Co., other and unallocated			
Three months ended March 31, 2014								
Revenues:								
Property and casualty insurance net earned premiums	\$ 754	\$ —	\$ —	\$ —	\$ —	\$ 754	\$ —	\$ 754
Life, accident and health net earned premiums	—	—	28	—	—	28	—	28
Net investment income	67	275	23	(5)	1	361	—	361
Realized gains on securities	—	—	—	—	—	—	19	19
Income (loss) of MIEs:								
Investment income	—	—	—	28	—	28	—	28
Gain (loss) on change in fair value of assets/liabilities	—	—	—	—	—	—	—	—
Other income	2	18	—	(3)	4	21	—	21
Total revenues	823	293	51	20	5	1,192	19	1,211
Costs and Expenses:								
Property and casualty insurance:								
Losses and loss adjustment expenses	429	—	—	—	—	429	—	429
Commissions and other underwriting expenses	267	—	—	—	—	267	—	267
Annuity benefits	—	168	—	—	—	168	—	168
Life, accident and health benefits	—	—	43	—	—	43	—	43
Annuity and supplemental insurance acquisition expenses	—	31	4	—	—	35	—	35
Interest charges on borrowed money	1	—	—	—	17	18	—	18
Expenses of MIEs	—	—	—	20	—	20	—	20
Other expenses	14	21	6	—	29	70	—	70
Total costs and expenses	711	220	53	20	46	1,050	—	1,050
Earnings before income taxes	112	73	(2)	—	(41)	142	19	161
Provision for income taxes	35	26	(1)	—	(13)	47	7	54
Net earnings, including noncontrolling interests	77	47	(1)	—	(28)	95	12	107
Less: Net earnings (loss) attributable to noncontrolling interests	4	—	—	—	—	4	—	4
Core Net Operating Earnings	73	47	(1)	—	(28)	91		
Non-core earnings attributable to shareholders (a):								
Realized gains on securities, net of tax	—	—	—	—	12	12	(12)	—
Net Earnings Attributable to Shareholders	\$ 73	\$ 47	\$ (1)	\$ —	\$ (16)	\$ 103	\$ —	\$ 103

Management's Discussion and Analysis of Financial Condition and Results of Operations — Continued

	P&C	Annuity	Run-off long-term care and life	Other		Total	Non-core reclass	GAAP Total
				Consol. MIEs	Holding Co., other and unallocated			
Three months ended March 31, 2013								
Revenues:								
Property and casualty insurance net earned premiums	\$ 687	\$ —	\$ —	\$ —	\$ —	\$ 687	\$ —	\$ 687
Life, accident and health net earned premiums	—	—	30	—	—	30	—	30
Net investment income	66	248	19	(11)	4	326	—	326
Realized gains on securities	—	—	—	—	—	—	57	57
Income (loss) of MIEs:								
Investment income	—	—	—	34	—	34	—	34
Gain (loss) on change in fair value of assets/liabilities	—	—	—	(8)	—	(8)	—	(8)
Other income	3	14	1	(4)	8	22	—	22
Total revenues	756	262	50	11	12	1,091	57	1,148
Costs and Expenses:								
Property and casualty insurance:								
Losses and loss adjustment expenses	393	—	—	—	—	393	—	393
Commissions and other underwriting expenses	251	—	—	—	—	251	—	251
Annuity benefits	—	134	—	—	—	134	—	134
Life, accident and health benefits	—	—	40	—	—	40	—	40
Annuity and supplemental insurance acquisition expenses	—	31	5	—	—	36	—	36
Interest charges on borrowed money	1	—	—	—	17	18	—	18
Expenses of MIEs	—	—	—	22	—	22	—	22
Other expenses	12	21	6	—	40	79	—	79
Total costs and expenses	657	186	51	22	57	973	—	973
Earnings before income taxes	99	76	(1)	(11)	(45)	118	57	175
Provision for income taxes	31	26	—	—	(15)	42	20	62
Net earnings, including noncontrolling interests	68	50	(1)	(11)	(30)	76	37	113
Less: Net earnings (loss) attributable to noncontrolling interests	3	—	—	(11)	—	(8)	1	(7)
Core Net Operating Earnings	65	50	(1)	—	(30)	84		
Non-core earnings attributable to shareholders (a):								
Realized gains on securities, net of tax	—	—	—	—	36	36	(36)	—
Net Earnings Attributable to Shareholders	\$ 65	\$ 50	\$ (1)	\$ —	\$ 6	\$ 120	\$ —	\$ 120

(a) See the reconciliation of core earnings to GAAP net earnings under *Results of Operations — General* for details on the tax and noncontrolling interest impacts of these reconciling items.

Property and Casualty Insurance Segment — Results of Operations Performance measures such as underwriting profit or loss and related combined ratios are often used by property and casualty insurers to help users of their financial statements better understand the company's performance. Underwriting profitability is measured by the combined ratio, which is a sum of the ratios of losses and loss adjustment expenses, and commissions and other underwriting expenses to premiums. A combined ratio under 100% indicates an underwriting profit. The combined ratio does not reflect net investment income, other income, other expenses or federal income taxes. AFG's property and casualty insurance operations contributed \$112 million in pretax earnings in the first three months of 2014 compared to \$99 million in the first three months of 2013, an increase of \$13 million (13%). The increase in pretax earnings reflects significantly higher underwriting profit in the Specialty casualty group, partially offset by slightly lower underwriting profits in the Property and transportation and Specialty financial groups.

Management's Discussion and Analysis of Financial Condition and Results of Operations — Continued

The following table details AFG's earnings before income taxes from its property and casualty insurance operations for the three months ended March 31, 2014 and 2013 (dollars in millions):

	Three months ended March 31,		% Change
	2014	2013	
Gross written premiums	\$ 1,024	\$ 925	11%
Reinsurance premiums ceded	(269)	(221)	22%
Net written premiums	755	704	7%
Change in unearned premiums	(1)	(17)	(94%)
Net earned premiums	754	687	10%
Loss and loss adjustment expenses	429	393	9%
Commissions and other underwriting expenses	267	251	6%
Underwriting gain	58	43	35%
Net investment income	67	66	2%
Other income and expenses, net	(13)	(10)	30%
Earnings before income taxes	\$ 112	\$ 99	13%

Combined Ratios:

Specialty lines			Change
Loss and LAE ratio	56.9%	56.5%	0.4%
Underwriting expense ratio	35.3%	36.6%	(1.3%)
Combined ratio	92.2%	93.1%	(0.9%)
Aggregate — including discontinued lines			
Loss and LAE ratio	56.9%	57.2%	(0.3%)
Underwriting expense ratio	35.3%	36.6%	(1.3%)
Combined ratio	92.2%	93.8%	(1.6%)

While AFG desires and seeks to earn an underwriting profit on all of its business, it is not always possible to do so. As a result, AFG attempts to expand in the most profitable businesses and control growth or even reduce its involvement in the least profitable businesses.

AFG reports the underwriting performance of its Specialty property and casualty insurance business in the following sub-segments: (i) Property and transportation, (ii) Specialty casualty and (iii) Specialty financial.

To understand the overall profitability of particular lines, the timing of claims payments and the related impact of investment income must be considered. Certain "short-tail" lines of business (primarily property coverages) generally have quick loss payouts, which reduce the time funds are held, thereby limiting investment income earned thereon. In contrast, "long-tail" lines of business (primarily liability coverages and workers' compensation) generally have payouts that are either structured over many years or take many years to settle, thereby significantly increasing investment income earned on related premiums received.

Management's Discussion and Analysis of Financial Condition and Results of Operations — Continued
Gross Written Premiums

Gross written premiums ("GWP") for AFG's property and casualty insurance segment were \$1.02 billion for the first three months of 2014 compared to \$925 million for the first three months of 2013, an increase of \$99 million (11%). Detail of AFG's property and casualty gross written premiums is shown below (dollars in millions):

	Three months ended March 31,				
	2014		2013		% Change
	GWP	%	GWP	%	
Property and transportation	\$ 376	37%	\$ 352	38%	7%
Specialty casualty	507	49%	430	47%	18%
Specialty financial	141	14%	143	15%	(1%)
	<u>\$ 1,024</u>	<u>100%</u>	<u>\$ 925</u>	<u>100%</u>	<u>11%</u>

Reinsurance Premiums Ceded

Reinsurance premiums ceded ("Ceded") for AFG's property and casualty insurance segment were 26% of gross written premiums for the first three months of 2014 compared to 24% for the first three months of 2013, an increase of 2 percentage points. Detail of AFG's property and casualty reinsurance premiums ceded is shown below (dollars in millions):

	Three months ended March 31,				
	2014		2013		Change in % of GWP
	Ceded	% of GWP	Ceded	% of GWP	
Property and transportation	\$ (92)	24%	\$ (76)	22%	2%
Specialty casualty	(176)	35%	(135)	31%	4%
Specialty financial	(25)	18%	(30)	21%	(3%)
Other specialty	24		20		
	<u>\$ (269)</u>	<u>26%</u>	<u>\$ (221)</u>	<u>24%</u>	<u>2%</u>

Net Written Premiums

Net written premiums ("NWP") for AFG's property and casualty insurance segment were \$755 million for the first three months of 2014 compared to \$704 million for the first three months of 2013, an increase of \$51 million (7%). Detail of AFG's property and casualty net written premiums is shown below (dollars in millions):

	Three months ended March 31,				
	2014		2013		% Change
	NWP	%	NWP	%	
Property and transportation	\$ 284	38%	\$ 276	39%	3%
Specialty casualty	331	44%	295	42%	12%
Specialty financial	116	15%	113	16%	3%
Other specialty	24	3%	20	3%	20%
	<u>\$ 755</u>	<u>100%</u>	<u>\$ 704</u>	<u>100%</u>	<u>7%</u>

Management's Discussion and Analysis of Financial Condition and Results of Operations — Continued**Net Earned Premiums**

Net earned premiums ("NEP") for AFG's property and casualty insurance segment were \$754 million for the first three months of 2014 compared to \$687 million for the first three months of 2013, an increase of \$67 million (10%). Detail of AFG's property and casualty net earned premiums is shown below (dollars in millions):

	Three months ended March 31,				
	2014		2013		% Change
	NEP	%	NEP	%	
Property and transportation	\$ 301	40%	\$ 293	43%	3%
Specialty casualty	313	42%	259	38%	21%
Specialty financial	117	16%	116	17%	1%
Other specialty	23	2%	19	2%	21%
	<u>\$ 754</u>	<u>100%</u>	<u>\$ 687</u>	<u>100%</u>	<u>10%</u>

The \$99 million increase in gross written premiums for the first three months of 2014 compared to the first three months of 2013 reflects significant growth in the Specialty casualty group. Overall average renewal rates increased approximately 3% in the first three months of 2014.

Property and transportation Gross written premiums increased \$24 million (7%) in the first three months of 2014 compared to the same period in 2013 due primarily to higher premiums in the transportation businesses resulting from rate increases. Average renewal rates were up approximately 4% for this group in the first quarter of 2014. Reinsurance premiums ceded as a percentage of gross written premiums increased 2 percentage points in the first quarter of 2014 compared to the first quarter of 2013 reflecting higher cessions of multi-peril crop business.

Specialty casualty Gross written premiums increased \$77 million (18%) for the first three months of 2014 compared to the first three months of 2013 as a result of increased premiums in nearly all businesses in this group, particularly in the workers' compensation, excess and surplus lines and targeted markets operations. New business opportunities, increased exposures from higher payroll on existing accounts, and sustained pricing increases have contributed to increased premiums in the workers' compensation businesses. Strong premium growth in the excess and surplus lines and targeted markets operations is the result of broadening opportunities to write business coupled with the benefit from rate increases over multiple quarters. Average renewal rates were up approximately 3% for this group in the first quarter of 2014. Reinsurance premiums ceded as a percentage of gross written premiums increased 4 percentage points for the first quarter of 2014 compared to the first quarter of 2013 reflecting timing of reinsurance premiums between quarters.

Specialty financial Gross written premiums decreased by \$2 million (1%) for the first three months of 2014 compared to the first three months of 2013. The impact of the October 2013 sale of a service contracts business, which ceded all of its premiums under reinsurance contracts, more than offset growth in gross written premiums across the remaining businesses in this group. Average renewal rates for this group were flat in the first quarter of 2014. Reinsurance premiums ceded as a percentage of gross written premiums declined 3 percentage points reflecting the sale of the service contract business, which was 100% reinsured, partially offset by an increase in ceded business in the financial institutions operations.

Other specialty The amounts shown as reinsurance premiums ceded represent business assumed by AFG's internal reinsurance program from the operations that make up AFG's other Specialty sub-segments.

Management's Discussion and Analysis of Financial Condition and Results of Operations — Continued
Combined Ratio

Performance measures such as the combined ratio are often used by property and casualty insurers to help users of their financial statements better understand the company's performance. The combined ratio is the sum of the loss and loss adjustment expenses ("LAE") and underwriting expense ratios. These ratios are calculated by dividing each of the respective expenses by net earned premiums. The table below (dollars in millions) details the components of the combined ratio for AFG's property and casualty segment:

	Three months ended March 31,			Three months ended March 31,	
	2014	2013	Change	2014	2013
Property and transportation					
Loss and LAE ratio	67.0%	65.4%	1.6%		
Underwriting expense ratio	31.1%	31.1%	—%		
Combined ratio	98.1%	96.5%	1.6%		
Underwriting profit				\$ 6	\$ 10
Specialty casualty					
Loss and LAE ratio	55.0%	57.3%	(2.3%)		
Underwriting expense ratio	32.8%	35.4%	(2.6%)		
Combined ratio	87.8%	92.7%	(4.9%)		
Underwriting profit				\$ 38	\$ 19
Specialty financial					
Loss and LAE ratio	37.9%	35.8%	2.1%		
Underwriting expense ratio	53.1%	52.7%	0.4%		
Combined ratio	91.0%	88.5%	2.5%		
Underwriting profit				\$ 10	\$ 13
Total Specialty					
Loss and LAE ratio	56.9%	56.5%	0.4%		
Underwriting expense ratio	35.3%	36.6%	(1.3%)		
Combined ratio	92.2%	93.1%	(0.9%)		
Underwriting profit				\$ 59	\$ 48
Aggregate — including discontinued lines					
Loss and LAE ratio	56.9%	57.2%	(0.3%)		
Underwriting expense ratio	35.3%	36.6%	(1.3%)		
Combined ratio	92.2%	93.8%	(1.6%)		
Underwriting profit				\$ 58	\$ 43

The Specialty property and casualty insurance operations generated an underwriting profit of \$59 million in the first three months of 2014 compared to \$48 million in the first three months of 2013, an increase of \$11 million (23%). The higher profit in the 2014 quarter reflects significantly higher underwriting profit in the Specialty casualty group, partially offset by slightly lower profitability in the Property and transportation and Specialty financial groups. Catastrophe losses were \$12 million (1.6 points on the combined ratio), compared to \$10 million (1.5 points) in the first three months of 2013.

Property and transportation This group reported an underwriting gain of \$6 million for the first three months of 2014 compared to \$10 million for the first three months of 2013, a decrease of \$4 million (40%). Improved results in the transportation and property and inland marine operations were more than offset by lower profitability in the agricultural operations. Catastrophe losses for this group were \$9 million (2.8 points) in the first three months of 2014, compared to \$10 million (3.4 points) during the first three months of 2013.

Specialty casualty Underwriting profit was \$38 million for the first three months of 2014 compared to \$19 million in the first three months of 2013, an increase of \$19 million (100%). This increase was due primarily to higher profitability in the workers' compensation and excess and surplus lines businesses.

Management's Discussion and Analysis of Financial Condition and Results of Operations — Continued

Specialty financial Underwriting profit was \$10 million for the first three months of 2014 compared to \$13 million in the first three months of 2013, a decrease of \$3 million (23%). Higher underwriting profits in the fidelity and crime and surety businesses were more than offset by lower profitability in the trade credit and financial institutions businesses.

Losses and Loss Adjustment Expenses

AFG's overall loss and LAE ratio was 56.9% for the first three months of 2014 compared to 57.2% for first three months of 2013, a decrease of 0.3 percentage points. The components of AFG's property and casualty losses and LAE amounts and ratio are detailed below (dollars in millions):

	Three months ended March 31,				Change in Ratio
	Amount		Ratio		
	2014	2013	2014	2013	
Property and transportation					
Current year, excluding catastrophe losses	\$ 196	\$ 188	65.3%	64.0%	1.3%
Prior accident years development	(4)	(6)	(1.1%)	(2.0%)	0.9%
Current year catastrophe losses	9	10	2.8%	3.4%	(0.6%)
Property and transportation losses and LAE and ratio	<u>\$ 201</u>	<u>\$ 192</u>	<u>67.0%</u>	<u>65.4%</u>	<u>1.6%</u>
Specialty casualty					
Current year, excluding catastrophe losses	\$ 195	\$ 164	62.3%	63.5%	(1.2%)
Prior accident years development	(24)	(16)	(7.7%)	(6.2%)	(1.5%)
Current year catastrophe losses	1	—	0.4%	—%	0.4%
Specialty casualty losses and LAE and ratio	<u>\$ 172</u>	<u>\$ 148</u>	<u>55.0%</u>	<u>57.3%</u>	<u>(2.3%)</u>
Specialty financial					
Current year, excluding catastrophe losses	\$ 44	\$ 48	37.1%	40.3%	(3.2%)
Prior accident years development	(1)	(6)	(0.7%)	(4.8%)	4.1%
Current year catastrophe losses	2	—	1.5%	0.3%	1.2%
Specialty financial losses and LAE and ratio	<u>\$ 45</u>	<u>\$ 42</u>	<u>37.9%</u>	<u>35.8%</u>	<u>2.1%</u>
Total Specialty					
Current year, excluding catastrophe losses	\$ 448	\$ 411	59.5%	59.8%	(0.3%)
Prior accident years development	(32)	(33)	(4.2%)	(4.8%)	0.6%
Current year catastrophe losses	12	10	1.6%	1.5%	0.1%
Total Specialty losses and LAE and ratio	<u>\$ 428</u>	<u>\$ 388</u>	<u>56.9%</u>	<u>56.5%</u>	<u>0.4%</u>
Aggregate — including discontinued lines					
Current year, excluding catastrophe losses	\$ 448	\$ 411	59.4%	59.8%	(0.4%)
Prior accident years development	(31)	(28)	(4.1%)	(4.1%)	—%
Current year catastrophe losses	12	10	1.6%	1.5%	0.1%
Aggregate losses and LAE and ratio	<u>\$ 429</u>	<u>\$ 393</u>	<u>56.9%</u>	<u>57.2%</u>	<u>(0.3%)</u>

Net prior year reserve development

AFG's Specialty property and casualty insurance operations recorded net favorable reserve development related to prior accident years of \$32 million in the first three months of 2014 compared to \$33 million in the first three months of 2013, a decrease of \$1 million (3%).

Property and transportation Net favorable reserve development of \$4 million in the first three months of 2014 reflects lower than expected loss frequency in crop products and lower than expected claim severity in the ocean marine business. Net favorable reserve development of \$6 million in the first three months of 2013 reflects a decrease in frequency of new claims being filed in a run-off book of homebuilders business.

Management's Discussion and Analysis of Financial Condition and Results of Operations — Continued

Specialty casualty Net favorable reserve development of \$24 million in the first three months of 2014 reflects lower than expected claim severity in directors and officers liability insurance, lower than expected claim frequency and severity in excess liability insurance and lower than anticipated claim severity in California workers' compensation business. Net favorable reserve development of \$16 million in the first three months of 2013 reflects lower than expected claim severity in directors and officers liability insurance and lower than expected claim severity and frequency in excess liability business.

Specialty financial Net favorable reserve development of \$1 million in the first three months of 2014 reflects lower than expected claim frequency and severity in the foreign credit business. Net favorable reserve development of \$6 million in the first three months of 2013 is due to lower than expected frequency and severity in the foreign credit and financial institutions businesses as economic conditions did not affect these lines as adversely as had been anticipated.

Other specialty In addition to the development discussed above, total specialty net favorable reserve development reflects amortization of the deferred gain on the retroactive insurance transaction entered into in connection with the sale of a business in 1998 and reserve development associated with AFG's internal reinsurance program.

Aggregate Aggregate results for AFG's property and casualty segment also include adverse development of \$1 million in the first three months of 2014 related to businesses outside of the Specialty group that AFG no longer writes and \$5 million in the first three months of 2013 related to asbestos and environmental reserves.

Catastrophe losses

AFG generally seeks to reduce its exposure to catastrophes through individual risk selection, including minimizing coastal and known fault-line exposures, and the purchase of reinsurance. Based on data available at December 31, 2013, AFG's exposure to a catastrophic earthquake or windstorm that industry models indicate could occur once in every 500 years (a "500-year event") is expected to be less than 2.5% of AFG's shareholders' equity. The \$9 million in catastrophe losses in the Property and transportation group in the first three months of 2014 were primarily from winter storms in the month of January. The \$10 million in catastrophe losses in the Property and transportation group in the first three months of 2013 resulted primarily from March storms in the southeastern United States.

Commissions and Other Underwriting Expenses

AFG's property and casualty commissions and other underwriting expenses ("U/W Exp") were \$267 million in the first three months of 2014 compared to \$251 million for the first three months of 2013, an increase of \$16 million (6%). AFG's underwriting expense ratio, calculated as commissions and other underwriting expenses divided by net premiums earned, was 35.3% for the first three months of 2014 compared to 36.6% for the first three months of 2013, a decrease of 1.3 percentage points. Detail of AFG's property and casualty commissions and other underwriting expenses and underwriting expense ratios is shown below (dollars in millions):

	Three months ended March 31,				Change in % of NEP
	2014		2013		
	U/W Exp	% of NEP	U/W Exp	% of NEP	
Property and transportation	\$ 94	31.1%	\$ 91	31.1%	—%
Specialty casualty	103	32.8%	92	35.4%	(2.6%)
Specialty financial	62	53.1%	61	52.7%	0.4%
Other specialty	8	34.1%	7	37.4%	(3.3%)
	<u>\$ 267</u>	<u>35.3%</u>	<u>\$ 251</u>	<u>36.6%</u>	<u>(1.3%)</u>

The overall decrease of 1.3% in AFG's expense ratio for the first three months of 2014 as compared to the first three months of 2013 reflects the impact of higher premiums in the Specialty casualty group on the ratio.

Property and transportation Commissions and other underwriting expenses as a percentage of net earned premiums were 31.1 percentage points for both the first three months of 2014 and the first three months of 2013.

Specialty casualty Commissions and other underwriting expenses as a percentage of net earned premiums decreased 2.6 percentage points for the first three months of 2014 compared to the first three months of 2013 due to the impact of higher premiums on the ratio.

Management's Discussion and Analysis of Financial Condition and Results of Operations — Continued

Specialty financial Commissions and other underwriting expenses as a percentage of net earned premiums increased 0.4 percentage points for the first three months of 2014 compared to the first three months of 2013.

Property and Casualty Net Investment Income

Net investment income in AFG's property and casualty operations was \$67 million for the first three months of 2014 compared to \$66 million in the first three months of 2013, an increase of \$1 million (2%). Net investment in AFG's property and casualty operations includes \$3 million from recording equity in the earnings of limited partnerships and similar investments. Equity in the earnings of these investments has not been material and was included in realized gains (losses) on securities prior to 2014. In recent years, yields available in the financial markets on fixed maturity securities have generally declined, placing downward pressure on AFG's investment portfolio yield. The average invested assets and overall earned yield on investments held by AFG's property and casualty operations are provided below (dollars in millions):

	Three months ended March 31,		Change	% Change
	2014	2013		
Net investment income	\$ 67	\$ 66	\$ 1	2%
Average invested assets (at amortized cost)	\$ 6,941	\$ 6,916	\$ 25	—%
Yield (net investment income as a % of average invested assets)	3.86%	3.82%	0.04%	
Tax equivalent yield (*)	4.46%	4.42%	0.04%	

(*) Adjusts the yield on equity securities and tax-exempt bonds to the fully taxable equivalent yield.

The property and casualty segment's overall yield on investments (net investment income as a percentage of average invested assets) was 3.86% for the first three months of 2014 compared to 3.82% for the first three months of 2013. The impact of equity in the earnings of limited partnerships and similar investments was substantially offset by the impact of lower yields available in the financial markets.

Property and Casualty Other Income and Expense, Net

Other income and expenses, net for AFG's property and casualty operations was a net expense of \$13 million for the first three months of 2014 compared to \$10 million for the first three months of 2013, an increase of \$3 million (30%). The table below details the items included in other income and expenses, net for AFG's property and casualty operations (in millions):

	Three months ended March 31,	
	2014	2013
Other income	\$ 2	\$ 3
Other expenses		
Amortization of intangibles	3	4
Tender offer expenses	3	—
Other	8	8
Total other expense	14	12
Interest expense	1	1
Other income and expenses, net	\$ (13)	\$ (10)

AFG and its consolidated subsidiaries incurred \$3 million in transaction expenses related to the February 2014 tender offer by Great American Insurance Company ("GAI") to acquire all of the National Interstate Corporation common stock that GAI did not already own. These expenses consisted primarily of financial advisory and legal services. The tender offer was terminated in March 2014.

Interest expense for AFG's property and casualty operations includes interest charges on long-term debt within the property and casualty operations, primarily notes secured by real estate.

Management's Discussion and Analysis of Financial Condition and Results of Operations — Continued
Annuity Segment — Results of Operations

AFG's annuity operations contributed \$73 million in pretax earnings in the first three months of 2014 compared to \$76 million in the first three months of 2013, a decrease of \$3 million (4%). While AFG's average annuity investments (at amortized cost) were 19% higher for the first three months of 2014 as compared to the first three months of 2013, the benefit of this growth was more than offset by the run-off of higher yielding investments and the negative impact of sharply lower interest rates and relatively flat stock market performance in the first three months of 2014 on the fixed-indexed annuity business.

The following table details AFG's earnings before income taxes from its annuity operations for the three months ended March 31, 2014 and 2013 (dollars in millions).

	Three months ended March 31,		% Change
	2014	2013	
Revenues:			
Net investment income	\$ 275	\$ 248	11%
Other income:			
Guaranteed withdrawal benefit fees	8	5	60%
Policy charges and other miscellaneous income	10	9	11%
Total revenues	293	262	12%
Costs and Expenses:			
Annuity benefits (*)	168	134	25%
Acquisition expenses	31	31	—%
Other expenses	21	21	—%
Total costs and expenses	220	186	18%
Earnings before income taxes	\$ 73	\$ 76	(4%)

(*) Annuity benefits consisted of the following (dollars in millions):

	Three months ended March 31,		% Change
	2014	2013	
Interest credited — fixed	\$ 121	\$ 109	11%
Interest credited — fixed component of variable annuities	1	2	(50%)
Change in expected death and annuitization reserve	4	4	—%
Amortization of sales inducements	7	7	—%
Change in guaranteed withdrawal benefit reserve	8	8	—%
Change in other benefit reserves	3	1	200%
Derivatives related to fixed-indexed annuities:			
Embedded derivative mark-to-market	54	80	(33%)
Equity option mark-to-market	(30)	(77)	(61%)
Total annuity benefits	\$ 168	\$ 134	25%

The profitability of a fixed annuity business is largely dependent on the ability of a company to earn income on the assets supporting the business in excess of the amounts credited to policyholder accounts plus expenses incurred (earning a "spread"). Performance measures such as net interest spread and net spread earned are often presented by annuity businesses to help users of their financial statements better understand the company's performance.

Management's Discussion and Analysis of Financial Condition and Results of Operations — Continued
Net Spread on Fixed Annuities (excludes variable annuity earnings)

The table below (dollars in millions) details the components of these spreads for AFG's fixed annuity operations (including fixed-indexed annuities):

	Three months ended March 31,		% Change
	2014	2013	
Average fixed annuity investments (at amortized cost)	\$ 21,402	\$ 17,945	19%
Average fixed annuity benefits accumulated	21,066	17,506	20%
As % of fixed annuity benefits accumulated (except as noted):			
Net investment income (as % of fixed annuity investments)	5.10%	5.48%	
Interest credited — fixed	(2.29%)	(2.49%)	
Net interest spread	2.81%	2.99%	
Policy charges and other miscellaneous income	0.13%	0.14%	
Other annuity benefit expenses, net of guaranteed withdrawal benefit fees	(0.27%)	(0.35%)	
Acquisition expenses	(0.55%)	(0.69%)	
Other expenses	(0.37%)	(0.45%)	
Change in fair value of derivatives related to fixed-indexed annuities	(0.45%)	(0.06%)	
Net spread earned on fixed annuities	<u>1.30%</u>	<u>1.58%</u>	

Annuity Net Investment Income

Net investment income for the first three months of 2014 was \$275 million compared to \$248 million for the first three months of 2013, an increase of \$27 million (11%). This increase reflects primarily the growth in AFG's annuity business. The overall yield earned on investments in AFG's annuity operations, calculated as net investment income divided by average investment balances (at amortized cost), declined by 0.38 percentage points in the first three months of 2014 compared to the first three months of 2013. This decline in net investment yield reflects the investment of new premium dollars at lower yields as compared to the existing investment portfolio and the impact of the maturity and redemption of higher yielding investments.

Annuity Interest Credited — Fixed

Interest credited — fixed for the first three months of 2014 was \$121 million compared to \$109 million for the first three months of 2013, an increase of \$12 million (11%). The impact of growth in the annuity business was partially offset by lower interest crediting rates on new premiums as compared to the crediting rates on policyholder funds surrendered or withdrawn. The average interest rate credited to policyholders, calculated as interest credited divided by average fixed annuity benefits accumulated, decreased 0.20 percentage points in the first three months of 2014 compared to the first three months of 2013. During the first three months of 2014, interest rates credited on new premiums of AFG's principal fixed annuity products generally ranged from 1.25% to 2.00%.

Excluding those annuities that have guaranteed withdrawal benefits, at March 31, 2014, AFG could reduce the average crediting rate on approximately \$16 billion of traditional fixed and fixed-indexed deferred annuities by an additional 0.51% (on a weighted average basis). Annuity policies are subject to Guaranteed Minimum Interest Rates ("GMIRs") at policy issuance. The table below shows the breakdown of annuity reserves by GMIR. The current interest crediting rates on substantially all of AFG's annuities with a GMIR of 3% or higher are at their minimum.

GMIR	% of Reserves
1 — 1.99%	54%
2 — 2.99%	11%
3 — 3.99%	20%
4.00% and above	15%

Management's Discussion and Analysis of Financial Condition and Results of Operations — Continued**Annuity Net Interest Spread**

AFG's net interest spread decreased 0.18 percentage points in the first three months of 2014 compared to the same period in 2013 due primarily to the run-off of higher yielding investments. Due to the continued run-off of higher yielding investments, AFG expects its net interest spread to continue to narrow in the future.

Annuity Policy Charges and Other Miscellaneous Income

Annuity policy charges and other miscellaneous income, which consist primarily of surrender charges, were \$10 million for the first three months of 2014 and \$9 million for the first three months of 2013, an increase of \$1 million (11%).

Other Annuity Benefits

Other annuity benefits, net of guaranteed withdrawal benefit fees, for the first three months of 2014 were \$14 million compared to \$15 million for the first three months of 2013, a decrease of \$1 million (7%). In addition to interest credited to policyholders' accounts and the change in fair value of derivatives related to fixed-indexed annuities, annuity benefits expense also includes the following expenses (in millions, net of guaranteed withdrawal benefit fees):

	Three months ended March 31,	
	2014	2013
Change in expected death and annuitization reserve	\$ 4	\$ 4
Amortization of sales inducements	7	7
Change in guaranteed withdrawal benefit reserve	8	8
Change in other benefit reserves	3	1
Other annuity benefits	22	20
Offset guaranteed withdrawal benefit fees	(8)	(5)
Other annuity benefits, net	<u>\$ 14</u>	<u>\$ 15</u>

Annuity Acquisition Expenses

AFG's amortization of DPAC and commission expenses as a percentage of average fixed annuity benefits accumulated was 0.55% for the first three months of 2014 compared to 0.69% for the first three months of 2013 and has generally ranged between 0.70% and 0.80%. Variances from the general range relate primarily to the impact of (i) material changes in interest rates or the stock market on AFG's fixed-indexed annuity business, and (ii) differences in actual experience from actuarially projected estimates and assumptions. For example, the negative impact of lower interest rates and relatively flat stock market performance during the first three months of 2014 on the fair value of derivatives related to fixed-indexed annuities (discussed below) resulted in a partially offsetting deceleration in the amortization of deferred policy acquisition costs.

Annuity Other Expenses

Annuity other expenses for the first three months of 2014 and 2013 were \$21 million in each period. Annuity other expenses represent primarily general and administrative expenses, as well as selling and issuance expenses that are not deferred. As a percentage of average fixed annuity benefits accumulated, these expenses declined 0.08 percentage points for the first three months of 2014 as compared to the first three months of 2013. In general, this percentage is expected to decrease as AFG's annuity business grows and annuity other expenses remain relatively stable.

Change in Fair Value of Derivatives Related to Fixed-Indexed Annuities

AFG's fixed-indexed annuities, which represented approximately one-half of annuity benefits accumulated at March 31, 2014, provide policyholders with a crediting rate tied, in part, to the performance of an existing stock market index. AFG attempts to mitigate the risk in the index-based component of these products through the purchase of call options on the appropriate index. AFG's strategy is designed so that an increase in the liabilities, due to an increase in the market index, will generally be offset by unrealized and realized gains on the call options purchased by AFG. Both the index-based component of the annuities and the related call options are considered derivatives that must be marked-to-market through earnings each period. The fair values of these derivatives are impacted by actual and expected stock market performance and interest rates as well as other factors. For a list of other factors impacting the fair value of the index-based component of AFG's annuity benefits accumulated, see *Note D — "Fair Value Measurements"* to the financial statements. The net change in fair value of derivatives related to fixed-indexed annuities increased annuity benefits by \$24 million in the first three months of 2014, reflecting the negative impact of sharply lower interest rates and relatively flat stock market performance, compared to \$3 million in the first three months of 2013.

Management's Discussion and Analysis of Financial Condition and Results of Operations — Continued
Annuity Net Spread Earned on Fixed Annuities

AFG's net spread earned on fixed annuities decreased 0.28 percentage points in the first three months of 2014 compared to the same period in 2013 due to the 0.18 percentage points decrease in AFG's net interest spread and the net impact of changes in the fair value of derivatives and related DPAC amortization offset discussed above. These items were partially offset by the impact of growth in AFG's annuity business on other expenses and other annuity benefits as a percent of fixed annuity benefits accumulated discussed above. AFG expects its net spread earned on fixed annuities to be closer to 1.35% to 1.40% for the full-year 2014 as compared to the 1.30% earned in the first three months of 2014 and 1.60% earned for the full year 2013.

Annuity Benefits Accumulated

Annuity premiums received and benefit payments are recorded as increases or decreases in annuity benefits accumulated rather than as revenue and expense. Increases in this liability for interest credited and other benefits are charged to expense and decreases for surrender and other policy charges are credited to other income.

For certain products, annuity benefits accumulated also includes reserves for accrued persistency and premium bonuses, excess benefits expected to be paid on future deaths and annuitizations ("EDAR") and guaranteed withdrawal benefits. Annuity benefits accumulated also includes amounts advanced from the Federal Home Loan Bank of Cincinnati. The following table is a progression of AFG's annuity benefits accumulated liability for the three months ended March 31, 2014 and 2013 (in millions):

	Three months ended March 31,	
	2014	2013
Beginning fixed annuity reserves	\$ 20,679	\$ 17,274
Fixed annuity premiums (receipts)	955	609
Surrenders, benefits and other withdrawals	(375)	(352)
Interest and other annuity benefit expenses:		
Interest credited	121	109
Embedded derivative mark-to-market	54	80
Change in other benefit reserves	19	17
Ending fixed annuity reserves	\$ 21,453	\$ 17,737
Reconciliation to annuity benefits accumulated per balance sheet:		
Ending fixed annuity reserves (from above)	\$ 21,453	\$ 17,737
Impact of unrealized investment gains	97	140
Fixed component of variable annuities	194	198
Annuity benefits accumulated per balance sheet	\$ 21,744	\$ 18,075

Statutory Annuity Premiums

AFG's annuity operations generated statutory premiums of \$967 million in the first three months of 2014 compared to \$624 million in the first three months of 2013, an increase of \$343 million (55%). The following table summarizes AFG's annuity sales (dollars in millions):

	Three months ended March 31,		% Change
	2014	2013	
Financial institutions single premium annuities — indexed	\$ 366	\$ 83	341%
Financial institutions single premium annuities — fixed	114	111	3%
Retail single premium annuities — indexed	386	333	16%
Retail single premium annuities — fixed	39	27	44%
Education market — 403(b) fixed and indexed annuities	50	55	(9%)
Total fixed annuity premiums	955	609	57%
Variable annuities	12	15	(20%)
Total annuity premiums	\$ 967	\$ 624	55%

The 55% increase in annuity premiums as compared to the first three months of 2013 was largely the result of growth in the sales of fixed-indexed annuities in the financial institutions market. New products, expanded distribution and improved market penetration within existing distribution channels contributed to this growth.

Management's Discussion and Analysis of Financial Condition and Results of Operations — Continued
Annuity Earnings before Income Taxes Reconciliation

The following table reconciles the net spread earned on AFG's fixed annuities to overall annuity pretax earnings for the three months ended March 31, 2014 and 2013 (in millions):

	Three months ended March 31,	
	2014	2013
Earnings on fixed annuity benefits accumulated	\$ 68	\$ 69
Earnings on investments in excess of fixed annuity benefits accumulated (*)	5	6
Variable annuity earnings	—	1
Earnings before income taxes	\$ 73	\$ 76

(*) Net investment income (as a % of investments) of 5.10% and 5.48% for the three months ended March 31, 2014 and 2013, respectively, multiplied by the difference between average fixed annuity investments (at amortized cost) and average fixed annuity benefits accumulated in each period.

Run-off Long-Term Care and Life Segment — Results of Operations The following table details AFG's loss before income taxes from its run-off long-term care and life operations for the three months ended March 31, 2014 and 2013 (dollars in millions):

	Three months ended March 31,		% Change
	2014	2013	
Revenues:			
Net earned premiums:			
Long-term care	\$ 19	\$ 20	(5%)
Life operations	9	10	(10%)
Net investment income	23	19	21%
Other income	—	1	(100%)
Total revenues	51	50	2%
Costs and Expenses:			
Life, accident and health benefits:			
Long-term care	29	26	12%
Life operations	14	14	—%
Acquisition expenses	4	5	(20%)
Other expenses	6	6	—%
Total costs and expenses	53	51	4%
Loss before income taxes	\$ (2)	\$ (1)	100%

AFG expects revenues and expenses related to the long-term care business to generally increase over time as this closed block of business ages. The increase in long-term care benefits expense in the first three months of 2014 as compared to the first three months of 2013 is due primarily to an increase in new claims. Due to the age and relatively small size of its long-term care business, AFG expects claims volatility from period to period. Management continues to monitor its claims experience and update its loss recognition assumptions as needed.

Management's Discussion and Analysis of Financial Condition and Results of Operations — Continued

Holding Company, Other and Unallocated — Results of Operations AFG's net pretax loss outside of its insurance operations (excluding realized gains) totaled \$41 million for the first three months of 2014 compared to \$45 million for the first three months of 2013, a decrease of \$4 million (9%).

The following table details AFG's loss before income taxes from operations outside of its insurance operations for three months ended March 31, 2014 and 2013 (dollars in millions):

	Three months ended March 31,		% Change
	2014	2013	
Revenues:			
Net investment income	\$ 1	\$ 4	(75%)
Other income	4	8	(50%)
Total revenues	5	12	(58%)
Costs and Expenses:			
Interest charges on borrowed money	17	17	—%
Other expenses	29	40	(28%)
Total costs and expenses	46	57	(19%)
Loss before income taxes, excluding realized gains	\$ (41)	\$ (45)	(9%)

Holding Company and Other — Net Investment Income

Net investment income for the first three months of 2014 was \$1 million compared to \$4 million in the first three months of 2013. The parent company holds a small portfolio of securities that are classified as "trading" and marked-to-market through investment income. These trading securities decreased in value by less than \$1 million in the first three months of 2014 compared to an increase in value of approximately \$3 million in the first three months of 2013.

Holding Company and Other — Other Income

Other income in the table above includes \$3 million and \$4 million in the first three months of 2014 and 2013, respectively, in management fees paid to AFG by the AFG-managed CLOs (AFG's consolidated managed investment entities). These fees are eliminated in consolidation — see the other income line in the Consolidate MIEs column under "Results of Operations — Segmented Statement of Earnings." Excluding amounts eliminated in consolidation, AFG recorded other income outside of its insurance operations of \$1 million in the first three months of 2014 and \$4 million in the first three months of 2013.

Holding Company and Other — Interest Charges on Borrowed Money

AFG's holding companies and other operations outside of its insurance operations recorded interest expense of \$17 million in both the first three months of 2014 and 2013. The following table details AFG's long-term debt balances as of March 31, 2014 compared to March 31, 2013 (dollars in millions):

	March 31, 2014	March 31, 2013
Direct obligations of AFG:		
9-7/8% Senior Notes due June 2019	\$ 350	\$ 350
6-3/8% Senior Notes due June 2042	230	230
5-3/4% Senior Notes due August 2042	125	125
7% Senior Notes due September 2050	132	132
Other	3	3
	<u>840</u>	<u>840</u>
Other holding company obligations:		
Secured borrowings (guaranteed by AFG)	—	15
AAG Holding Variable Rate Subordinated Debentures	—	20
	<u>—</u>	<u>35</u>
Total Holding Company and Other Debt	\$ 840	\$ 875
Weighted Average Interest Rate	7.8%	7.7%

Management's Discussion and Analysis of Financial Condition and Results of Operations — Continued
Holding Company and Other — Other Expenses

AFG's holding companies and other operations outside of its insurance operations recorded other expenses of \$29 million in the first three months of 2014 compared to \$40 million in the first three months of 2013, a decrease of \$11 million (28%). The decrease reflects lower holding company expenses associated with employee benefit plans that are tied to stock market performance and certain share-based incentive plans.

Consolidated Realized Gains on Securities AFG's consolidated realized gains on securities, which are not allocated to segments, were \$19 million in the first three months of 2014 compared to \$57 million in the first three months of 2013, a decrease of \$38 million (67%). Realized gains (losses) on securities consisted of the following (in millions):

	Three months ended March 31,	
	2014	2013
Realized gains (losses) before impairments:		
Disposals	\$ 20	\$ 54
Change in the fair value of derivatives	—	4
Adjustments to annuity deferred policy acquisition costs and related items	—	(1)
	<u>20</u>	<u>57</u>
Impairment charges:		
Securities	(1)	—
Adjustments to annuity deferred policy acquisition costs and related items	—	—
	<u>(1)</u>	<u>—</u>
Realized gains on securities	<u>\$ 19</u>	<u>\$ 57</u>

Realized gains on disposals include gains on sales of Verisk Analytics, Inc. of \$25 million in the first three months of 2013.

Consolidated Income Taxes AFG's consolidated provision for income taxes was \$54 million for the first three months of 2014 compared to \$62 million in the first three months of 2013, a decrease of \$8 million (13%). See *Note L — "Income Taxes"* to the financial statements for an analysis of items affecting AFG's effective tax rate.

Consolidated Noncontrolling Interests AFG's consolidated net earnings attributable to noncontrolling interests were \$4 million for the first three months of 2014 compared to a net loss of \$7 million for the first three months of 2013. The following table details net earnings (loss) in consolidated subsidiaries attributable to holders other than AFG (dollars in millions):

	Three months ended March 31,		% Change
	2014	2013	
National Interstate	\$ 4	\$ 4	—%
Managed Investment Entities	—	(11)	(100%)
Earnings (loss) attributable to noncontrolling interests	<u>\$ 4</u>	<u>\$ (7)</u>	(157%)

As discussed in *Note A — "Accounting Policies,"* and *Note H — "Managed Investment Entities"* to the financial statements, the losses of Managed Investment Entities represent CLO losses that ultimately inure to holders of the CLO debt.

ITEM 3

Quantitative and Qualitative Disclosure of Market Risk

As of March 31, 2014, there were no material changes to the information provided in *Item 7A — Quantitative and Qualitative Disclosures about Market Risk* of AFG's 2013 Form 10-K.

ITEM 4

Controls and Procedures

AFG's management, with participation of its Co-Chief Executive Officers and its Chief Financial Officer, has evaluated AFG's disclosure controls and procedures (as defined in Exchange Act Rule 13a-15) as of the end of the period covered by this report. Based on that evaluation, AFG's Co-CEOs and CFO concluded that the controls and procedures are effective. There have been no changes in AFG's internal control over financial reporting during the first fiscal quarter of 2014 that materially affected, or are reasonably likely to materially affect, AFG's internal control over financial reporting.

In the ordinary course of business, AFG and its subsidiaries routinely enhance their information systems by either upgrading current systems or implementing new systems. There has been no change in AFG's business processes and procedures during the first fiscal quarter of 2014 that has materially affected, or is reasonably likely to materially affect, AFG's internal control over financial reporting.

**PART II
OTHER INFORMATION**

ITEM 2

Unregistered Sales of Equity Securities and Use of Proceeds

Issuer Purchases of Equity Securities AFG repurchased shares of its Common Stock during the first three months of 2014 as follows:

	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares that May Yet be Purchased Under the Plans or Programs (a)
January	—	\$ —	—	6,114,701
February	46,783	\$ 55.14	46,783	6,067,918
March	373,155	\$ 56.87	373,155	5,694,763
Total	419,938	\$ 56.68	419,938	

(a) Represents the remaining shares that may be repurchased under the Plans authorized by AFG's Board of Directors in August 2012 and February 2013.

In addition, AFG acquired 23,790 shares of its Common Stock (at an average of \$56.15 per share) in February 2014 in connection with its stock incentive plans.

ITEM 6

Exhibits

<u>Number</u>	<u>Exhibit Description</u>
12	Computation of ratios of earnings to fixed charges.
31(a)	Certification of Co-Chief Executive Officer pursuant to section 302(a) of the Sarbanes-Oxley Act of 2002.
31(b)	Certification of Co-Chief Executive Officer pursuant to section 302(a) of the Sarbanes-Oxley Act of 2002.
31(c)	Certification of Chief Financial Officer pursuant to section 302(a) of the Sarbanes-Oxley Act of 2002.
32	Certification of Co-Chief Executive Officers and Chief Financial Officer pursuant to section 906 of the Sarbanes-Oxley Act of 2002.
101	The following financial information from American Financial Group's Form 10-Q for the quarter ended March 31, 2014, formatted in XBRL (Extensible Business Reporting Language): <ul style="list-style-type: none">(i) Consolidated Balance Sheet(ii) Consolidated Statement of Earnings(iii) Consolidated Statement of Comprehensive Income(iv) Consolidated Statement of Changes in Equity(v) Consolidated Statement of Cash Flows(vi) Notes to Consolidated Financial Statements

Signature

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

American Financial Group, Inc.

May 9, 2014

By: /s/ Joseph E. (Jeff) Consolino
Joseph E. (Jeff) Consolino
Executive Vice President and Chief Financial Officer

AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES
COMPUTATION OF RATIOS OF EARNINGS TO FIXED CHARGES
(Dollars in Millions)

	Three months ended March 31, 2014	Year ended December 31, 2013
Earnings before income taxes	\$ 161	\$ 689
Undistributed equity in (earnings) losses of investees	(6)	—
Losses of managed investment entities attributable to noncontrolling interest	—	26
Fixed charges:		
Interest on annuities	168	531
Interest expense	18	71
Debt discount, expense and other fixed charges	—	1
Portion of rentals representing interest	5	19
EARNINGS	\$ 346	\$ 1,337
Fixed charges:		
Interest on annuities	\$ 168	\$ 531
Interest expense	18	71
Debt discount, expense and other fixed charges	—	1
Portion of rentals representing interest	5	19
FIXED CHARGES	\$ 191	\$ 622
Ratio of Earnings to Fixed Charges	1.81	2.15
Earnings in Excess of Fixed Charges	\$ 155	\$ 715

AMERICAN FINANCIAL GROUP, INC. 10-Q
SARBANES-OXLEY SECTION 302(a) CERTIFICATIONS

I, Carl H. Lindner III, certify that:

1. I have reviewed this quarterly report on Form 10-Q of American Financial Group, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
 - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

May 9, 2014

By: /s/ Carl H. Lindner III

Carl H. Lindner III

Co-Chief Executive Officer

AMERICAN FINANCIAL GROUP, INC. 10-Q
SARBANES-OXLEY SECTION 302(a) CERTIFICATIONS

I, S. Craig Lindner, certify that:

1. I have reviewed this quarterly report on Form 10-Q of American Financial Group, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
 - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

May 9, 2014

By: /s/ S. Craig Lindner

S. Craig Lindner

Co-Chief Executive Officer

AMERICAN FINANCIAL GROUP, INC. 10-Q
SARBANES-OXLEY SECTION 302(a) CERTIFICATIONS

I, Joseph E. (Jeff) Consolino, certify that:

1. I have reviewed this quarterly report on Form 10-Q of American Financial Group, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
 - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

May 9, 2014

By: /s/ Joseph E. (Jeff) Consolino

Joseph E. (Jeff) Consolino

Executive Vice President and Chief Financial Officer

AMERICAN FINANCIAL GROUP, INC. 10-Q

CERTIFICATION OF CHIEF EXECUTIVE OFFICER AND CHIEF FINANCIAL OFFICER

Pursuant to section 906 of the Sarbanes-Oxley Act of 2002

In connection with the filing with the Securities and Exchange Commission of the Quarterly Report of American Financial Group, Inc. (the "Company") on Form 10-Q for the period ended March 31, 2014 (the "Report"), the undersigned officers of the Company, certify, pursuant to section 906 of the Sarbanes-Oxley Act of 2002, that to the best of their knowledge:

- (1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

May 9, 2014

Date

By: /s/ S. Craig Lindner

S. Craig Lindner
Co-Chief Executive Officer

May 9, 2014

Date

By: /s/ Carl H. Lindner III

Carl H. Lindner III
Co-Chief Executive Officer

May 9, 2014

Date

By: /s/ Joseph E. (Jeff) Consolino

Joseph E. (Jeff) Consolino
Executive Vice President and Chief Financial Officer

A signed original of this written statement will be retained by the Registrant and furnished to the Securities and Exchange Commission or its staff upon request.