

CNA FINANCIAL CORP
Form 10-Q
November 05, 2018

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 September 30, 2018
OR

TRANSITION
REPORT
PURSUANT
TO SECTION
13 OR 15(d)
OF THE
SECURITIES
EXCHANGE
ACT OF 1934

For the transition period from _____ to _____
Commission File Number 1-5823

CNA FINANCIAL CORPORATION
(Exact name of registrant as specified in its charter)
Delaware 36-6169860
(State or other jurisdiction of (I.R.S. Employer
incorporation or organization) Identification No.)
151 N. Franklin 60606
Chicago, Illinois (Zip Code)
(Address of principal executive offices) (312) 822-5000
(Registrant's telephone number, including area code)

Not Applicable

(Former name, former address and former fiscal year, if changed since last report)

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 (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

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Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit such files).

Yes No

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

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

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Class	Outstanding at November 1, 2018
Common Stock, Par value \$2.50	271,410,714

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PART I. Financial Information

Item 1. Condensed Consolidated Financial Statements

CNA Financial Corporation

Condensed Consolidated Statements of Operations (Unaudited)

Periods ended September 30

(In millions, except per share data)

	Three Months		Nine Months	
	2018	2017	2018	2017
Revenues				
Net earned premiums	\$1,853	\$1,806	\$5,453	\$5,185
Net investment income	487	509	1,483	1,529
Net realized investment gains (losses):				
Other-than-temporary impairment losses	(3)	(5)	(9)	(9)
Other net realized investment gains (losses)	17	(19)	34	71
Net realized investment gains (losses)	14	(24)	25	62
Non-insurance warranty revenue (Note J)	258	99	744	290
Other revenues	10	8	26	28
Total revenues	2,622	2,398	7,731	7,094
Claims, Benefits and Expenses				
Insurance claims and policyholders' benefits	1,312	1,480	3,978	4,053
Amortization of deferred acquisition costs	337	309	992	926
Non-insurance warranty expense (Note J)	235	74	676	216
Other operating expenses	302	307	903	875
Interest	34	41	104	124
Total claims, benefits and expenses	2,220	2,211	6,653	6,194
Income before income tax	402	187	1,078	900
Income tax expense	(66)	(43)	(181)	(224)
Net income	\$336	\$144	\$897	\$676
Basic earnings per share	\$1.24	\$0.53	\$3.30	\$2.49
Diluted earnings per share	\$1.23	\$0.53	\$3.29	\$2.48
Dividends declared per share	\$0.35	\$0.30	\$2.95	\$2.80
Weighted Average Outstanding Common Stock and Common Stock Equivalents				
Basic	271.6	271.2	271.5	271.1
Diluted	272.5	272.1	272.4	272.0

The accompanying Notes are an integral part of these Condensed Consolidated Financial Statements (Unaudited).

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CNA Financial Corporation

Condensed Consolidated Statements of Comprehensive Income (Unaudited)

Periods ended September 30

(In millions)

Comprehensive Income

Net income

Other Comprehensive (Loss) Income, Net of Tax

Changes in:

Net unrealized gains on investments with other-than-temporary impairments

Net unrealized gains on other investments

Net unrealized gains on investments

Foreign currency translation adjustment

Pension and postretirement benefits

Other comprehensive (loss) income, net of tax

Total comprehensive income

The accompanying Notes are an integral part of these Condensed Consolidated Financial Statements (Unaudited).

	Three Months		Nine Months	
	2018	2017	2018	2017

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Condensed Consolidated Balance Sheets

(In millions, except share data)	September 30, 2018 (Unaudited)	December 31, 2017
Assets		
Investments:		
Fixed maturity securities at fair value (amortized cost of \$38,052 and \$38,215)	\$ 39,628	\$ 41,487
Equity securities at fair value (cost of \$784 and \$659)	795	695
Limited partnership investments	2,297	2,369
Other invested assets	51	44
Mortgage loans	868	839
Short term investments	1,290	1,436
Total investments	44,929	46,870
Cash	310	355
Reinsurance receivables (less allowance for uncollectible receivables of \$29 and \$29)	4,224	4,261
Insurance receivables (less allowance for uncollectible receivables of \$46 and \$44)	2,354	2,292
Accrued investment income	406	411
Deferred acquisition costs	654	634
Deferred income taxes	314	137
Property and equipment at cost (less accumulated depreciation of \$208 and \$274)	332	326
Goodwill	147	148
Other assets (Note A)	3,589	1,133
Total assets	\$ 57,259	\$ 56,567
Liabilities		
Insurance reserves:		
Claim and claim adjustment expenses	\$ 21,604	\$ 22,004
Unearned premiums	4,289	4,029
Future policy benefits	10,605	11,179
Short term debt	—	150
Long term debt	2,680	2,708
Other liabilities (includes \$52 and \$143 due to Loews Corporation) (Note A)	6,571	4,253
Total liabilities	45,749	44,323
Commitments and contingencies (Notes C and F)		
Stockholders' Equity		
Common stock (\$2.50 par value; 500,000,000 shares authorized; 273,040,243 shares issued; 271,410,714 and 271,205,390 shares outstanding)	683	683
Additional paid-in capital	2,186	2,175
Retained earnings	9,456	9,414
Accumulated other comprehensive (loss) income	(757) 32
Treasury stock (1,629,529 and 1,834,853 shares), at cost	(58) (60
Total stockholders' equity	11,510	12,244
Total liabilities and stockholders' equity	\$ 57,259	\$ 56,567
The accompanying Notes are an integral part of these Condensed Consolidated Financial Statements (Unaudited).		

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CNA Financial Corporation

Condensed Consolidated Statements of Cash Flows (Unaudited)

Nine months ended September 30

(In millions)

Cash Flows from Operating Activities

	2018	2017
Net income	\$897	\$676
Adjustments to reconcile net income to net cash flows provided by operating activities:		
Deferred income tax expense	37	125
Trading portfolio activity	2	8
Net realized investment gains	(25)	(62)
Equity method investees	136	89
Net amortization of investments	(48)	(30)
Depreciation and amortization	59	66
Changes in:		
Receivables, net	(47)	18
Accrued investment income	5	(31)
Deferred acquisition costs	(24)	(34)
Insurance reserves	108	248
Other assets	(193)	(121)
Other liabilities	(107)	(106)
Other, net	68	48
Total adjustments	(29)	218
Net cash flows provided by operating activities	868	894
Cash Flows from Investing Activities		
Dispositions:		
Fixed maturity securities - sales	6,622	4,167
Fixed maturity securities - maturities, calls and redemptions	1,838	2,635
Equity securities	69	22
Limited partnerships	304	160
Mortgage loans	83	22
Purchases:		
Fixed maturity securities	(8,244)	(6,877)
Equity securities	(177)	(18)
Limited partnerships	(380)	(85)
Mortgage loans	(112)	(153)
Change in other investments	(10)	(2)
Change in short term investments	158	(29)
Purchases of property and equipment	(87)	(80)
Other, net	16	20
Net cash flows provided (used) by investing activities	80	(218)

The accompanying Notes are an integral part of these Condensed Consolidated Financial Statements (Unaudited).

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Nine months ended September 30

(In millions)	2018	2017
Cash Flows from Financing Activities		
Dividends paid to common stockholders	\$(801)	\$(761)
Proceeds from the issuance of debt	—	496
Repayment of debt	(180)	(391)
Other, net	(8)	(17)
Net cash flows used by financing activities	(989)	(673)
Effect of foreign exchange rate changes on cash	(4)	9
Net change in cash	(45)	12
Cash, beginning of year	355	271
Cash, end of period	\$310	\$283

The accompanying Notes are an integral part of these Condensed Consolidated Financial Statements (Unaudited).

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CNA Financial Corporation

Condensed Consolidated Statements of Stockholders' Equity (Unaudited)

Nine months ended September 30

(In millions)	2018	2017
Common Stock		
Balance, beginning of period	\$683	\$683
Balance, end of period	683	683
Additional Paid-in Capital		
Balance, beginning of period	2,175	2,173
Stock-based compensation	11	(6)
Balance, end of period	2,186	2,167
Retained Earnings		
Balance, beginning of period, as previously reported	9,414	9,359
Cumulative effect adjustments from changes in accounting guidance, net of tax	(50)	—
Balance, beginning of period, as adjusted	9,364	9,359
Dividends to common stockholders	(805)	(762)
Net income	897	676
Balance, end of period	9,456	9,273
Accumulated Other Comprehensive (Loss) Income		
Balance, beginning of period, as previously reported	32	(173)
Cumulative effect adjustments from changes in accounting guidance, net of tax	(16)	—
Balance, beginning of period, as adjusted	16	(173)
Other comprehensive (loss) income	(773)	280
Balance, end of period	(757)	107
Treasury Stock		
Balance, beginning of period	(60)	(73)
Stock-based compensation	2	12
Balance, end of period	(58)	(61)
Total stockholders' equity	\$11,510	\$12,169

The accompanying Notes are an integral part of these Condensed Consolidated Financial Statements (Unaudited).

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CNA Financial Corporation

Notes to Condensed Consolidated Financial Statements (Unaudited)

Note A. General

Basis of Presentation

The Condensed Consolidated Financial Statements include the accounts of CNA Financial Corporation (CNAF) and its subsidiaries. Collectively, CNAF and its subsidiaries are referred to as CNA or the Company. Loews Corporation (Loews) owned approximately 89% of the outstanding common stock of CNAF as of September 30, 2018.

The accompanying Condensed Consolidated Financial Statements have been prepared in conformity with accounting principles generally accepted in the United States of America (GAAP). Intercompany amounts have been eliminated. Certain financial information that is normally included in annual financial statements prepared in accordance with GAAP, including certain financial statement notes, is not required for interim reporting purposes and has been condensed or omitted. These statements should be read in conjunction with the Consolidated Financial Statements and notes thereto included in CNAF's Annual Report on Form 10-K filed with the Securities and Exchange Commission for the year ended December 31, 2017, including the summary of significant accounting policies in Note A. The preparation of Condensed Consolidated Financial Statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the Condensed Consolidated Financial Statements and the reported amounts of revenues and expenses during the reporting period. Actual results may differ from those estimates.

The interim financial data as of September 30, 2018 and for the three and nine months ended September 30, 2018 and 2017 is unaudited. However, in the opinion of management, the interim data includes all adjustments, including normal recurring adjustments, necessary for a fair statement of the Company's results for the interim periods. The results of operations for the interim periods are not necessarily indicative of the results to be expected for the full year. Recently Adopted Accounting Standards Updates (ASU)

ASU 2014-09: In May 2014, the Financial Accounting Standards Board (FASB) issued ASU No. 2014-09, Revenue Recognition (Topic 606): Revenue from Contracts with Customers. The standard excludes from its scope the accounting for insurance contracts, financial instruments, and certain other agreements that are governed under other GAAP guidance. The updated guidance requires an entity to recognize revenue as performance obligations are met, in an amount that reflects the consideration the entity is entitled to receive for the transfer of the promised goods or services.

On January 1, 2018, the Company adopted the updated guidance using the modified retrospective method applied to all contracts which were not completed as of the date of adoption, with the cumulative effect recognized as an adjustment to the opening balance of Retained earnings. Prior period amounts have not been adjusted and continue to be reported in accordance with the previous accounting guidance.

Under the new guidance, revenue on warranty products and services was recognized more slowly compared to the historic revenue recognition pattern. In addition, for warranty products where the Company acts as the principal in the transaction, Non-insurance warranty revenue and Non-insurance warranty expense are increased to reflect the gross amount paid by consumers, including the retail seller's markup which is considered a commission to the Company's agent. This gross-up of revenue and expense also resulted in an increase to Other assets and Other liabilities on the Company's Condensed Consolidated Balance Sheets as the revenue and expense are recognized over the actuarially determined expected claims emergence pattern.

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The cumulative effect changes to the Condensed Consolidated Balance Sheet for the adoption of the updated guidance on January 1, 2018 were as follows:

(In millions)	Balance as of December 31, 2017	Adjustments Due to Adoption of Topic 606	Balance as of January 1, 2018
Other assets	\$ 1,133	\$ 1,882	\$ 3,015
Other liabilities	4,253	1,969	6,222
Deferred income taxes	137	21	158
Retained earnings	9,414	(66)	9,348

The impact of adoption on the Condensed Consolidated Statements of Operations and Balance Sheet was as follows:

(In millions)	Periods ended September 30, 2018			Periods ended September 30, 2018		
	Three Months	Three Months	As Reported	Nine Months	Nine Months	As Reported
	Prior to Adoption	Effect of Adoption	As Reported	Prior to Adoption	Effect of Adoption	As Reported
Statement of operations:						
Non-insurance warranty revenue	\$ 109	\$ 149	\$ 258	\$ 315	\$ 429	\$ 744
Total revenues	2,473	149	2,622	7,302	429	7,731
Non-insurance warranty expense	82	153	235	240	436	676
Total claims, benefits and expenses	2,067	153	2,220	6,217	436	6,653
Income before income tax	406	(4)	402	1,085	(7)	1,078
Income tax expense	(67)	1	(66)	(183)	2	(181)
Net income	339	(3)	336	902	(5)	897

Balance sheet⁽¹⁾ at September 30, 2018:

Other assets	\$ 3,284	\$ 305	\$ 3,589
Other liabilities	6,259	312	6,571
Deferred income taxes	312	2	314
Retained earnings	9,461	(5)	9,456

(1) The Prior to Adoption amounts presented in this table include the cumulative effect adjustment at adoption presented in the prior table.

See Note J to the Condensed Consolidated Financial Statements for additional information regarding non-insurance revenues from contracts with customers.

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ASU 2016-01: In January 2016, the FASB issued ASU No. 2016-01, Financial Instruments - Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities. The updated accounting guidance requires changes to the reporting model for financial instruments. The guidance primarily changes the model for equity securities by requiring changes in the fair value of equity securities (except those accounted for under the equity method of accounting, those without readily determinable fair values and those that result in consolidation of the investee) to be recognized through the income statement. The Company adopted the updated guidance on January 1, 2018 and recognized a cumulative effect adjustment that increased beginning Retained earnings by \$28 million, net of tax. Prior period amounts have not been adjusted and continue to be reported in accordance with the previous accounting guidance.

For the three and nine months ended September 30, 2018, the Company recognized \$2 million in pretax gains and \$23 million in pretax losses within Net realized investment gains (losses) for the change in fair value of non-redeemable preferred stock and \$1 million in pretax losses and \$1 million in pretax gains within Net investment income for the change in fair value of common stock as a result of this change. For the three and nine months ended September 30, 2017, there was a \$1 million increase and less than a \$1 million increase in the fair value of common stock and less than a \$1 million increase and a \$7 million increase in the fair value of non-redeemable preferred stock recognized in Other comprehensive income. The Company's non-redeemable preferred stock contain characteristics of debt securities, are priced similarly to bonds, and are held primarily for income generation through periodic dividends. While recognition of gains and losses on these securities are no longer discretionary, management does not consider the changes in fair value of non-redeemable preferred stock to be reflective of our primary operations. As such, the changes in the fair value of these securities are recorded through Net realized investments gains (losses). The Company owns certain common stock with the intention of holding the securities primarily for market appreciation and as such, the changes in the fair value of these securities are recorded through Net investment income.

ASU 2017-07: In March 2017, the FASB issued ASU No. 2017-07, Compensation-Retirement Benefits (Topic 715): Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost. The updated accounting guidance requires changes to the presentation of the components of net periodic benefit cost on the income statement by requiring service cost to be presented with other employee compensation costs and other components of net periodic pension cost to be presented outside of any subtotal of operating income. The ASU also stipulates that only the service cost component of net benefit cost is eligible for capitalization. The Company adopted the updated guidance effective January 1, 2018. The guidance was applied on a prospective basis for capitalization of service costs and on a retrospective basis for the presentation of the service cost and other components of net periodic benefit costs in the Company's Condensed Consolidated Statements of Operations and in its disclosures. The Company expanded the related footnote disclosure, Note G to the Condensed Consolidated Financial Statements, to disclose the amount of service cost and non-service cost components of net periodic benefit cost and the line items in the Condensed Consolidated Statements of Operations in which such amounts are reported. The change limiting the costs eligible for capitalization is not material to the Company's results of operations or financial position.

ASU 2018-02: In February 2018, the FASB issued ASU No. 2018-02, Income Statement - Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income.

GAAP requires the remeasurement of deferred tax assets and liabilities due to a change in the tax rate to be included in Net income, even if the related income tax effects were originally recognized in Accumulated other comprehensive income (AOCI). The ASU allows a reclassification from AOCI to Retained earnings for stranded tax effects resulting from the new U.S. Federal corporate income tax rate enacted on December 22, 2017. The Company early adopted the updated guidance effective January 1, 2018 and elected to reclassify the stranded income tax effects relating to the reduction in the Federal corporate income tax rate from AOCI to Retained earnings at the beginning of the period of adoption. The net impact of the accounting change resulted in a \$12 million increase in AOCI and a corresponding decrease in Retained earnings. The \$12 million increase in AOCI is comprised of a \$142 million increase in net unrealized gains (losses) on investments partially offset by a \$130 million decrease in unrecognized pension and postretirement benefits.

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The Company releases tax effects from AOCI utilizing the security-by-security approach for Net unrealized gains (losses) on investments with Other-than-temporary impairment (OTTI) losses and Net unrealized gains (losses) on other investments. For Pension and postretirement benefits, tax effects from AOCI are released at enacted tax rates based on the pre-tax adjustments to pension liabilities or assets recognized within OCI.

ASU 2018-13: In August 2018, the FASB issued ASU No. 2018-13, Fair Value Measurement (Topic 820) Disclosure Framework - Changes to the Disclosure Requirements for Fair Value Measurement. The updated accounting guidance requires changes to the disclosures for fair value measurement by adding, removing and modifying disclosures. This guidance is effective for fiscal years beginning after December 15, 2019, including interim periods therein and early adoption is permitted. As of September 30, 2018, the Company adopted the updated guidance and added disclosures on changes in unrealized gains (losses) on Level 3 assets recognized in Other comprehensive income as well as the weighted average rate used to develop significant inputs utilized in the fair value measurements of Level 3 assets. The Company also eliminated disclosures on the amount of transfers between Level 1 and Level 2 assets and the policy for timing of transfers between Levels.

Accounting Standards Pending Adoption

In February 2016, the FASB issued ASU No. 2016-02, Leases (Topic 842): Accounting for Leases. The updated accounting guidance requires lessees to recognize on the balance sheet assets and liabilities for the rights and obligations created by the majority of leases, including those historically accounted for as operating leases. The guidance is effective for interim and annual periods beginning after December 15, 2018 and prescribes a modified retrospective transition method but allows entities to utilize a practical expedient and apply the guidance prospectively beginning with the adoption date. The Company has decided to utilize the practical expedient. The Company is currently evaluating the effect the updated guidance will have on the Company's financial statements. It is expected that assets and liabilities will increase based on the present value of remaining lease payments for leases in place at the adoption date; however, this is not expected to be material to the Company's results of operations or financial position. In June 2016, the FASB issued ASU No. 2016-13, Financial Instruments-Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments. The updated accounting guidance requires changes to the recognition of credit losses on financial instruments not accounted for at fair value through net income. The guidance is effective for interim and annual periods beginning after December 15, 2019. The Company is currently evaluating the effect the guidance will have on the Company's financial statements, but expects the primary changes to be the use of the expected credit loss model for its mortgage loan portfolio and reinsurance receivables and the use of the allowance method rather than the write-down method for credit losses within the available-for-sale fixed maturities portfolio. The expected credit loss model will require a financial asset to be presented at the net amount expected to be collected. The allowance method for available-for-sale debt securities will allow the Company to record reversals of credit losses if the estimate of credit losses declines.

In August 2018, the FASB issued ASU 2018-12, Financial Services-Insurance (Topic 944): Targeted Improvements to the Accounting for Long-Duration Contracts. The updated accounting guidance requires changes to the measurement and disclosure of long-duration contracts. The standard requires entities to annually update cash flow assumptions, including morbidity and persistency, and update discount rate assumptions quarterly using an upper-medium grade fixed-income instrument yield. The effect of changes in cash flow assumptions will be recorded in Net income and the effect of changes in discount rate assumptions will be recorded in Other comprehensive income.

This guidance is effective for interim and annual periods beginning after December 15, 2020, and requires restatement of the prior periods presented. Early adoption is permitted. The Company is currently evaluating the method and timing of adoption and the effect the updated guidance will have on its financial statements. The annual updating of cash flow assumptions is expected to increase income statement volatility. The quarterly change in discount rate is expected to increase volatility in the Company's stockholders' equity, but that will be somewhat mitigated because Shadow Adjustments are eliminated under the new guidance.

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In August 2018, the FASB issued ASU No. 2018-14, Compensation - Retirement Benefits - Defined Benefit Plans - General (Subtopic 715-20) Disclosure Framework - Changes to the Disclosure Requirements for Defined Benefit Plans. The updated accounting guidance modifies the disclosure requirements for employers that sponsor defined benefit pension or other postretirement plans by removing, modifying and adding disclosures. The guidance is effective for annual periods ending after December 15, 2020, and early adoption is permitted. The Company anticipates early adopting this standard in the fourth quarter of 2018.

Income Tax Reform Update

On December 22, 2017, H.R.1, "An Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018," was signed into law (Tax Reform Legislation).

Shortly after enactment, the Securities and Exchange Commission Staff issued Staff Accounting Bulletin No. 118 (SAB 118) to provide guidance on accounting for the Tax Reform Legislation impacts when the measurements of the income tax effects are complete, incomplete, or incomplete but for which a provisional amount can be estimated. SAB 118 permits the recognition of provisional amounts, and adjustments to provisional amounts, in subsequent reporting periods within the one year measurement period.

The Company has reflected the following incomplete but reasonably estimated provisional items in Deferred income taxes on the Condensed Consolidated Balance Sheet at September 30, 2018. Adjustments to the Company's provisional amounts for the three and nine months ended September 30, 2018 did not impact income tax expense.

• The Company has recalculated its insurance reserves and the transition adjustment from existing law.

• The Company has recalculated amounts under special accounting method provisions for recognizing income for Federal income tax purposes no later than for financial accounting purposes and the transition adjustment from existing law.

• The Company has not recorded current or deferred taxes with respect to the international provisions since it does not expect to have inclusions in U.S. taxable income for certain earnings of foreign subsidiaries in future years.

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Note B. Earnings (Loss) Per Share

Earnings (loss) per share is based on the weighted average number of outstanding common shares. Basic earnings (loss) per share excludes the impact of dilutive securities and is computed by dividing Net income (loss) by the weighted average number of common shares outstanding for the period. Diluted earnings (loss) per share reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock.

For the three and nine months ended September 30, 2018, approximately 900 thousand and 925 thousand potential shares attributable to exercises or conversions into common stock under stock-based employee compensation plans were included in the calculation of diluted earnings per share. For those same periods, approximately 1 thousand and 3 thousand potential shares attributable to exercises or conversions into common stock under stock-based employee compensation plans were not included in the calculation of diluted earnings per share, because the effect would have been antidilutive.

For the three and nine months ended September 30, 2017, approximately 907 thousand and 916 thousand potential shares attributable to exercises or conversions into common stock under stock-based employee compensation plans were included in the calculation of diluted earnings per share. For those same periods, less than 1 thousand and approximately 4 thousand potential shares attributable to exercises or conversions into common stock under stock-based employee compensation plans were not included in the calculation of diluted earnings per share, because the effect would have been antidilutive.

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Note C. Investments

The significant components of Net investment income are presented in the following table.

Periods ended September 30	Three Months		Nine Months	
	2018	2017	2018	2017
(In millions)				
Fixed maturity securities	\$449	\$455	\$1,339	\$1,367
Equity securities	10	1	32	4
Limited partnership investments	23	51	93	157
Mortgage loans	11	9	36	24
Short term investments	6	4	18	10
Trading portfolio	1	3	6	9
Other	1	1	4	2
Gross investment income	501	524	1,528	1,573
Investment expense	(14)	(15)	(45)	(44)
Net investment income	\$487	\$509	\$1,483	\$1,529

During the three and nine months ended September 30, 2018, Net investment income was reduced by a \$2 million loss due to the change in fair value of common stock still held as of September 30, 2018.

Net realized investment gains (losses) are presented in the following table.

Periods ended September 30	Three Months		Nine Months	
	2018	2017	2018	2017
(In millions)				
Net realized investment gains (losses):				
Fixed maturity securities:				
Gross realized gains	\$42	\$34	\$148	\$139
Gross realized losses	(32)	(18)	(116)	(47)
Net realized investment gains (losses) on fixed maturity securities	10	16	32	92
Equity securities	2	—	(23)	—
Derivatives	1	(1)	10	(3)
Short term investments and other	1	(39)	6	(27)
Net realized investment gains (losses)	\$14	\$(24)	\$25	\$62

During the three and nine months ended September 30, 2018, \$2 million of Net realized investment gains and \$23 million of Net realized investment losses were recognized due to the change in fair value of non-redeemable preferred stock still held as of September 30, 2018. Net realized investment gains (losses) for the three and nine months ended September 30, 2017 included a \$42 million loss related to the redemption of the Company's \$350 million senior notes due November 2019.

The components of OTTI losses recognized in earnings by asset type are presented in the following table.

Periods ended September 30	Three Months		Nine Months	
	2018	2017	2018	2017
(In millions)				
Fixed maturity securities available-for-sale:				
Corporate and other bonds	\$ 1	\$ 4	\$ 6	\$ 8
Asset-backed	2	1	3	1
OTTI losses recognized in earnings	\$ 3	\$ 5	\$ 9	\$ 9

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The following tables present a summary of fixed maturity and equity securities.

September 30, 2018 ⁽¹⁾

(In millions)	Cost or Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value	Unrealized OTTI Losses (Gains)
Fixed maturity securities available-for-sale:					
Corporate and other bonds	\$ 18,348	\$ 887	\$ 215	\$ 19,020	\$ —
States, municipalities and political subdivisions	10,171	994	20	11,145	—
Asset-backed:					
Residential mortgage-backed	5,024	62	115	4,971	(24)
Commercial mortgage-backed	2,165	23	36	2,152	—
Other asset-backed	1,732	6	9	1,729	—
Total asset-backed	8,921	91	160	8,852	(24)
U.S. Treasury and obligations of government-sponsored enterprises	145	2	2	145	—
Foreign government	457	4	6	455	—
Redeemable preferred stock	9	1	—	10	—
Total fixed maturity securities available-for-sale	38,051	1,979	403	39,627	\$ (24)
Total fixed maturity securities trading	1			1	
Total fixed maturity securities	\$ 38,052	\$ 1,979	\$ 403	\$ 39,628	

December 31, 2017

(In millions)	Cost or Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value	Unrealized OTTI Losses (Gains)
Fixed maturity securities available-for-sale:					
Corporate and other bonds	\$ 17,210	\$ 1,625	\$ 28	\$ 18,807	\$ —
States, municipalities and political subdivisions	12,478	1,551	2	14,027	(11)
Asset-backed:					
Residential mortgage-backed	5,043	109	32	5,120	(27)
Commercial mortgage-backed	1,840	46	14	1,872	—
Other asset-backed	1,083	16	5	1,094	—
Total asset-backed	7,966	171	51	8,086	(27)
U.S. Treasury and obligations of government-sponsored enterprises	111	2	4	109	—
Foreign government	437	9	2	444	—
Redeemable preferred stock	10	1	—	11	—
Total fixed maturity securities available-for-sale	38,212	3,359	87	41,484	\$ (38)
Total fixed maturity securities trading	3			3	
Equity securities available-for-sale:					
Common stock	21	7	1	27	
Preferred stock	638	31	1	668	
Total equity securities available-for-sale	659	38	2	695	
Total fixed maturity and equity securities	\$ 38,874	\$ 3,397	\$ 89	\$ 42,182	

As of January 1, 2018, the Company adopted ASU 2016-01, Financial Instruments - Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities. The change in fair value of equity securities is now recognized through the income statement. See Note A to the Condensed Consolidated Financial Statements for additional information.

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The net unrealized gains on investments included in the tables above are recorded as a component of AOCI. When presented in AOCI, these amounts are net of tax and any required Shadow Adjustments. To the extent that unrealized gains on fixed income securities supporting certain products within the Life & Group segment would result in a premium deficiency if realized, a related increase in Insurance reserves is recorded, net of tax, as a reduction of net unrealized gains through Other comprehensive income (loss) (Shadow Adjustments). As of September 30, 2018 and December 31, 2017, the net unrealized gains on investments included in AOCI were correspondingly reduced by Shadow Adjustments of \$1,115 million and \$1,411 million.

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The following tables present the estimated fair value and gross unrealized losses of fixed maturity and equity securities in a gross unrealized loss position by the length of time in which the securities have continuously been in that position.

September 30, 2018 ⁽¹⁾ (In millions)	Less than 12 Months		12 Months or Longer		Total	
	Estimated Fair Value	Gross Unrealized Losses	Estimated Fair Value	Gross Unrealized Losses	Estimated Fair Value	Gross Unrealized Losses
Fixed maturity securities available-for-sale:						
Corporate and other bonds	\$7,546	\$ 197	\$342	\$ 18	\$7,888	\$ 215
States, municipalities and political subdivisions	807	19	2	1	809	20
Asset-backed:						
Residential mortgage-backed	3,409	89	501	26	3,910	115
Commercial mortgage-backed	968	15	322	21	1,290	36
Other asset-backed	953	9	45	—	998	9
Total asset-backed	5,330	113	868	47	6,198	160
U.S. Treasury and obligations of government-sponsored enterprises	35	—	42	2	77	2
Foreign government	188	4	64	2	252	6
Total	\$13,906	\$ 333	\$1,318	\$ 70	\$15,224	\$ 403

December 31, 2017 (In millions)	Less than 12 Months		12 Months or Longer		Total	
	Estimated Fair Value	Gross Unrealized Losses	Estimated Fair Value	Gross Unrealized Losses	Estimated Fair Value	Gross Unrealized Losses
Fixed maturity securities available-for-sale:						
Corporate and other bonds	\$1,354	\$ 21	\$168	\$ 7	\$1,522	\$ 28
States, municipalities and political subdivisions	72	1	85	1	157	2
Asset-backed:						
Residential mortgage-backed	1,228	5	947	27	2,175	32
Commercial mortgage-backed	403	4	212	10	615	14
Other asset-backed	248	3	18	2	266	5
Total asset-backed	1,879	12	1,177	39	3,056	51
U.S. Treasury and obligations of government-sponsored enterprises	49	2	21	2	70	4
Foreign government	166	2	4	—	170	2
Total fixed maturity securities available-for-sale	3,520	38	1,455	49	4,975	87
Equity securities available-for-sale:						
Common stock	7	1	—	—	7	1
Preferred stock	93	1	—	—	93	1
Total equity securities available-for-sale	100	2	—	—	100	2
Total	\$3,620	\$ 40	\$1,455	\$ 49	\$5,075	\$ 89

As of January 1, 2018, the Company adopted ASU 2016-01, Financial Instruments - Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities. The change in fair value of equity securities is now recognized through the income statement. See Note A to the Condensed Consolidated Financial Statements for additional information.

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Based on current facts and circumstances, the Company believes the unrealized losses presented in the September 30, 2018 securities in a gross unrealized loss position table above are not indicative of the ultimate collectibility of the current amortized cost of the securities, but rather are attributable to changes in interest rates, credit spreads and other factors. The Company has no current intent to sell securities with unrealized losses, nor is it more likely than not that it will be required to sell prior to recovery of amortized cost; accordingly, the Company has determined that there are no additional OTTI losses to be recorded as of September 30, 2018.

The following table presents the activity related to the pretax credit loss component reflected in Retained earnings on fixed maturity securities still held as of September 30, 2018 and 2017 and for which a portion of an OTTI loss was recognized in Other comprehensive income (loss).

Periods ended September 30	Three		Nine	
	Months		Months	
(In millions)	2018	2017	2018	2017
Beginning balance of credit losses on fixed maturity securities	\$21	\$30	\$27	\$36
Reductions for securities sold during the period	(2)	(2)	(8)	(8)
Ending balance of credit losses on fixed maturity securities	\$19	\$28	\$19	\$28

Contractual Maturity

The following table presents available-for-sale fixed maturity securities by contractual maturity.

(In millions)	September 30, 2018		December 31, 2017	
	Cost or Amortized Cost	Estimated Fair Value	Cost or Amortized Cost	Estimated Fair Value
Due in one year or less	\$1,457	\$ 1,473	\$1,135	\$ 1,157
Due after one year through five years	8,017	8,197	8,165	8,501
Due after five years through ten years	16,453	16,475	16,060	16,718
Due after ten years	12,124	13,482	12,852	15,108
Total	\$38,051	\$ 39,627	\$38,212	\$ 41,484

Actual maturities may differ from contractual maturities because certain securities may be called or prepaid. Securities not due at a single date are allocated based on weighted average life.

Derivative Financial Instruments

The Company holds an embedded derivative on a funds withheld liability with a notional value of \$174 million and \$167 million as of September 30, 2018 and December 31, 2017 and a fair value of \$6 million and \$(3) million as of September 30, 2018 and December 31, 2017. The embedded derivative on the funds withheld liability is accounted for separately and reported with the funds withheld liability in Other liabilities on the Condensed Consolidated Balance Sheets.

Investment Commitments

As of September 30, 2018, the Company had committed approximately \$605 million to future capital calls from various third-party limited partnership investments in exchange for an ownership interest in the related partnerships. As of September 30, 2018, the Company had mortgage loan commitments of \$16 million representing signed loan applications received and accepted.

The Company invests in various privately placed debt securities, including bank loans, as part of its overall investment strategy and has committed to additional future purchases, sales and funding. Purchases and sales of privately placed debt securities are recorded once funded. As of September 30, 2018, the Company had commitments to purchase or fund additional amounts of \$282 million and sell \$87 million under the terms of such securities.

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Note D. Fair Value

Fair value is the price that would be received upon sale of an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The following fair value hierarchy is used in selecting inputs, with the highest priority given to Level 1, as these are the most transparent or reliable.

Level 1 - Quoted prices for identical instruments in active markets.

Level 2 - Quoted prices for similar instruments in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations in which all significant inputs are observable in active markets.

Level 3 - Valuations derived from valuation techniques in which one or more significant inputs are not observable. Prices may fall within Level 1, 2 or 3 depending upon the methodology and inputs used to estimate fair value for each specific security. In general, the Company seeks to price securities using third-party pricing services. Securities not priced by pricing services are submitted to independent brokers for valuation and, if those are not available, internally developed pricing models are used to value assets using a methodology and inputs the Company believes market participants would use to value the assets. Prices obtained from third-party pricing services or brokers are not adjusted by the Company.

The Company performs control procedures over information obtained from pricing services and brokers to ensure prices received represent a reasonable estimate of fair value and to confirm representations regarding whether inputs are observable or unobservable. Procedures may include i) the review of pricing service methodologies or broker pricing qualifications, ii) back-testing, where past fair value estimates are compared to actual transactions executed in the market on similar dates, iii) exception reporting, where period-over-period changes in price are reviewed and challenged with the pricing service or broker based on exception criteria, iv) deep dives, where the Company performs an independent analysis of the inputs and assumptions used to price individual securities and v) pricing validation, where prices received are compared to prices independently estimated by the Company.

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Assets and Liabilities Measured at Fair Value

Assets and liabilities measured at fair value on a recurring basis are presented in the following tables. Corporate bonds and other includes obligations of the U.S. Treasury, government-sponsored enterprises, foreign governments and redeemable preferred stock.

September 30, 2018

(In millions)	Level	Level 2	Level	Total Assets/Liabilities at Fair Value
	1		3	
Assets				
Fixed maturity securities:				
Corporate bonds and other	\$ 183	\$ 19,260	\$ 188	\$ 19,631
States, municipalities and political subdivisions	—	11,145	—	11,145
Asset-backed	—	8,554	298	8,852
Total fixed maturity securities	183	38,959	486	39,628
Equity securities:				
Common stock	101	—	4	105
Non-redeemable preferred stock	51	625	14	690
Total equity securities	152	625	18	795
Short term and other	252	931	—	1,183
Total assets	\$ 587	\$ 40,515	\$ 504	\$ 41,606
Liabilities				
Other liabilities	\$—	\$(6)	\$—	\$(6)
Total liabilities	\$—	\$(6)	\$—	\$(6)

December 31, 2017

(In millions)	Level	Level 2	Level	Total Assets/Liabilities at Fair Value
	1		3	
Assets				
Fixed maturity securities:				
Corporate bonds and other	\$ 128	\$ 19,148	\$ 98	\$ 19,374
States, municipalities and political subdivisions	—	14,026	1	14,027
Asset-backed	—	7,751	335	8,086
Total fixed maturity securities	128	40,925	434	41,487
Equity securities:				
Common stock	23	—	4	27
Non-redeemable preferred stock	68	584	16	668
Total equity securities	91	584	20	695
Short term and other	396	958	—	1,354
Total assets	\$ 615	\$ 42,467	\$ 454	\$ 43,536
Liabilities				
Other liabilities	\$—	\$ 3	\$—	\$ 3
Total liabilities	\$—	\$ 3	\$—	\$ 3

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The tables below present a reconciliation for all assets and liabilities measured at fair value on a recurring basis using significant unobservable inputs (Level 3).

Level 3 (In millions)	Corporate bonds and other	States, municipalities and political subdivisions	Asset-backed	Equity securities	Derivative financial instruments	Total
Balance as of July 1, 2018	\$ 94	\$ 1	\$ 273	\$ 17	\$	—\$385
Total realized and unrealized investment gains (losses):						
Reported in Net realized investment gains (losses)	—	—	(2)	1	—	(1)
Reported in Net investment income	—	—	—	—	—	—
Reported in Other comprehensive income	—	—	—	—	—	—
Total realized and unrealized investment gains (losses)						