MERCURY GENERAL CORP
Form 10-Q
October 30, 2013
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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 Quarter Ended September 30, 2013
Commission File No. 001-12257

MERCURY GENERAL CORPORATION
(Exact name of registrant as specified in its charter)

California	95-2211612
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
4484 Wilshire Boulevard, Los Angeles, California	90010
(Address of principal executive offices)	(Zip Code)

Registrant’s telephone number, including area code: (323) 937-1060

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 ý No o

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 (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ý No o

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 definition of “large accelerated filer,” “accelerated filer,” and “smaller reporting company” in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer	ý	Accelerated filer	o
Non-accelerated filer	o (Do not check if a smaller reporting company)	Smaller reporting company	o

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

At October 25, 2013, the Registrant had issued and outstanding an aggregate of 54,960,392 shares of its Common Stock.

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PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

MERCURY GENERAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(in thousands)

	September 30, 2013 (unaudited)	December 31, 2012
ASSETS		
Investments, at fair value:		
Fixed maturity securities (amortized cost $2,481,651; $2,270,903)	$2,538,514	$2,408,354
Equity securities (cost $267,614; $475,959)	336,367	477,088
Short-term investments (cost $251,550; $294,607)	251,449	294,653
Total investments	3,126,330	3,180,095
Cash	250,061	158,183
Receivables:		
Premiums	372,818	345,387
Accrued investment income	35,316	31,109
Other	18,399	17,756
Total receivables	426,533	394,252
Deferred policy acquisition costs	196,284	185,910
Fixed assets, net	154,467	161,940
Current income taxes	0	7,058
Deferred income taxes	26,437	0
Goodwill	42,796	42,796
Other intangible assets, net	43,098	47,589
Other assets	74,450	11,863
Total assets	$4,340,456	$4,189,686
LIABILITIES AND SHAREHOLDERS' EQUITY		
Losses and loss adjustment expenses	$1,010,534	$1,036,123
Unearned premiums	967,320	920,429
Notes payable	180,000	140,000
Accounts payable and accrued expenses	133,973	96,220
Current income taxes	26,324	0
Deferred income taxes	0	445
Other liabilities	182,150	153,972
Total liabilities	2,500,301	2,347,189
Commitments and contingencies		
Shareholders' equity:		
Common stock without par value or stated value: Authorized 70,000 shares; issued and outstanding 54,960; 54,922	81,109	79,380
Additional paid-in capital	128	0
Retained earnings	1,758,918	1,763,117
Total shareholders' equity	1,840,155	1,842,497
Total liabilities and shareholders' equity	$4,340,456	$4,189,686

See accompanying Condensed Notes to Consolidated Financial Statements.

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MERCURY GENERAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share data)
(unaudited)

	Three Months Ended September 30,	
	2013	2012
Revenues:		
Net premiums earned	$678,913	$646,084
Net investment income	30,857	33,410
Net realized investment gains	16,212	49,752
Other	2,685	2,532
Total revenues	728,667	731,778
Expenses:		
Losses and loss adjustment expenses	492,558	467,929
Policy acquisition costs	126,891	121,906
Other operating expenses	54,087	50,225
Interest	338	388
Total expenses	673,874	640,448
Income before income taxes	54,793	91,330
Income tax expense	15,223	25,129
Net income	$39,570	$66,201
Net income per share:		
Basic	$0.72	$1.21
Diluted	$0.72	$1.21
Weighted average shares outstanding:		
Basic	54,959	54,911
Diluted	54,973	54,925
Dividends paid per share	$0.6125	$0.61

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(in thousands)
(unaudited)

	Three Months Ended September 30,	
	2013	2012
Net income	$39,570	$66,201
Other comprehensive income, before tax:		
Gains on hedging instrument	0	0
Other comprehensive income, before tax:	0	0
Income tax expense related to gains on hedging instrument	0	0
Other comprehensive income, net of tax:	0	0
Comprehensive income	$39,570	$66,201

See accompanying Condensed Notes to Consolidated Financial Statements.

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MERCURY GENERAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share data)
(unaudited)

	Nine Months Ended September 30,	
	2013	2012
Revenues:		
Net premiums earned	$2,017,295	$1,919,143
Net investment income	93,706	96,569
Net realized investment (losses) gains	(7,153)	78,656
Other	7,539	7,790
Total revenues	2,111,387	2,102,158
Expenses:		
Losses and loss adjustment expenses	1,446,524	1,415,096
Policy acquisition costs	377,006	357,062
Other operating expenses	166,165	154,353
Interest	864	1,176
Total expenses	1,990,559	1,927,687
Income before income taxes	120,828	174,471
Income tax expense	24,061	40,178
Net income	$96,767	$134,293
Net income per share:		
Basic	$1.76	$2.45
Diluted	$1.76	$2.45
Weighted average shares outstanding:		
Basic	54,941	54,895
Diluted	54,957	54,918
Dividends paid per share	$1.8375	$1.83

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(in thousands)
(unaudited)

	Nine Months Ended September 30,	
	2013	2012
Net income	$96,767	$134,293
Other comprehensive income, before tax:		
Gains on hedging instrument	0	0
Other comprehensive income, before tax:	0	0
Income tax expense related to gains on hedging instrument	0	0
Other comprehensive income, net of tax:	0	0
Comprehensive income	$96,767	$134,293

See accompanying Condensed Notes to Consolidated Financial Statements.

MERCURY GENERAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(unaudited)

	Nine Months Ended September 30, 2013	2012
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	$96,767	$134,293
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	23,715	27,903
Net realized investment losses (gains)	7,153	(78,656)
Bond amortization, net	8,659	6,613
Excess tax benefit from exercise of stock options	(258)	(116)
Increase in premiums receivables	(27,431)	(57,518)
Change in current and deferred income taxes	6,758	10,848
Increase in deferred policy acquisition costs	(10,374)	(14,883)
Decrease in unpaid losses and loss adjustment expenses	(25,589)	(6,859)
Increase in unearned premiums	46,891	77,849
Increase in accounts payable and accrued expenses	38,749	6,553
Share-based compensation	216	312
Changes in other payables	9,142	10,503
Other, net	(4,681)	(3,512)
Net cash provided by operating activities	169,717	113,330
CASH FLOWS FROM INVESTING ACTIVITIES		
Fixed maturities available-for-sale in nature:		
Purchases	(625,326)	(386,262)
Sales	172,557	78,341
Calls or maturities	232,426	328,592
Equity securities available-for-sale in nature:		
Purchases	(463,056)	(236,785)
Sales	677,017	172,144
Calls	0	923
Changes in securities payable and receivable	(43,918)	(1,320)
Net decrease in short-term investments	42,614	14,510
Purchase of fixed assets	(12,983)	(12,205)
Sale of fixed assets	610	1,864
Other, net	1,547	1,904
Net cash used in investing activities	(18,512)	(38,294)
CASH FLOWS FROM FINANCING ACTIVITIES		
Dividends paid to shareholders	(100,967)	(100,469)
Proceeds from bank loan	40,000	0
Excess tax benefit from exercise of stock options	258	116
Proceeds from stock options exercised	1,382	2,098
Net cash used in financing activities	(59,327)	(98,255)
Net increase (decrease) in cash	91,878	(23,219)
Cash:		
Beginning of the year	158,183	211,393
End of period	$250,061	$188,174

SUPPLEMENTAL CASH FLOW DISCLOSURE		
Interest paid	$796	$1,319
Income taxes paid	$17,303	$29,330

See accompanying Condensed Notes to Consolidated Financial Statements.

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MERCURY GENERAL CORPORATION AND SUBSIDIARIES
CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

1. General

Consolidation and Basis of Presentation

The condensed consolidated financial statements include the accounts of Mercury General Corporation and its subsidiaries (referred to herein collectively as the "Company"). For the list of the Company's subsidiaries, see Note 1 "Summary of Significant Accounting Policies" of the Notes to Consolidated Financial Statements in the Company's Annual Report on Form 10-K for the year ended December 31, 2012.

The condensed consolidated financial statements have been prepared in conformity with U.S. generally accepted accounting principles ("GAAP"), which differ in some respects from those filed in reports to insurance regulatory authorities. All intercompany transactions and balances have been eliminated.

The financial data of the Company included herein are unaudited. In the opinion of management, all material adjustments of a normal recurring nature have been made to present fairly the Company's financial position at September 30, 2013 and the results of operations, comprehensive income, and cash flows for the periods presented. These statements were prepared in accordance with the instructions for interim reporting and do not contain certain information in the annual financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2012. Readers are urged to review the Company's Annual Report on Form 10-K for the year ended December 31, 2012 for more complete descriptions and discussions. Operating results and cash flows for the nine months ended September 30, 2013 are not necessarily indicative of the results that may be expected for the year ending December 31, 2013.

Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosures of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. These estimates require the Company to apply complex assumptions and judgments, and often the Company must make estimates about effects of matters that are inherently uncertain and will likely change in subsequent periods. The most significant assumptions in the preparation of these condensed consolidated financial statements relate to reserves for losses and loss adjustment expenses. Actual results could differ from those estimates (See Note 1 "Summary of Significant Accounting Policies" of the Notes to Consolidated Financial Statements in the Company's Annual Report on Form 10-K for the year ended December 31, 2012).

Earnings per Share

Potentially dilutive securities representing approximately 53,000 and 108,000 shares of common stock for the three months ended September 30, 2013 and 2012, respectively, and 76,000 and 77,000 shares of common stock for the nine months ended September 30, 2013 and 2012, respectively, were excluded from the computation of diluted earnings per common share for these periods because their effect would have been anti-dilutive.

Deferred Policy Acquisition Costs

Deferred policy acquisition costs consist of commissions paid to outside agents, premium taxes, salaries, and certain other underwriting costs that are incremental or directly related to the successful acquisition of new and renewal insurance contracts and are amortized over the life of the related policy in proportion to premiums earned. Deferred policy acquisition costs are limited to the amount that will remain after deducting from unearned premiums and anticipated investment income, the estimated losses and loss adjustment expenses, and the servicing costs that will be incurred as premiums are earned. The Company's deferred policy acquisition costs are further limited by excluding those costs not directly related to the successful acquisition of insurance contracts. Deferred policy acquisition cost amortization was $126.9 million and $121.9 million for the three months ended September 30, 2013 and 2012, respectively, and $377.0 million and $357.1 million for the nine months ended September 30, 2013 and 2012, respectively. The Company does not defer advertising expenditures but expenses them as incurred. The Company recorded net advertising expenses of approximately $16 million and $15 million for the nine months ended September 30, 2013 and 2012, respectively.

Total Return Swap

As of September 30, 2013, the Company formed and consolidated a special purpose investment vehicle, Animas Funding LLC (“AFL”). The Company is the sole managing member in AFL. On August 9, 2013, AFL entered into a three-year total return

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swap agreement with Citibank, N.A. (“Citibank”). Under the total return swap agreement, AFL receives the income equivalent on underlying obligations due to Citibank and pays to Citibank interest equal to LIBOR plus 120 basis points on the outstanding notional amount of the underlying obligations, which was approximately $80 million as of September 30, 2013. The total return swap agreement is secured by approximately $40 million of U.S. Treasuries as collateral, which is included in short-term investments on the consolidated balance sheets. In the event of a significant erosion in market value, AFL's position in the loan portfolio will be reduced and the Company has the option to add additional capital or terminate the total return swap agreement.

2. Recently Issued Accounting Standards

In July 2013, the Financial Accounting Standards Board (“FASB”) issued a new standard that requires entities to present an unrecognized tax benefit as a reduction of a deferred tax asset for a net operating loss carryforward, or similar tax loss or tax credit carryforward, rather than as a liability when the uncertain tax position would reduce the net operating loss or other carryforward under the tax law of the applicable jurisdiction and when the entity intends to use the deferred tax asset for that purpose. The new standard will be effective for fiscal years and interim periods within those years that begin after December 15, 2013. The adoption of the new standard will not have a material impact on the Company's consolidated financial statements.

In February 2013, the FASB issued a new standard that requires entities to disclose additional information about items reclassified out of accumulated other comprehensive income in their financial statements. Entities are required to include information about changes in accumulated other comprehensive income balances by component and additional information about significant items reclassified out of accumulated other comprehensive income in their interim reporting periods. The Company adopted the new standard which became effective for the interim period ended March 31, 2013. The adoption of the new standard did not have any impact on the Company’s consolidated financial statements.

3. Fair Value of Financial Instruments

The financial instruments recorded in the consolidated balance sheets include investments, receivables, the total return swap, interest rate swaps, accounts payable, equity contracts, and secured and unsecured notes payable. Due to their short-term maturity, the carrying values of receivables and accounts payable approximate their fair market values. The following table presents the estimated fair values of financial instruments at September 30, 2013 and December 31, 2012.

	September 30, 2013	December 31, 2012
	(Amounts in thousands)	
Assets		
Investments	$3,126,330	$3,180,095
Total return swap	$346	$0
Liabilities		
Interest rate swap	$0	$103
Equity contracts	$0	$175
Secured notes	$140,000	$140,000
Unsecured note	$40,000	$0

Methods and assumptions used in estimating fair values are as follows:

Investments

The Company applies the fair value option to all fixed maturity and equity securities and short-term investments at the time an eligible item is first recognized. The cost of investments sold is determined on a first-in and first-out method and realized gains and losses are included in net realized investment (losses) gains. For additional disclosures regarding methods and assumptions used in estimating fair values of these securities, see Note 5.

Total return swap and interest rate swap

The fair values of the total return swap and interest rate swap reflect the estimated amounts that the Company would pay at September 30, 2013 and December 31, 2012 in order to terminate the contracts based on models using inputs, such as interest rate yield curves, observable for substantially the full term of the contract. For additional disclosures regarding methods and assumptions used in estimating fair values, see Note 5.

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Equity contracts

The fair value of equity contracts is based on quoted prices for identical instruments in active markets. For additional disclosures regarding methods and assumptions used in estimating fair values of equity contracts, see Note 5.

Secured notes payable

The fair value of the Company’s $120 million and $20 million secured notes, classified as Level 2 in the fair value hierarchy described in Note 5, is estimated based on assumptions and inputs, such as the market value of underlying collateral and reset rates, for similarly termed notes that are observable in the market.

Unsecured note payable

The fair value of the Company’s $40 million unsecured note, classified as Level 2 in the fair value hierarchy described in Note 5, is based on the unadjusted quoted price for similar notes in active markets.

4. Fair Value Option

Gains and losses due to changes in fair value for items measured at fair value pursuant to application of the fair value option are included in net realized investment (losses) gains in the Company’s consolidated statements of operations, while interest and dividend income on investment holdings are recognized on an accrual basis on each measurement date and are included in net investment income in the Company’s consolidated statements of operations. The primary reasons for electing the fair value option were simplification and cost-benefit considerations as well as the expansion of the use of the Company's fair value measurement consistent with the long-term measurement objectives of the FASB for accounting for financial instruments.

The following table presents gains (losses) due to changes in fair value of investments that are measured at fair value pursuant to application of the fair value option:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
	(Amounts in thousands)			
Fixed maturity securities	$(11,295)	$19,198	$(81,268)	$50,013
Equity securities	32,602	25,629	67,625	20,153
Short-term investments	508	(44)	199	(828)
Total	$21,815	$44,783	$(13,444)	$69,338

5. Fair Value Measurement

The Company employs a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The fair value of a financial instrument is the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date using the exit price. Accordingly, when market observable data are not readily available, the Company’s own assumptions are used to reflect those that market participants would be presumed to use in pricing the asset or liability at the measurement date. Assets and liabilities recorded on the consolidated balance sheets at fair value are categorized based on the level of judgment associated with inputs used to measure their fair value and the level of market price observability, as follows:

Level 1 Unadjusted quoted prices are available in active markets for identical assets or liabilities as of the reporting date.

Level 2 Pricing inputs are other than quoted prices in active markets, which are based on the following:

- Quoted prices for similar assets or liabilities in active markets;
- Quoted prices for identical or similar assets or liabilities in non-active markets; or

- Either directly or indirectly observable inputs as of the reporting date.

Level 3	Pricing inputs are unobservable and significant to the overall fair value measurement, and the determination of fair value requires significant management judgment or estimation.

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In certain cases, inputs used to measure fair value may fall into different levels of the fair value hierarchy. In such cases, the level in the fair value hierarchy within which the fair value measurement in its entirety falls has been determined based on the lowest level input that is significant to the fair value measurement in its entirety. Thus, a Level 3 fair value measurement may include inputs that are observable (Level 1 or Level 2) and unobservable (Level 3). The Company's assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment and consideration of factors specific to the asset or liability.

The Company uses prices and inputs that are current as of the measurement date, including during periods of market disruption. In periods of market disruption, the ability to observe prices and inputs may be reduced for many instruments. This condition could cause an instrument to be reclassified from Level 1 to Level 2, or from Level 2 to Level 3. The Company recognizes transfers between levels at either the actual date of the event or a change in circumstances that caused the transfer.

Summary of Significant Valuation Techniques for Financial Assets and Financial Liabilities

The Company's fair value measurements are based on the market approach, which utilizes market transaction data for the same or similar instruments.

The Company obtained unadjusted fair values on approximately 98% of its portfolio from an independent pricing service. For approximately 2% of its portfolio, classified as Level 3, the Company obtained specific unadjusted broker quotes based on net fund value and, to a lesser extent, unobservable inputs from at least one knowledgeable outside security broker to determine the fair value as of September 30, 2013.

Level 1 Measurements - Fair values of financial assets and financial liabilities are obtained from an independent pricing service, and are based on unadjusted quoted prices for identical assets or liabilities in active markets. Additional pricing services and closing exchange values are used as a comparison to ensure that reasonable fair values are used in pricing the investment portfolio.

U.S. government bonds and agencies/Short-term bonds: Valued using unadjusted quoted market prices for identical assets in active markets.

Common stock: Comprised of actively traded, exchange listed U.S. and international equity securities and valued based on unadjusted quoted prices for identical assets in active markets.

Money market instruments: Valued based on unadjusted quoted prices for identical assets.

Equity contracts: Comprised of free-standing exchange listed derivatives that are actively traded and valued based on quoted prices for identical instruments in active markets.

Level 2 Measurements - Fair values of financial assets and financial liabilities are obtained from an independent pricing service or outside brokers, and are based on prices for similar assets or liabilities in active markets or valuation models whose inputs are observable, directly or indirectly, for substantially the full term of the asset or liability. Additional pricing services are used as a comparison to ensure reliable fair values are used in pricing the investment portfolio.

Municipal securities: Valued based on models or matrices using inputs such as quoted prices for identical or similar assets in active markets.

Mortgage-backed securities: Comprised of securities that are collateralized by mortgage loans and valued based on models or matrices using multiple observable inputs, such as benchmark yields, reported trades and broker/dealer quotes, for identical or similar assets in active markets. The Company had holdings of $16.7 million and $4.3 million at September 30, 2013 and December 31, 2012, respectively, in commercial mortgage-backed securities.

Corporate securities/Short-term bonds: Valued based on a multi-dimensional model using multiple observable inputs, such as benchmark yields, reported trades, broker/dealer quotes and issue spreads, for identical or similar assets in active markets.

Non-redeemable preferred stock: Valued based on observable inputs, such as underlying and common stock of same issuer and appropriate spread over a comparable U.S. Treasury security, for identical or similar assets in active markets.

Total return swap /Interest rate swap: Valued based on models using inputs such as interest rate yield curves, underlying debt/credit instruments and the appropriate benchmark spread for similar assets in active markets, observable for substantially the full term of the contract.

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Level 3 Measurements - Fair values of financial assets are based on inputs that are both unobservable and significant to the overall fair value measurement, including any items in which the evaluated prices obtained elsewhere were deemed to be of a distressed trading level.

Collateralized debt obligations/Partnership interest in a private credit fund: Valued based on underlying debt/credit instruments and the appropriate benchmark spread for similar assets in active markets; taking into consideration unobservable inputs related to liquidity assumptions.

The Company’s financial instruments at fair value are reflected in the consolidated balance sheets on a trade-date basis. Related unrealized gains or losses are recognized in net realized investment (losses) gains in the consolidated statements of operations. Fair value measurements are not adjusted for transaction costs.

The following tables present information about the Company’s assets and liabilities measured at fair value on a recurring basis as of September 30, 2013 and December 31, 2012, and indicate the fair value hierarchy of the valuation techniques utilized by the Company to determine such fair value:

	September 30, 2013			
	Level 1	Level 2	Level 3	Total
	(Amounts in thousands)			
Assets				
Fixed maturity securities:				
U.S. government bonds and agencies	$16,128	$0	$0	$16,128
Municipal securities	0	2,149,615	0	2,149,615
Mortgage-backed securities	0	36,096	0	36,096
Corporate securities	0	300,331	0	300,331
Collateralized debt obligations	0	0	36,344	36,344
Equity securities:				
Common stock:				
Public utilities	107,102	0	0	107,102
Banks, trusts and insurance companies	9,963	0	0	9,963
Energy and other	181,333	0	0	181,333
Non-redeemable preferred stock	0	25,845	0	25,845
Partnership interest in a private credit fund	0	0	12,124	12,124
Short-term bonds	39,996	22,488	0	62,484
Money market instruments	188,965	0	0	188,965
Total return swap	0	346	0	346
Total assets at fair value	$543,487	$2,534,721	$48,468	$3,126,676

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	December 31, 2012			
	Level 1	Level 2	Level 3	Total
	(Amounts in thousands)			
Assets				
Fixed maturity securities:				
U.S. government bonds and agencies	$14,204	$0	$0	$14,204
Municipal securities	0	2,165,095	0	2,165,095
Mortgage-backed securities	0	30,703	0	30,703
Corporate securities	0	155,551	0	155,551
Collateralized debt obligations	0	0	42,801	42,801
Equity securities:				
Common stock:				
Public utilities	85,106	0	0	85,106
Banks, trusts and insurance companies	22,166	0	0	22,166
Energy and other	346,809	0	0	346,809
Non-redeemable preferred stock	0	11,701	0	11,701
Partnership interest in a private credit fund	0	0	11,306	11,306
Short-term bonds	0	24,530	0	24,530
Money market instruments	270,123	0	0	270,123
Total assets at fair value	$738,408	$2,387,580	$54,107	$3,180,095
Liabilities				
Equity contracts	$175	$0	$0	$175
Interest rate swap	0	103	0	103
Total liabilities at fair value	$175	$103	$0	$278

The following tables present a summary of changes in fair value of Level 3 financial assets and financial liabilities held at fair value.

	Three Months Ended September 30,			
	2013		2012	
	Collateralized Debt Obligations	Partnership Interest in a Private Credit Fund	Collateralized Debt Obligations	Partnership Interest in a Private Credit Fund
	(Amounts in thousands)			
Beginning Balance	$38,992	$11,990	$76,325	$11,030
Realized gains (losses) included in earnings	5,616	134	5,032	(455)
Settlements	(8,264)	0	0	0
Ending Balance	$36,344	$12,124	$81,357	$10,575
The amount of total gains (losses) for the period included in earnings attributable to assets still held at September 30	$5,616	$134	$5,032	$(455)

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	Nine Months Ended September 30, 2013		2012	
	Collateralized Debt Obligations	Partnership Interest in a Private Credit Fund	Collateralized Debt Obligations	Partnership Interest in a Private Credit Fund
	(Amounts in thousands)			
Beginning Balance	$42,801	$11,306	$47,503	$10,008
Realized gains included in earnings	5,993	818	8,854	567
Purchase	0	0	25,000	0
Sales	(4,186)	0	0	0
Settlements	(8,264)	0	0	0
Ending Balance	$36,344	$12,124	$81,357	$10,575
The amount of total gains for the period included in earnings attributable to assets still held at September 30	$6,510	$818	$8,854	$567

There were no transfers between Levels 1, 2, and 3 of the fair value hierarchy during the nine months ended September 30, 2013 and 2012.

At September 30, 2013, the Company did not have any nonrecurring fair value measurements of nonfinancial assets or nonfinancial liabilities.

6. Derivative Financial Instruments

The Company is exposed to certain risks relating to its ongoing business operations. The primary risks managed by using derivative instruments are equity price risk and interest rate risk. Equity contracts on various equity securities are intended to manage the price risk associated with forecasted purchases or sales of such securities. Interest rate swaps are intended to manage the interest rate risk associated with the Company’s debts with fixed or floating rates.

On August 9, 2013, AFL entered into a three-year total return swap agreement with Citibank. Under the total return swap agreement, AFL receives the income equivalent on underlying obligations due to Citibank and pays to Citibank interest equal to LIBOR plus 120 basis points on the outstanding notional amount of the underlying obligations, which was approximately $80 million as of September 30, 2013. The total return swap is secured by approximately $40 million of U.S. Treasuries as collateral, which is included in short-term investments on the consolidated balance sheets.

On February 6, 2009, the Company entered into an interest rate swap of its floating LIBOR rate on a $120 million credit facility for a fixed rate of 1.93% that matured on January 3, 2012. The purpose of the swap was to offset the variability of cash flows resulting from the variable interest rate. The swap was not designated as a hedge and changes in the fair value were adjusted through the consolidated statement of operations in the period of change.

On March 3, 2008, the Company entered into an interest rate swap of its floating LIBOR rate on a Bank of America $18 million LIBOR plus 50 basis points loan for a fixed rate of 4.25% that matured on March 1, 2013. On October 4, 2011, the Company refinanced the $18 million loan that was scheduled to mature on March 1, 2013 with a Union Bank $20 million LIBOR plus 40 basis points loan that matures on January 2, 2015. The related swap expired on March 1, 2013.

Fair value amounts, and gains and losses on derivative instruments

The following tables present the location and amounts of derivative fair values in the consolidated balance sheets and derivative gains in the consolidated statements of operations:

	Asset Derivatives		Liability Derivatives	
	September 30, 2013	December 31, 2012	September 30, 2013	December 31, 2012
	(Amount in thousands)			
Total return swap - Other assets	$346	$0	$0	$0

Equity contracts - Other liabilities	0	0	0	175
Interest rate swap - Other liabilities	0	0	0	103
Total derivatives	$346	$0	$0	$278

	Gain Recognized in Income			
	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
	(Amounts in thousands)			
Total return swap - Net realized investment (losses) gains	$381	$0	$381	$0
Equity contracts - Net realized investment (losses) gains	543	757	1,722	2,342
Interest rate swap - Other revenue	0	139	103	410
Total	$924			