

OLD REPUBLIC INTERNATIONAL CORP

Form 10-Q

November 04, 2016

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D. C. 20549

FORM 10-Q

Quarterly report pursuant to section 13 or 15(d) of the Security Exchange Act of 1934
for the quarterly period ended: September 30, 2016 or

Transition report pursuant to section 13 or 15(d) of the Security Exchange Act of 1934

Commission File Number: 001-10607

OLD REPUBLIC INTERNATIONAL CORPORATION

(Exact name of registrant as specified in its charter)

Delaware No. 36-2678171
(State or other jurisdiction of (IRS Employer Identification No.)
incorporation or organization)

307 North Michigan Avenue, Chicago, Illinois 60601
(Address of principal executive office) (Zip Code)

Registrant's telephone number, including area code: 312-346-8100

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:

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

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 Exchange Act Rule 12b-2). Yes: No:

Class	Shares Outstanding September 30, 2016
Common Stock / \$1 par value	262,600,130

There are 48 pages in this report

OLD REPUBLIC INTERNATIONAL CORPORATION

Report on Form 10-Q / September 30, 2016

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Old Republic International Corporation and Subsidiaries
Consolidated Balance Sheets
(\$ in Millions, Except Share Data)

	(Unaudited)	
	September 30, 2016	December 31, 2015
Assets		
Investments:		
Available for sale:		
Fixed maturity securities (at fair value) (amortized cost: \$8,014.1 and \$8,149.4)	\$ 8,354.7	\$ 8,181.5
Equity securities (at fair value) (cost: \$2,396.6 and \$1,826.4)	2,787.4	1,987.8
Short-term investments (at fair value which approximates cost)	707.0	669.4
Miscellaneous investments	30.8	27.2
Total	11,880.1	10,866.1
Held to maturity:		
Fixed maturity securities (at amortized cost) (fair value: \$766.7 and \$359.7)	748.5	355.8
Other investments	3.0	3.5
Total investments	12,631.7	11,225.5
Other Assets:		
Cash	144.6	159.8
Securities and indebtedness of related parties	20.6	27.7
Accrued investment income	94.1	90.1
Accounts and notes receivable	1,508.6	1,310.2
Federal income tax recoverable: Current	27.2	26.5
Deferred	—	154.5
Prepaid federal income taxes	82.4	63.3
Reinsurance balances and funds held	129.3	129.0
Reinsurance recoverable: Paid losses	93.8	61.1
Policy and claim reserves	3,329.7	3,122.5
Deferred policy acquisition costs	277.0	255.4
Sundry assets	471.0	475.6
Total Other Assets	6,178.8	5,876.1
Total Assets	\$ 18,810.6	\$ 17,101.6
Liabilities, Preferred Stock, and Common Shareholders' Equity		
Liabilities:		
Losses, claims, and settlement expenses	\$ 9,247.0	\$ 9,120.1
Unearned premiums	1,969.8	1,748.7
Other policyholders' benefits and funds	192.1	196.4
Total policy liabilities and accruals	11,409.0	11,065.3
Commissions, expenses, fees, and taxes	454.5	452.3
Reinsurance balances and funds	641.4	496.1
Federal income tax payable: Deferred	52.3	—
Debt	1,528.0	952.8
Sundry liabilities	279.0	253.9
Commitments and contingent liabilities		
Total Liabilities	14,364.4	13,220.7
Preferred Stock (1)	—	—
Common Shareholders' Equity:		
Common stock (1)	262.6	261.9

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Additional paid-in capital	710.4	698.0
Retained earnings	3,127.2	2,937.5
Accumulated other comprehensive income	386.8	29.2
Unallocated ESSOP shares (at cost)	(40.9) (45.8
Total Common Shareholders' Equity	4,446.1	3,880.8
Total Liabilities, Preferred Stock and Common Shareholders' Equity	\$ 18,810.6	\$ 17,101.6

(1) At September 30, 2016 and December 31, 2015, there were 75,000,000 shares of \$0.01 par value preferred stock authorized, of which no shares were outstanding. As of the same dates, there were 500,000,000 shares of common stock, \$1.00 par value, authorized, of which 262,600,130 and 261,968,328 were issued as of September 30, 2016 and December 31, 2015, respectively. At September 30, 2016 and December 31, 2015, there were 100,000,000 shares of Class B Common Stock, \$1.00 par value, authorized, of which no shares were issued.

See accompanying Notes to Consolidated Financial Statements.

Old Republic International Corporation and Subsidiaries
Consolidated Statements of Income (Unaudited)
(\$ in Millions, Except Share Data)

	Quarters Ended		Nine Months Ended	
	September 30,		September 30,	
	2016	2015	2016	2015
Revenues:				
Net premiums earned	\$1,238.6	\$ 1,259.4	\$3,582.1	\$ 3,520.7
Title, escrow, and other fees	126.7	112.7	342.9	319.4
Total premiums and fees	1,365.4	1,372.1	3,925.1	3,840.1
Net investment income	95.7	104.2	287.0	288.9
Other income	27.5	27.8	81.4	79.8
Total operating revenues	1,488.7	1,504.2	4,293.6	4,208.9
Realized investment gains (losses):				
From sales	12.2	41.4	63.1	77.0
From impairments	(4.9)	—	(4.9)	—
Total realized investment gains (losses)	7.2	41.4	58.1	77.0
Total revenues	1,496.0	1,545.7	4,351.7	4,285.9
Benefits, Claims and Expenses:				
Benefits, claims and settlement expenses	590.7	653.4	1,747.8	1,822.6
Dividends to policyholders	4.4	3.3	14.3	12.3
Underwriting, acquisition, and other expenses	724.0	693.9	2,060.3	1,929.5
Interest and other charges	12.6	10.2	34.0	31.0
Total expenses	1,331.9	1,360.9	3,856.5	3,795.5
Income before income taxes (credits)	164.0	184.7	495.2	490.3
Income Taxes (Credits):				
Current	49.4	68.6	145.2	164.1
Deferred	3.6	(9.8)	14.9	(5.2)
Total	53.1	58.8	160.2	158.8
Net Income	\$110.9	\$ 125.9	\$335.0	\$ 331.4
Net Income Per Share:				
Basic	\$.43	\$.48	\$1.29	\$ 1.28
Diluted	\$.39	\$.44	\$1.17	\$ 1.16
Average shares outstanding:				
Basic	259,414,230	259,266,696	259,227,603	259,411,347
Diluted	296,444,432	295,868,117	296,193,090	295,930,527
Dividends Per Common Share:				
Cash	\$.1875	\$.1850	\$.5625	\$.5550

See accompanying Notes to Consolidated Financial Statements.

Old Republic International Corporation and Subsidiaries
Consolidated Statements of Comprehensive Income (Unaudited)
(\$ in Millions)

	Quarters Ended		Nine Months Ended	
	September 30, 2016	September 30, 2015	September 30, 2016	September 30, 2015
Net Income As Reported	\$110.9	\$125.9	\$335.0	\$331.4
Other comprehensive income (loss):				
Unrealized gains (losses) on securities:				
Unrealized gains (losses) on securities before reclassifications	7.5	(148.5)	596.5	(265.1)
Amounts reclassified as realized investment gains from sales in the statements of income	(7.2)	(41.4)	(58.1)	(77.0)
Pretax unrealized gains (losses) on securities	.2	(190.0)	538.3	(342.2)
Deferred income taxes (credits)	—	(66.2)	188.2	(119.7)
Net unrealized gains (losses) on securities, net of tax	.1	(123.7)	350.1	(222.5)
Defined benefit pension plans:				
Net pension adjustment before reclassifications	—	—	.1	.1
Amounts reclassified as underwriting, acquisition, and other expenses in the statements of income	.1	.2	.4	.7
Net adjustment related to defined benefit pension plans	.1	.2	.6	.9
Deferred income taxes (credits)	—	—	.2	.3
Net adjustment related to defined benefit pension plans, net of tax	.1	.1	.3	.6
Foreign currency translation and other adjustments	(.5)	(8.5)	7.0	(14.6)
Net adjustments	(.2)	(132.1)	357.5	(236.5)
Comprehensive Income (Loss)	\$110.7	\$(6.1)	\$692.5	\$94.9

See accompanying Notes to Consolidated Financial Statements.

Old Republic International Corporation and Subsidiaries
 Consolidated Statements of Cash Flows (Unaudited)
 (\$ in Millions)

	Nine Months Ended September 30, 2016 2015	
Cash flows from operating activities:		
Net income	\$335.0	\$331.4
Adjustments to reconcile net income to net cash provided by operating activities:		
Deferred policy acquisition costs	(21.2)	(38.1)
Premiums and other receivables	(198.1)	(145.9)
Unpaid claims and related items	25.7	195.6
Unearned premiums and other policyholders' liabilities	87.1	117.5
Income taxes	13.7	31.4
Prepaid federal income taxes	(19.1)	(17.5)
Reinsurance balances and funds	112.0	97.1
Realized investment (gains) losses	(58.1)	(77.0)
Accounts payable, accrued expenses and other	124.9	71.9
Total	401.9	566.5
Cash flows from investing activities:		
Fixed maturity securities:		
Available for sale:		
Maturities and early calls	715.2	499.7
Sales	282.1	214.6
Sales of:		
Equity securities	374.6	264.3
Other - net	14.6	17.2
Purchases of:		
Fixed maturity securities:		
Available for sale	(876.4)	(733.6)
Held to maturity	(401.3)	(196.4)
Equity securities	(885.3)	(405.7)
Other - net	(35.5)	(34.3)
Net decrease (increase) in short-term investments	(37.4)	8.8
Other - net	—	.1
Total	(849.5)	(365.3)
Cash flows from financing activities:		
Issuance of debentures and notes	576.8	—
Issuance of common shares	6.9	5.6
Redemption of debentures and notes	(3.5)	(3.3)
Purchase of unallocated ESSOP shares	—	(34.0)
Dividends on common shares	(145.3)	(143.7)
Other - net	(2.5)	(2.3)
Total	432.3	(177.8)

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Increase (decrease) in cash	(15.1)	23.3
Cash, beginning of period	159.8	136.7
Cash, end of period	\$144.6	\$160.1

Supplemental cash flow information:

Cash paid (received) during the period for: Interest	\$40.7	\$40.7
Income taxes	\$146.4	\$128.1

See accompanying Notes to Consolidated Financial Statements.

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OLD REPUBLIC INTERNATIONAL CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)
(\$ in Millions, Except Share Data)

1. Accounting Policies and Basis of Presentation:

The accompanying consolidated financial statements have been prepared in conformity with the Financial Accounting Standards Board's ("FASB") Accounting Standards Codification ("ASC") of accounting principles generally accepted in the United States of America ("GAAP"). These interim financial statements should be read in conjunction with these notes and those included in the Company's 2015 Annual Report on Form 10-K incorporated herein by reference.

Pertinent accounting and disclosure pronouncements issued from time to time by the FASB are adopted by the Company as they become effective. In May 2015, the FASB issued guidance requiring additional disclosures about short-duration insurance contracts. The new disclosures, which are required for annual periods beginning after December 31, 2015 and for interim periods beginning after December 31, 2016, are intended to provide additional information about insurance liabilities including the nature, amount, timing, and uncertainty of future cash flows related to those liabilities. In May 2014, the FASB issued a comprehensive revenue recognition standard which will be effective in 2018 and applies to all entities that have contracts with customers, except for those that fall within the scope of other standards, such as insurance contracts. In January 2016, the FASB issued guidance on the recognition and measurement of financial instruments which will be effective in 2018. Among other changes, the standard will require equity investments to be measured at fair value with changes in fair value recognized in the consolidated statement of income. In February 2016, the FASB issued guidance on lease accounting which will be effective in 2019 and requires balance sheet recognition of all leases with a term of greater than 12 months. In March 2016, the FASB issued guidance intended to simplify certain aspects of accounting for share-based payment award transactions which will be effective beginning in 2017. Most recently, in June 2016, the FASB issued guidance on accounting for credit losses on financial instruments which will be effective in 2020. The guidance will require immediate recognition of expected credit losses for certain financial instruments and also modifies the impairment model for available for sale debt securities. The Company is currently evaluating the foregoing guidance to determine the potential impact of its adoption on its consolidated financial statements. Certain debt amounts have been reduced due to the reclassification of immaterial debt issuance costs previously classified as deferred assets, in order to comply with a 2015 pronouncement issued by the FASB.

The financial accounting and reporting process relies on estimates and on the exercise of judgment. In the opinion of management all adjustments consisting only of normal recurring accruals necessary for a fair presentation of the results have been recorded for the interim periods. Amounts shown in the consolidated financial statements and applicable notes are stated (except as otherwise indicated and as to share data) in millions, which amounts may not add to totals shown due to truncation. Necessary reclassifications are made in prior periods' financial statements whenever appropriate to conform to the most current presentation.

2. Common Share Data:

Earnings Per Share - Consolidated basic earnings per share excludes the dilutive effect of common stock equivalents and is computed by dividing income available to common stockholders by the weighted-average number of common shares actually outstanding for the quarterly and year-to-date periods. Diluted earnings per share are similarly calculated with the inclusion of dilutive common stock equivalents. The following table provides a reconciliation of net income and the number of shares used in basic and diluted earnings per share calculations.

	Quarters Ended		Nine Months Ended	
	September 30,		September 30,	
	2016	2015	2016	2015
Numerator:				
Net income	\$ 110.9	\$ 125.9	\$ 335.0	\$ 331.4
Numerator for basic earnings per share - income available to common stockholders	110.9	125.9	335.0	331.4
Adjustment for interest expense incurred on assumed conversion of convertible notes	3.6	3.6	10.9	10.9
Numerator for diluted earnings per share - income available to common stockholders after assumed conversion of convertible notes	\$ 114.6	\$ 129.6	\$ 345.9	\$ 342.4
Denominator:				
Denominator for basic earnings per share - weighted-average shares (a)	259,414,250	266,696	259,227,205	265,411,347
Effect of dilutive securities - stock based compensation awards	1,328,657	989,911	1,287,205	1,030,917
Effect of dilutive securities - convertible senior notes	35,701,345	611,510	35,678,280	588,263
Denominator for diluted earnings per share - adjusted weighted-average shares and assumed conversion of convertible notes (a)	296,444,252	868,117	296,193,790	930,527
Earnings per share: Basic	\$.43	\$.48	\$1.29	\$ 1.28
Diluted	\$.39	\$.44	\$1.17	\$ 1.16
Anti-dilutive common stock equivalents excluded from earning per share computations:				
Stock based compensation awards	1,678,675	040,050	1,678,675	040,050
Convertible senior notes	—	—	—	—
Total	1,678,675	040,050	1,678,675	040,050

(a) In calculating earnings per share, pertinent accounting rules require that common shares owned by the Company's Employee Savings and Stock Ownership Plan that are not yet allocated to participants in the plan be excluded from the calculation. Such shares are issued and outstanding and have the same voting and other rights applicable to all other common shares.

3. Investments:

The Company may classify its invested assets in terms of those assets relative to which it either (1) has the positive intent and ability to hold until maturity, (2) has available for sale or (3) has the intention of trading. As of September 30, 2016 and December 31, 2015, substantially all the Company's invested assets were classified as "available for sale."

Fixed maturity securities classified as "held to maturity" are carried at amortized cost while fixed maturity securities and other preferred and common stocks (equity securities) classified as "available for sale" are included at fair value with changes in such values, net of deferred income taxes, reflected directly in shareholders' equity. Fair values for fixed maturity securities and equity securities are based on quoted market prices or estimates using values obtained from independent pricing services as applicable.

The Company reviews the status and fair value changes of each of its investments on at least a quarterly basis during the year, and estimates of other-than-temporary impairments ("OTTI") in the portfolio's value are evaluated and established at each quarterly balance sheet date. In reviewing investments for OTTI, the Company, in addition to a security's market price history, considers the totality of such factors as the issuer's operating results, financial condition and liquidity, its ability to access capital markets, credit rating trends, most current audit opinion, industry and securities markets conditions, and analyst expectations to reach its conclusions. Sudden fair value declines caused by such adverse developments as newly emerged or imminent bankruptcy filings, issuer default on significant obligations, or reports of financial accounting developments that bring into question the validity of the issuer's previously reported earnings or financial condition, are recognized as realized losses as soon as credible publicly available information emerges to confirm such developments. Absent issuer-specific circumstances that would result in a contrary conclusion, any equity security with an unrealized investment loss amounting to a 20% or greater decline consecutively during a six month period is considered OTTI. In the event the Company's estimate of OTTI is insufficient at any point in time, future periods' net income (loss) would be adversely affected by the recognition of additional realized or impairment losses, but its financial position would not necessarily be affected adversely inasmuch as such losses, or a portion of them, could have been recognized previously as unrealized losses in shareholders' equity. The Company recognized \$4.9 of OTTI adjustments for the quarter and nine months ended September 30, 2016 and no adjustments for the same periods of 2015.

The amortized cost and estimated fair values by type and contractual maturity of fixed maturity securities are shown in the following tables. Expected maturities will differ from contractual maturities since borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Fixed Maturity Securities by Type:				
September 30, 2016:				
Available for sale:				
U.S. & Canadian Governments	\$ 1,402.7	\$ 41.0	\$ —	\$ 1,443.7
Corporate	6,611.3	317.0	17.4	6,911.0
	\$ 8,014.1	\$ 358.1	\$ 17.4	\$ 8,354.7
Held to maturity:				
Tax-exempt	\$ 748.5	\$ 18.7	\$.5	\$ 766.7
December 31, 2015:				
Available for sale:				
U.S. & Canadian Governments	\$ 1,269.5	\$ 18.9	\$ 3.6	\$ 1,284.9
Corporate	6,879.9	166.8	150.2	6,896.5
	\$ 8,149.4	\$ 185.8	\$ 153.8	\$ 8,181.5
Held to maturity:				
Tax-exempt	\$ 355.8	\$ 4.0	\$.1	\$ 359.7

	Amortized Cost	Estimated Fair Value
Fixed Maturity Securities Stratified by Contractual Maturity at September 30, 2016:		
Available for sale:		
Due in one year or less	\$ 718.4	\$ 726.2
Due after one year through five years	3,997.6	4,170.1
Due after five years through ten years	3,150.1	3,299.1
Due after ten years	147.9	159.2
	\$ 8,014.1	\$ 8,354.7
Held to maturity:		
Due in one year or less	\$ —	\$ —
Due after one year through five years	23.3	23.3
Due after five years through ten years	687.1	704.3
Due after ten years	38.0	39.1
	\$ 748.5	\$ 766.7

A summary of the Company's equity securities follows:

	Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Equity Securities:				
September 30, 2016	\$2,396.6	\$ 423.1	\$ 32.3	\$ 2,787.4
December 31, 2015	\$1,826.4	\$ 266.7	\$ 105.3	\$ 1,987.8

The following table reflects the Company's gross unrealized losses and fair value, aggregated by category and length of time that individual available for sale and held to maturity securities have been in an unrealized loss position. Fair value and issuer's cost comparisons follow:

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	12 Months or Less		Greater than 12 Months		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
September 30, 2016:						
Fixed Maturity Securities:						
U.S. & Canadian Governments	\$70.1	\$ —	\$1.2	\$ —	\$71.4	\$ —
Tax-exempt	141.0	.5	—	—	141.0	.5
Corporate	219.7	2.6	287.0	14.7	506.7	17.4
Subtotal	430.8	3.2	288.2	14.7	719.1	18.0
Equity Securities	217.0	7.3	193.4	25.0	410.4	32.3
Total	\$647.9	\$ 10.5	\$481.7	\$ 39.8	\$1,129.6	\$ 50.3

December 31, 2015:

Fixed Maturity Securities:						
U.S. & Canadian Governments	\$363.3	\$ 2.8	\$59.2	\$.7	\$422.6	\$ 3.6
Tax-exempt	49.5	.1	—	—	49.5	.1
Corporate	2,214.5	100.0	336.4	50.2	2,550.9	150.2
Subtotal	2,627.4	103.0	395.7	50.9	3,023.1	154.0
Equity Securities	502.1	87.3	31.3	17.9	533.4	105.3
Total	\$3,129.5	\$ 190.4	\$427.0	\$ 68.9	\$3,556.6	\$ 259.3

At September 30, 2016, the Company held 185 fixed maturity and 15 equity securities in an unrealized loss position, representing 10.1% (as to fixed maturities) and 14.4% (as to equity securities) of the total number of such issues it held. At December 31, 2015, the Company held 709 fixed maturity and 22 equity securities in an unrealized loss position, representing 39.2% (as to fixed maturities) and 23.9% (as to equity securities) of the total number of such issues it held. Of the securities in an unrealized loss position, 51 and 79 fixed maturity securities and 3 and 1 equity securities, had been in a continuous unrealized loss position for more than 12 months as of September 30, 2016 and December 31, 2015, respectively. The unrealized losses on these securities are primarily deemed to reflect changes in the interest rate environment and changes in fair values of fixed income and equity securities issued by participants in the extractive industries in particular. As part of its assessment of other-than-temporary impairments, the Company considers its intent to continue to hold, and the likelihood that it will not be required to sell investment securities in an unrealized loss position until cost recovery, principally on the basis of its asset and liability maturity matching procedures.

Fair Value Measurements - Fair value is defined as the estimated price that is likely to be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants (an exit price) at the measurement date. A fair value hierarchy is established that prioritizes the sources ("inputs") used to measure fair value into three broad levels: inputs based on quoted market prices in active markets (Level 1); observable inputs based on corroboration with available market data (Level 2); and unobservable inputs based on uncorroborated market data or a reporting entity's own assumptions (Level 3). Following is a description of the valuation methodologies and general classification used for financial instruments measured at fair value.

The Company uses quoted values and other data provided by a nationally recognized independent pricing source as inputs into its quarterly process for determining fair values of its fixed maturity and equity securities. To validate the techniques or models used by pricing sources, the Company's review process includes, but is not limited to: (i) initial and ongoing evaluation of methodologies used by outside parties to calculate fair value; and (ii) comparing other

sources including the fair value estimates to its knowledge of the current market and to independent fair value estimates provided by the investment custodian. The independent pricing source obtains market quotations and actual transaction prices for securities that have quoted prices in active markets and uses its own proprietary method for determining the fair value of securities that are not actively traded. In general, these methods involve the use of "matrix pricing" in which the independent pricing source uses observable market inputs including, but not limited to, investment yields, credit risks and spreads, benchmarking of like securities, broker-dealer quotes, reported trades and sector groupings to determine a reasonable fair value.

Level 1 securities include U.S. and Canadian Treasury notes, publicly traded common stocks, the quoted net asset value ("NAV") mutual funds, and most short-term investments in highly liquid money market instruments. Level 2 securities generally include corporate bonds, municipal bonds, and certain U.S. and Canadian government agency securities. Securities classified within Level 3 include non-publicly traded bonds and equity securities. There were no significant changes in the fair value of assets measured with the use of significant unobservable inputs as of September 30, 2016 and December 31, 2015.

The following tables show a summary of the fair value of financial assets segregated among the various input levels described above:

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As of September 30, 2016:	Fair Value Measurements			
	Level 1	Level 2	Level 3	Total
Available for sale:				
Fixed maturity securities:				
U.S. & Canadian Governments	\$745.5	\$698.2	\$	-\$1,443.7
Corporate	—	6,900.5	10.5	6,911.0
Equity securities	2,785.2	—		