ALLEGHANY CORP /DE
Form 10-Q
May 03, 2018
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(MARK ONE)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
FOR THE QUARTERLY PERIOD ENDED MARCH 31, 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 1-9371

ALLEGHANY CORPORATION

EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER

DELAWARE

STATE OR OTHER JURISDICTION OF INCORPORATION OR ORGANIZATION

51-0283071

I.R.S. EMPLOYER IDENTIFICATION NO.

1411 BROADWAY, 34TH FLOOR, NY, NY 10018

ADDRESS OF PRINCIPAL EXECUTIVE OFFICES, INCLUDING ZIP CODE

212-752-1356

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

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 (SECTION 232.405 OF THIS CHAPTER) DURING THE PRECEDING 12 MONTHS (OR 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, 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.

ARGE ACCELERATED FILER	ACCELERATED FILER	EMERGING GROWTH COMPANY
ON-ACCELERATED FILER	SMALLER REPORTING 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 REGISRANT IS A SHELL COMPANY (AS DEFINED IN RULE 12b-2 OF THE ACT). YES NO

INDICATE THE NUMBER OF SHARES OUTSTANDING OF EACH OF THE ISSUER S CLASSES OF COMMON STOCK, AS OF THE LAST PRACTICABLE DATE.

15,289,793 SHARES, PAR VALUE $1.00 PER SHARE, AS OF APRIL 23, 2018

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ALLEGHANY CORPORATION

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Part I. FINANCIAL INFORMATION

Item 1. Financial Statements.

ALLEGHANY CORPORATION AND SUBSIDIARIES

Consolidated Balance Sheets

	March 31, 2018 (unaudited)	December 31, 2017
	($ in thousands, except share amounts)	
Assets		
Investments:		
Securities at fair value:		
Equity securities (cost: 2018 $3,721,932; 2017 $3,170,673)	$ 4,545,899	$ 4,099,467
Debt securities (amortized cost: 2018 $12,065,159; 2017 $12,536,772)	12,066,223	12,721,399
Short-term investments	611,655	578,054
	17,223,777	17,398,920
Commercial mortgage loans	663,933	658,364
Other invested assets	601,555	743,358
Total investments	18,489,265	18,800,642
Cash	711,040	838,375
Accrued investment income	97,998	105,877
Premium balances receivable	856,078	797,346
Reinsurance recoverables	1,653,758	1,746,488
Ceded unearned premiums	204,640	190,252
Deferred acquisition costs	467,524	453,346
Property and equipment at cost, net of accumulated depreciation and amortization	198,707	125,337
Goodwill	345,306	334,905
Intangible assets, net of amortization	467,475	459,037
Current taxes receivable	63,568	31,085
Net deferred tax assets	123,944	136,489
Funds held under reinsurance agreements	705,433	706,042
Other assets	712,520	659,096
Total assets	$ 25,097,256	$ 25,384,317
Liabilities, Redeemable Noncontrolling Interests and Stockholders Equity		
Loss and loss adjustment expenses	$ 11,714,269	$ 11,871,250

Unearned premiums	2,251,593	2,182,294
Senior Notes and other debt	1,540,865	1,484,897
Reinsurance payable	160,228	156,376
Other liabilities	919,270	1,068,907
Total liabilities	16,586,225	16,763,724
Redeemable noncontrolling interests	137,631	106,530
Common stock (shares authorized: 2018 and 2017 22,000,000; shares issued: 2018 and 2017 17,459,961)	17,460	17,460
Contributed capital	3,613,630	3,612,109
Accumulated other comprehensive (loss) income	(123,620)	618,118
Treasury stock, at cost (2018 2,097,820 shares; 2017 2,069,461 shares)	(843,497)	(824,906)
Retained earnings	5,709,427	5,091,282
Total stockholders equity attributable to Alleghany stockholders	8,373,400	8,514,063
Total liabilities, redeemable noncontrolling interest and stockholders equity	$ 25,097,256	$ 25,384,317

See accompanying Notes to Unaudited Consolidated Financial Statements.

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ALLEGHANY CORPORATION AND SUBSIDIARIES

Consolidated Statements of Earnings and Comprehensive Income

(unaudited)

	Three Months Ended March 31, 2018	Three Months Ended March 31, 2017
	($ in thousands, except per share amounts)	
Revenues		
Net premiums earned	$ 1,207,856	$ 1,209,188
Net investment income	124,126	115,538
Change in the fair value of equity securities	(42,649)	-
Net realized capital gains	44,505	59,651
Other than temporary impairment losses	(511)	(3,217)
Noninsurance revenue	251,627	151,292
Total revenues	1,584,954	1,532,452
Costs and Expenses		
Net loss and loss adjustment expenses	670,578	699,305
Commissions, brokerage and other underwriting expenses	406,295	408,515
Other operating expenses	264,897	175,138
Corporate administration	7,785	16,885
Amortization of intangible assets	5,264	3,764
Interest expense	21,531	20,935
Total costs and expenses	1,376,350	1,324,542
Earnings before income taxes	208,604	207,910
Income taxes	37,422	58,550
Net earnings	171,182	149,360
Net earnings attributable to noncontrolling interest	(393)	184
Net earnings attributable to Alleghany stockholders	$ 171,575	$ 149,176
Net earnings	$ 171,182	$ 149,360
Other comprehensive income:		
Change in unrealized gains (losses), net of deferred taxes of ($38,905) and $67,270 for 2018 and 2017, respectively	(146,358)	124,929
Less: reclassification for net realized capital gains and other than temporary impairment losses, net of taxes of $366 and ($19,752) for 2018 and 2017, respectively	1,379	(36,682)

Change in unrealized currency translation adjustment, net of deferred taxes of $1,356 and $2,719 for 2018 and 2017, respectively		5,100		5,049
Retirement plans		(1,322)		(395)
Comprehensive income		29,981		242,261
Comprehensive income attributable to noncontrolling interest		(393)		184
Comprehensive income attributable to Alleghany stockholders	$	30,374	$	242,077
Basic earnings per share attributable to Alleghany stockholders	$	11.15	$	9.68
Diluted earnings per share attributable to Alleghany stockholders		11.04		9.67

See accompanying Notes to Unaudited Consolidated Financial Statements.

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ALLEGHANY CORPORATION AND SUBSIDIARIES

Consolidated Statements of Cash Flows

(unaudited)

	Three Months Ended March 31, 2018	Three Months Ended March 31, 2017
	($ in thousands)	
Cash flows from operating activities		
Net earnings	$ 171,182	$ 149,360
Adjustments to reconcile net earnings to net cash provided by (used in) operating activities:		
Depreciation and amortization	33,107	35,663
Change in the fair value of equity securities	42,649	-
Net realized capital (gains) losses	(44,505)	(59,651)
Other than temporary impairment losses	511	3,217
(Increase) decrease in reinsurance recoverables, net of reinsurance payable	96,582	34,196
(Increase) decrease in premium balances receivable	(58,732)	(62,971)
(Increase) decrease in ceded unearned premiums	(14,388)	(17,874)
(Increase) decrease in deferred acquisition costs	(14,178)	(6,488)
(Increase) decrease in funds held under reinsurance agreements	609	(23,885)
Increase (decrease) in unearned premiums	69,299	39,448
Increase (decrease) in loss and loss adjustment expenses	(156,981)	(97,254)
Change in unrealized foreign exchange losses (gains)	(35,143)	(19,971)
Other, net	(95,181)	(16,322)
Net adjustments	(176,351)	(191,892)
Net cash provided by (used in) operating activities	(5,169)	(42,532)
Cash flows from investing activities		
Purchases of debt securities	(989,813)	(1,811,566)
Purchases of equity securities	(451,519)	(304,343)
Sales of debt securities	1,014,024	1,349,608
Maturities and redemptions of debt securities	466,457	443,960
Sales of equity securities	172,819	1,363,269
Net (purchases) sales of short-term investments	(33,634)	(949,847)
Net (purchases) sales and maturities of commercial mortgage loans	(5,569)	(24,803)
(Purchases) sales of property and equipment	(11,057)	(4,480)
Purchases of affiliates and subsidiaries, net of cash acquired	(105,386)	-
Other, net	(23,951)	29,388

Net cash provided by (used in) investing activities	32,371	91,186
Cash flows from financing activities		
Treasury stock acquisitions	(21,268)	-
Increase (decrease) in other debt	9,957	(5,509)
Cash dividends paid	(153,967)	-
Other, net	4,654	(13,057)
Net cash provided by (used in) financing activities	(160,624)	(18,566)
Effect of exchange rate changes on cash	6,087	266
Net increase (decrease) in cash	(127,335)	30,354
Cash at beginning of period	838,375	594,091
Cash at end of period	$ 711,040	$ 624,445
Supplemental disclosures of cash flow information		
Cash paid during period for:		
Interest paid	$ 16,942	$ 16,359
Income taxes paid (refund received)	20,275	5,949

See accompanying Notes to Unaudited Consolidated Financial Statements.

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ALLEGHANY CORPORATION AND SUBSIDIARIES

Notes to Unaudited Consolidated Financial Statements

1. Summary of Significant Accounting Principles

(a) Principles of Financial Statement Presentation

This Quarterly Report on Form 10-Q (this Form 10-Q) should be read in conjunction with the Annual Report on Form 10-K for the year ended December 31, 2017 (the 2017 Form 10-K) of Alleghany Corporation (Alleghany).

Alleghany Corporation, a Delaware corporation, owns and manages certain operating subsidiaries and investments, anchored by a core position in property and casualty reinsurance and insurance. Through its wholly-owned subsidiary TransRe, Alleghany is engaged in the property and casualty reinsurance business. TransRe has been Alleghany s wholly-owned subsidiary since March 2012. Through its wholly-owned subsidiary Alleghany Insurance Holdings LLC (AIHL) and its subsidiaries, Alleghany is engaged in the property and casualty insurance business. AIHL s insurance operations are principally conducted by its subsidiaries RSUI Group, Inc. (RSUI), CapSpecialty, Inc. (CapSpecialty) and, prior to December 31, 2017, Pacific Compensation Corporation (PacificComp). CapSpecialty has been a subsidiary of AIHL since January 2002 and RSUI has been a subsidiary of AIHL since July 2003. AIHL Re LLC (AIHL Re), a captive reinsurance company which provides reinsurance to Alleghany s current and former insurance operating subsidiaries and affiliates, has been a wholly-owned subsidiary of Alleghany since its formation in May 2006.

On September 12, 2017, AIHL signed a definitive agreement to sell PacificComp to CopperPoint Mutual Insurance Company (CopperPoint) for total cash consideration of approximately $158 million. The transaction closed on December 31, 2017, at which time: (i) approximately $442 million of PacificComp assets, consisting primarily of debt securities, and approximately $316 million of PacificComp liabilities, consisting primarily of loss and loss adjustment expenses (LAE) reserves, were transferred; and (ii) AIHL recorded an after-tax gain of approximately $16 million, which included a tax benefit. In connection with the transaction, AIHL Re will continue to provide adverse development reinsurance coverage on PacificComp s pre-acquisition claims, subject to certain terms and conditions. AIHL Re s obligations, which are guaranteed by Alleghany, are subject to: (i) an aggregate limit of $150.0 million; and (ii) a final commutation and settlement as of December 31, 2024.

Although Alleghany s primary sources of revenues and earnings are its reinsurance and insurance operations and investments, Alleghany also sources, executes, manages and monitors certain private investments primarily through its wholly-owned subsidiary Alleghany Capital Corporation (Alleghany Capital). Alleghany Capital s investments include:

- Bourn & Koch, Inc. (Bourn & Koch), a manufacturer/remanufacturer of specialty machine tools and supplier of replacement parts, accessories and services for a variety of cutting technologies, headquartered in Rockford, Illinois;

- R.C. Tway Company, LLC (Kentucky Trailer), a manufacturer of custom trailers and truck bodies for the moving and storage industry and other markets, headquartered in Louisville, Kentucky;

IPS-Integrated Project Services, LLC (IPS), a technical engineering-focused service provider focused on the global pharmaceutical and biotechnology industries, headquartered in Blue Bell, Pennsylvania;

Jazwares, LLC (together with its affiliates, Jazwares), a global toy, entertainment and musical instrument company, headquartered in Sunrise, Florida;

WWSC Holdings, LLC (W&W|AFCO Steel), a structural steel fabricator and erector, headquartered in Oklahoma City, Oklahoma; and

a 45 percent equity interest in Wilbert Funeral Services, Inc. (Wilbert), a provider of products and services for the funeral and cemetery industries and precast concrete markets, headquartered in Overland Park, Kansas.

The results of W&W|AFCO Steel have been included in Alleghany s consolidated results beginning with its acquisition by Alleghany Capital on April 28, 2017. On February 7, 2018, W&W|AFCO Steel acquired Hirschfeld Holdings, LP (Hirschfeld).

Wilbert is accounted for under the equity method of accounting and is included in other invested assets. The results of Wilbert have been included in Alleghany s consolidated results beginning with its acquisition by Alleghany Capital on August 1, 2017.

In addition, Alleghany owns certain other holding-company investments. Stranded Oil Resources Corporation (SORC) is an exploration and production company focused on enhanced oil recovery, headquartered in Golden, Colorado. Alleghany also owns and manages properties in the Sacramento, California region through its wholly-owned subsidiary Alleghany Properties Holdings LLC (Alleghany Properties). Alleghany s public equity investments are managed primarily through Alleghany s wholly-owned subsidiary Roundwood Asset Management LLC.

Unless the context otherwise requires, references to Alleghany include Alleghany together with its subsidiaries.

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The accompanying consolidated financial statements include the results of Alleghany and its wholly-owned and majority-owned subsidiaries and have been prepared in accordance with accounting principles generally accepted in the U.S. (GAAP). All material inter-company balances and transactions have been eliminated in consolidation.

The portion of stockholders equity, net earnings and comprehensive income that is not attributable to Alleghany stockholders is presented on the Consolidated Balance Sheets and the Consolidated Statements of Earnings and Comprehensive Income as noncontrolling interests. Because all noncontrolling interests have the option to sell their ownership interests to Alleghany in the future (generally through 2024), the portion of stockholders equity that is not attributable to Alleghany stockholders is presented on the Consolidated Balance Sheets as redeemable noncontrolling interests for all periods presented. During the first three months of 2018, the approximate noncontrolling interests outstanding were as follows: Bourn & Koch - 11 percent; Kentucky Trailer - 21 percent; IPS - 16 percent; Jazwares - 23 percent; and W&W|AFCO Steel - 20 percent.

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions. These estimates and assumptions affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of the date of the financial statements, as well as the reported amounts of revenues and expenses during the reporting period. Alleghany relies on historical experience and on various other assumptions that it believes to be reasonable under the circumstances to make judgments about the carrying value of assets and liabilities that are not readily apparent from other sources. Actual results may differ materially from those reported results to the extent that those estimates and assumptions prove to be inaccurate. Changes in estimates are reflected in the Consolidated Statements of Earnings and Comprehensive Income in the period in which the changes are made.

(b) Other Significant Accounting Principles

Alleghany s significant accounting principles can be found in Note 1 to Notes to Consolidated Financial Statements set forth in Part II, Item 8, Financial Statements and Supplementary Data of the 2017 Form 10-K.

(c) Recent Accounting Standards

Recently Adopted

In February 2018, the Financial Accounting Standards Board (the FASB) issued guidance on certain tax effects caused by the Tax Cuts and Jobs Act of 2017 (the Tax Act), which was signed into law on December 22, 2017. The Tax Act reduced the corporate federal income tax rate from 35.0 percent to 21.0 percent, effective January 1, 2018 for the 2018 tax year, among other provisions. Under such circumstances, GAAP requires that the value of deferred tax assets and liabilities be reduced through tax expense. The new guidance provides an option to reclassify any stranded tax amounts that remain in accumulated other comprehensive income to retained earnings, either retrospectively or at the beginning of the period in which the adoption is elected. This guidance became effective in the first quarter of 2018 for public entities, with early adoption permitted in 2017. Alleghany adopted this new guidance in the first quarter of 2018, and has elected to reclassify stranded tax amounts that remain in accumulated other comprehensive income, in the amount of approximately $135 million, to retained earnings as of January 1, 2018. See Note 7(b) of this Form 10-Q for further information on accumulated other comprehensive income, and see Note 9 to Notes to Consolidated Financial Statements set forth in Part II, Item 8, Financial Statements and Supplementary Data of the 2017 Form 10-K for additional information on the Tax Act and its impact on Alleghany.

In March 2017, the FASB issued guidance that reduces the amortization period for the premium on certain purchased callable debt securities to the earliest call date. The guidance applies specifically to noncontingent call features that are callable at a predetermined and fixed price and date. The accounting for purchased callable debt securities held at a discount is not affected. This guidance is effective in the first quarter of 2019 for public entities, with early adoption permitted. Alleghany adopted this guidance in the fourth quarter of 2017, and recorded a cumulative effect reduction of approximately $13 million directly to opening 2017 retained earnings and an offsetting increase in opening 2017 accumulated other comprehensive income. The implementation did not have a material impact on Alleghany s results of operations and financial condition. See Note 7(b) of this Form 10-Q for further information on accumulated other comprehensive income.

In May 2014, the FASB, together with the International Accounting Standards Board, issued guidance on the recognition of revenue from contracts with customers. Under this guidance, revenue is recognized as the transfer of goods and services to customers takes place and in amounts that reflect the payment or payments that are expected to be received from the customers for those goods and services. This guidance also requires new disclosures about revenue. Revenues related to insurance and reinsurance contracts and revenues from investments are not impacted by this guidance, whereas noninsurance revenues arising from the sale of manufactured goods and services is generally included within the scope of this guidance. This guidance became effective in the first quarter of 2018 for public entities, with early adoption permitted in 2017. Alleghany adopted this guidance in the first quarter of 2018 using the modified retrospective transition approach, and the implementation did not have a material impact on its results of operations and financial condition.

In January 2016, the FASB issued guidance that changes the recognition and measurement of certain financial instruments. This guidance requires investments in equity securities (except those accounted for under the equity method of accounting, but including partnership investments not accounted for under the equity method) to be measured at fair value with changes in fair value recognized in net income. For equity securities that do not have readily determinable fair values, measurement may be at cost, adjusted for any impairment and changes resulting from observable price changes for a similar investment of the same issuer. This guidance also changes the presentation and disclosure of financial instruments by: (i) requiring that financial instrument disclosures of fair value use the exit price notion; (ii) requiring separate presentation of financial assets and financial liabilities by measurement category and form, either on the balance sheet or the accompanying notes to the financial statements; (iii) requiring separate presentation in other comprehensive income for the portion of the change in a liability s fair value resulting from instrument-specific credit risk when an election has been made to measure the liability at fair value; and (iv) eliminating the requirement to disclose the methods and significant assumptions used to estimate the fair value for financial instruments measured at amortized cost on the balance sheet. This guidance is effective for fiscal years beginning after December 15, 2017 for public entities, including interim periods within those fiscal years. Except for the change in presentation for instrument-specific credit risk, this guidance does not permit early adoption. Alleghany adopted this guidance in the first quarter of 2018. As of January 1, 2018, approximately $736 million of net unrealized gains of equity securities, net of deferred taxes, were reclassified from accumulated other comprehensive income to retained earnings. Subsequently, all changes in unrealized gains or losses of equity securities, net of deferred taxes, were presented in the Consolidated Statements of Earnings rather than the Consolidated Statements of Comprehensive Income, under the caption change in the fair value of equity securities. Results arising from partnership investments, whether accounted for under the equity method or at fair value, continue to be reported as a component of net investment income. The implementation did not have a material impact on Alleghany s financial condition. See Note 3 of this Form 10-Q for further information on Alleghany s equity securities, and Note 7(b) of this Form 10-Q for further information on accumulated other comprehensive income.

Future Application of Accounting Standards

In February 2016, the FASB issued guidance on leases. Under this guidance, a lessee is required to recognize lease liabilities and corresponding right-of-use assets for leases with terms of more than one year, whereas under current guidance, a lessee is only required to recognize assets and liabilities for those leases qualifying as capital leases. This guidance also requires new disclosures about the amount, timing and uncertainty of cash flows arising from leases. The accounting by lessors is to remain largely unchanged. This guidance is effective in the first quarter of 2019 for public entities, with early adoption permitted. A modified retrospective transition approach is required for all leases in existence as of, or entered into after, the beginning of the earliest comparative period presented in the financial statements. Alleghany will adopt this guidance in the first quarter of 2019 and does not currently believe that the implementation will have a material impact on its results of operations and financial condition. See Note 12(b) to Notes to Consolidated Financial Statements set forth in Part II, Item 8, Financial Statements and Supplementary Data of the 2017 Form 10-K for further information on Alleghany s leases.

In June 2016, the FASB issued guidance on credit losses. Under this guidance, a company is required to measure all expected credit losses on loans, reinsurance recoverables and other financial assets accounted for at cost or amortized cost, as applicable. Estimates of expected credit losses are to be based on historical experience, current conditions and reasonable and supportable forecasts. Credit losses for securities accounted for on an available-for-sale (AFS) basis are to be measured in a manner similar to GAAP as currently applied and cannot exceed the amount by which the fair value is less than the amortized cost. Credit losses for all financial assets are to be recorded through an allowance for credit losses. Subsequent reversals in credit loss estimates are permitted and are to be recognized in earnings. This guidance also requires new disclosures about the significant estimates and judgments used in estimating credit losses, as well as the credit quality of financial assets. This guidance is effective in the first quarter of 2020 for public entities, with early adoption permitted. Alleghany will adopt this guidance in the first quarter of 2020 and does not currently believe that the implementation will have a material impact on its results of operations and financial condition.

In January 2017, the FASB issued guidance that simplifies the subsequent measurement of goodwill. Under this guidance, if an initial qualitative assessment indicates that the fair value of an operating subsidiary may be less than its carrying amount, an impairment charge is recognized for the amount by which the carrying amount of the operating subsidiary exceeds its estimated fair value. Any resulting impairment loss recognized cannot exceed the total amount of goodwill associated with the operating subsidiary. This guidance is effective in the first quarter of 2020 for public entities, with early adoption permitted. Alleghany will adopt this guidance in the first quarter of 2020 and does not currently believe that the implementation will have a material impact on its results of operations and financial condition. See Note 2 to Notes to Consolidated Financial Statements set forth in Part II, Item 8, Financial Statements and Supplementary Data of the 2017 Form 10-K for further information on Alleghany s goodwill.

In August 2017, the FASB issued guidance that simplifies the requirements to achieve hedge accounting, better reflects the economic results of hedging in the financial statements and better aligns hedge accounting with a company s risk management activities. This guidance is effective in the first quarter of 2019 for public entities, with early adoption permitted. Alleghany will adopt this guidance in the first quarter of 2019 and does not currently believe that the implementation will have a material impact on its results of operations and financial condition.

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2. Fair Value of Financial Instruments

The following table presents the carrying value and estimated fair value of Alleghany s consolidated financial instruments as of March 31, 2018 and December 31, 2017:

	March 31, 2018		December 31, 2017	
	Carrying Value	Fair Value	Carrying Value	Fair Value
	($ in millions)			
Assets				
Investments (excluding equity method investments and loans)(1)	$ 17,284.1	$ 17,284.1	$ 17,406.5	$ 17,406.5
Liabilities				
Senior Notes and other debt(2)	$ 1,540.9	$ 1,677.8	$ 1,484.9	$ 1,614.6

(1) This table includes debt and equity securities, as well as partnership and non-marketable equity investments carried at fair value that are included in other invested assets. This table excludes investments accounted for using the equity method and commercial mortgage loans that are carried at unpaid principal balance. The fair value of short-term investments approximates amortized cost. The fair value of all other categories of investments is discussed below.

(2) See Note 8 to Notes to Consolidated Financial Statements set forth in Part II, Item 8, Financial Statements and Supplementary Data of the 2017 Form 10-K for additional information on the senior notes and other debt.

The following tables present Alleghany s financial instruments measured at fair value and the level of the fair value hierarchy of inputs used as of March 31, 2018 and December 31, 2017:

	Level 1	Level 2	Level 3	Total
	($ in millions)			
As of March 31, 2018				
Equity securities:				
Common stock	$ 4,537.1	$ 3.6	$ -	$ 4,540.7
Preferred stock	-	-	5.2	5.2
Total equity securities	4,537.1	3.6	5.2	4,545.9
Debt securities:				
U.S. Government obligations	-	1,031.7	-	1,031.7
Municipal bonds	-	3,140.6	-	3,140.6
Foreign government obligations	-	958.1	-	958.1
U.S. corporate bonds	-	1,985.5	290.2	2,275.7
Foreign corporate bonds	-	1,343.3	73.0	1,416.3
Mortgage and asset-backed securities:				
Residential mortgage-backed securities (RMBS(1))	-	897.4	161.8	1,059.2

Commercial mortgage-backed securities (CMBS)		-		525.1		-		525.1
Other asset-backed securities[2]		-		578.2		1,081.3		1,659.5
Total debt securities		-		10,459.9		1,606.3		12,066.2
Short-term investments		-		611.7		-		611.7
Other invested assets[3]		-		-		60.3		60.3
Total investments (excluding equity method investments and loans)	$	4,537.1	$	11,075.2	$	1,671.8	$	17,284.1
Senior Notes and other debt	$	-	$	1,520.9	$	156.9	$	1,677.8

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	Level 1		Level 2		Level 3		Total	
			($ in millions)					
As of December 31, 2017								
Equity securities:								
Common stock	$	4,090.7	$	3.8	$	-	$	4,094.5
Preferred stock		-		3.1		1.9		5.0
Total equity securities		4,090.7		6.9		1.9		4,099.5
Debt securities:								
U.S. Government obligations		-		948.0		-		948.0
Municipal bonds		-		3,682.1		-		3,682.1
Foreign government obligations		-		1,006.6		-		1,006.6
U.S. corporate bonds		-		2,173.0		260.0		2,433.0
Foreign corporate bonds		-		1,424.6		75.2		1,499.8
Mortgage and asset-backed securities:								
RMBS(1)		-		833.8		161.8		995.6
CMBS		-		550.1		1.6		551.7
Other asset-backed securities(2)		-		503.3		1,101.3		1,604.6
Total debt securities		-		11,121.5		1,599.9		12,721.4
Short-term investments		-		578.1		-		578.1
Other invested assets(3)		-		-		7.5		7.5
Total investments (excluding equity method investments and loans)	$	4,090.7	$	11,706.5	$	1,609.3	$	17,406.5
Senior Notes and other debt	$	-	$	1,513.6	$	101.0	$	1,614.6

(1) Primarily includes government agency pass-through securities guaranteed by a government agency or government sponsored enterprise, among other types of RMBS.

(2) Includes $1,071.8 million and $1,101.3 million of collateralized loan obligations as of March 31, 2018 and December 31, 2017, respectively.

(3) Includes partnership and non-marketable equity investments accounted for at fair value, and excludes investments accounted for using the equity method.

In the three months ended March 31, 2018, Alleghany transferred $1.6 million of CMBS securities out of Level 3, principally due to an increase in observable inputs related to the valuation of such assets and, specifically, an increase in broker quotes.

As further described in Note 3(g), on March 15, 2018, most of AIHL s limited partnership interests in certain subsidiaries of Ares Management LLC (Ares) were converted into Ares common units. As a result of the conversion, $208.2 million of Ares common units, classified as common stock, was transferred into Level 1, and $58.7 million of Ares limited partner interests, classified as other invested assets, was transferred into Level 3 as of March 15, 2018.

In addition to the above, in the three months ended March 31, 2018, Alleghany transferred $4.3 million of financial instruments into Level 3, principally due to a decrease in observable inputs related to the valuation of such assets and, specifically, a decrease in broker quotes. Of the $4.3 million of transfers, $3.1 million related to preferred stock and $1.2 million related to U.S. corporate bonds. There were no other material transfers between Levels 1, 2 or 3 in the three months ended March 31, 2018.

In the three months ended March 31, 2017, Alleghany transferred $4.1 million of financial instruments out of Level 3, principally due to an increase in observable inputs related to the valuation of such assets and, specifically, an increase in broker quotes. Of the $4.1 million of transfers, $2.3 million related to common stock and $1.8 million related to U.S. corporate bonds.

In the three months ended March 31, 2017, Alleghany transferred $2.6 million of financial instruments into Level 3, principally due to a decrease in observable inputs related to the valuation of such assets and, specifically, a decrease in broker quotes. Of the $2.6 million of transfers, $1.9 million related to U.S. corporate bonds, $0.4 million related to common stock and $0.3 million related to foreign corporate bonds. There were no other material transfers between Levels 1, 2 or 3 in the three months ended March 31, 2017.

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The following tables present reconciliations of the changes during the three months ended March 31, 2018 and 2017 in Level 3 assets measured at fair value:

Three Months Ended March, 2018	Preferred Stock	Debt Securities U.S. Corporate Bonds	Foreign Corporate Bonds	Mortgage and asset-backed RMBS	CMBS	Other Asset-backed Securities	Other Invested Assets[1]	
			($ in millions)					
Balance as of January 1, 2018	$ 1.9	$ 260.0	$ 75.2	$ 161.8	$ 1.6	$ 1,101.3	$ 7.5	$
Net realized/unrealized gains (losses) included in:								
Net earnings[2]	-	-	-	-	-	0.4	1.2	
Other comprehensive income	0.2	(5.4)	(1.3)	-	-	(3.3)	(1.6)	
Purchases	-	36.2	-	-	-	128.2	-	
Sales	-	(1.8)	(0.9)	-	-	(145.3)	(5.5)	
Issuances	-	-	-	-	-	-	-	
Settlements	-	-	-	-	-	-	-	
Transfers into Level 3	3.1	1.2	-	-	-	-	58.7	
Transfers out of Level 3	-	-	-	-	(1.6)	-	-	
Balance as of March 31, 2018	$ 5.2	$ 290.2	$ 73.0	$ 161.8	$ -	$ 1,081.3	$ 60.3	$

Three Months Ended March, 2017	Equity Securities Common Stock	Preferred Stock	Debt Securities U.S. Corporate Bonds	Foreign Corporate Bonds	RMBS	Mortgage and asset-backed CMBS	Other Asset-backed Securities	
				($ in millions)				
Balance as of January 1, 2017	$ 4.3	$ -	$ 72.9	$ 0.4	$ 5.9	$ 4.3	$ 903.8	$
Net realized/unrealized gains (losses) included in:								
Net earnings[2]	-	-	(0.1)	-	0.1	-	1.5	
Other comprehensive income	0.2	-	0.2	-	-	-	11.6	
Purchases	-	2.4	43.8	3.1	-	-	380.6	
Sales	(1.8)	-	(2.0)	-	-	-	(16.0)	
Issuances	-	-	-	-	-	-	-	
Settlements	-	-	(3.2)	-	(0.4)	(0.2)	(82.2)	
Transfers into Level 3	0.4	-	1.9	0.3	-	-	-	
Transfers out of Level 3	(2.3)	-	(1.8)	-	-	-	-	
Balance as of March 31, 2017	$ 0.8	$ 2.4	$ 111.7	$ 3.8	$ 5.6	$ 4.1	$ 1,199.3	$

(1) Includes partnership and non-marketable equity investments accounted for at fair value.
(2) There were no other than temporary impairment (OTTI) losses recorded in net earnings related to Level 3 assets still held as of March 31, 2018 and 2017.

Net unrealized losses related to Level 3 assets as of March 31, 2018 and December 31, 2017 were not material.

See Note 1(c) to Notes to Consolidated Financial Statements set forth in Part II, Item 8, Financial Statements and Supplementary Data of the 2017 Form 10-K for Alleghany s accounting policy on fair value.

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3. Investments

(a) Unrealized Gains and Losses

The following tables present the amortized cost or cost and the fair value of AFS securities as of March 31, 2018 and December 31, 2017:

	Amortized Cost or Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
		($ in millions)		
As of March 31, 2018				
Debt securities:				
U.S. Government obligations	$ 1,060.4	$ 1.0	$ (29.7)	$ 1,031.7
Municipal bonds	3,101.2	58.2	(18.8)	3,140.6
Foreign government obligations	954.6	9.6	(6.1)	958.1
U.S. corporate bonds	2,275.4	29.5	(29.2)	2,275.7
Foreign corporate bonds	1,416.5	15.4	(15.6)	1,416.3
Mortgage and asset-backed securities:				
RMBS	1,077.0	3.9	(21.7)	1,059.2
CMBS	526.4	3.9	(5.2)	525.1
Other asset-backed securities[(1)]	1,653.7	9.2	(3.4)	1,659.5
Total debt securities	12,065.2	130.7	(129.7)	12,066.2
Short-term investments	611.7	-	-	611.7
Total investments	$ 12,676.9	$ 130.7	$ (129.7)	$ 12,677.9

	Amortized Cost or Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
		($ in millions)		
As of December 31, 2017				
Equity securities:				
Common stock	$ 3,165.8	$ 932.5	$ (3.8)	$ 4,094.5
Preferred stock	4.9	0.1	-	5.0
Total equity securities	3,170.7	932.6	(3.8)	4,099.5
Debt securities:				
U.S. Government obligations	963.9	1.7	(17.6)	948.0
Municipal bonds	3,578.9	109.8	(6.6)	3,682.1
Foreign government obligations	1,000.1	11.2	(4.7)	1,006.6
U.S. corporate bonds	2,381.1	61.6	(9.7)	2,433.0

Foreign corporate bonds		1,481.8		24.5		(6.5)		1,499.8
Mortgage and asset-backed securities:								
RMBS		993.9		6.3		(4.6)		995.6
CMBS		545.0		9.0		(2.3)		551.7
Other asset-backed securities[1]		1,592.1		13.8		(1.3)		1,604.6
Total debt securities		12,536.8		237.9		(53.3)		12,721.4
Short-term investments		578.1		-		-		578.1
Total investments	$	16,285.6	$	1,170.5	$	(57.1)	$	17,399.0

(1) Includes $1,071.8 million and $1,101.3 million of collateralized loan obligations as of March 31, 2018 and December 31, 2017, respectively.

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(b) Contractual Maturity

The following table presents the amortized cost or cost and estimated fair value of debt securities by contractual maturity as of March 31, 2018. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Amortized Cost or Cost	Fair Value
	($ in millions)	
As of March 31, 2018		
Short-term investments due in one year or less	$ 611.7	$ 611.7
Mortgage and asset-backed securities[1]	3,257.1	3,243.8
Debt securities with maturity dates:		
One year or less	293.9	294.7
Over one through five years	3,096.4	3,089.4
Over five through ten years	2,979.0	2,968.3
Over ten years	2,438.8	2,470.0
Total debt securities	$ 12,065.2	$ 12,066.2

(1) Mortgage and asset-backed securities by their nature do not generally have single maturity dates.

(c) Net Investment Income

The following table presents net investment income for the three months ended March 31, 2018 and 2017:

	Three Months Ended March 31, 2018	2017
	($ in millions)	
Interest income	$ 102.0	$ 99.2
Dividend income	16.4	9.4
Investment expenses	(12.0)	(7.3)
Pillar Investments[1]	-	3.4
Limited partnership interests in certain subsidiaries of Ares[1]	13.7	5.2
Other investment results	4.0	5.6

Total	$	124.1	$	115.5

(1) See Note 3(g) of this Form 10-Q for discussion of the Pillar Investments, as defined therein, and limited partnership interests in certain subsidiaries of Ares.

As of March 31, 2018, non-income producing invested assets were immaterial.

(d) Realized Gains and Losses

The proceeds from sales of debt and equity securities were $1.2 billion and $2.7 billion for the three months ended March 31, 2018 and 2017, respectively.

In the first quarter of 2018, Alleghany adopted new accounting guidance which requires changes in the fair value of equity securities, except those accounted for under the equity method, to be recognized in net income. See Note 1(c) of this Form 10-Q for additional information regarding Alleghany s adoption of this new investment accounting guidance.

Realized capital gains and losses for the three months ended March 31, 2018 primarily reflect a $45.7 million gain on AIHL s conversion of its limited partnership interests in certain subsidiaries of Ares into Ares common units. See Note 3(g) of this Form 10-Q for additional information on this conversion.

Realized capital gains and losses for the three months ended March 31, 2017 primarily reflect sales of equity securities.

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The following table presents amounts of gross realized capital gains and gross realized capital losses for the three months ended March 31, 2018 and 2017:

	Three Months Ended March 31, 2018	Three Months Ended March 31, 2017
	($ in millions)	
Gross realized capital gains	$ 60.3	$ 108.7
Gross realized capital losses	(15.8)	(49.1)
Net realized capital gains	$ 44.5	$ 59.6

Gross realized loss amounts exclude OTTI losses, as discussed below.

(e) OTTI Losses

Alleghany holds its debt securities as AFS and, as such, these securities are recorded at fair value. Alleghany continually monitors the difference between amortized cost and the estimated fair value of its debt investments, which involves uncertainty as to whether declines in value are temporary in nature. The analysis of a security s decline in value is performed in its functional currency. If the decline is deemed temporary, Alleghany records the decline as an unrealized loss in stockholders equity. If the decline is deemed to be other than temporary, Alleghany writes its amortized cost-basis down to the fair value of the security and records an OTTI loss on its statement of earnings. In addition, any portion of such decline related to a debt security that is believed to arise from factors other than credit is recorded as a component of other comprehensive income rather than charged against earnings.

Debt securities in an unrealized loss position are evaluated for OTTI if they meet any of the following criteria: (i) they are trading at a discount of at least 20 percent to amortized cost for an extended period of time (nine consecutive months or more); (ii) there has been a negative credit or news event with respect to the issuer that could indicate the existence of an OTTI; or (iii) Alleghany intends to sell, or it is more likely than not that Alleghany will sell, the debt security before recovery of its amortized cost basis.

If Alleghany intends to sell, or it is more likely than not that Alleghany will sell, a debt security before recovery of its amortized cost basis, the total amount of the unrealized loss position is recognized as an OTTI loss in earnings. To the extent that a debt security that is in an unrealized loss position is not impaired based on the preceding, Alleghany will consider a debt security to be impaired when it believes it to be probable that Alleghany will not be able to collect the entire amortized cost basis. For debt securities in an unrealized loss position as of the end of each quarter, Alleghany develops a best estimate of the present value of expected cash flows. If the results of the cash flow analysis indicate that Alleghany will not recover the full amount of its amortized cost basis in the debt security, Alleghany records an OTTI loss in earnings equal to the difference between the present value of expected cash flows and the amortized cost basis of the debt security. If applicable, the difference between the total unrealized loss position on the debt security and the OTTI loss recognized in earnings is the non-credit related portion, which is recorded as a component of other comprehensive income.

In developing the cash flow analyses for debt securities, Alleghany considers various factors for the different categories of debt securities. For municipal bonds, Alleghany takes into account the taxing power of the issuer, source of revenue, credit risk and enhancements and pre-refunding. For mortgage and asset-backed securities, Alleghany discounts its best estimate of future cash flows at an effective rate equal to the original effective yield of the security or, in the case of floating rate securities, at the current coupon. Alleghany s models include assumptions about prepayment speeds, default and delinquency rates, underlying collateral (if any), credit ratings, credit enhancements and other observable market data. For corporate bonds, Alleghany reviews business prospects, credit ratings and available information from asset managers and rating agencies for individual securities.

OTTI losses in the first three months of 2018 reflect $0.5 million of unrealized losses on debt securities that were deemed to be other than temporary and, as such, were required to be charged against earnings.

OTTI losses in the first three months of 2017 reflect $3.2 million of unrealized losses that were deemed to be other than temporary and, as such, were required to be charged against earnings. Of the $3.2 million of OTTI losses, $3.1 million related to equity securities, primarily in the retail sector, and $0.1 million related to debt securities. The determination that unrealized losses on equity and debt securities were other than temporary was primarily due to the duration of the decline in the fair value of equity and debt securities relative to their costs.

Upon the ultimate disposition of the securities for which OTTI losses have been recorded, a portion of the loss may be recoverable depending on market conditions at the time of disposition. After adjusting the amortized cost basis of securities for the recognition of OTTI losses, the remaining gross unrealized investment losses for debt securities as of March 31, 2018 were deemed to be temporary, based on, among other factors: (i) the duration of time and the relative magnitude to which the fair value of these investments had been below cost were not indicative of an OTTI loss; (ii) the absence of compelling evidence that would cause

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Alleghany to call into question the financial condition or near-term business prospects of the issuer of the security; and (iii) Alleghany s ability and intent to hold the security for a period of time sufficient to allow for any anticipated recovery.

Alleghany may ultimately record a realized loss after having originally concluded that the decline in value was temporary. Risks and uncertainties are inherent in the methodology. Alleghany s methodology for assessing other than temporary declines in value contains inherent risks and uncertainties which could include, but are not limited to, incorrect assumptions about financial condition, liquidity or future prospects, inadequacy of any underlying collateral and unfavorable changes in economic conditions or social trends, interest rates or credit ratings.

(f) Aging of Gross Unrealized Losses

The following tables present gross unrealized losses and related fair values for Alleghany s AFS securities, grouped by duration of time in a continuous unrealized loss position, as of March 31, 2018 and December 31, 2017:

	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
	($ in millions)					
As of March 31, 2018						
Debt securities:						
U.S. Government obligations	$ 480.1	$ 10.8	$ 381.6	$ 18.9	$ 861.7	$ 29.7
Municipal bonds	594.7	9.5	220.5	9.3	815.2	18.8
Foreign government obligations	301.5	3.9	70.6	2.2	372.1	6.1
U.S. corporate bonds	1,070.4	21.1	191.4	8.1	1,261.8	29.2
Foreign corporate bonds	648.3	10.2	155.4	5.4	803.7	15.6
Mortgage and asset-backed securities:						
RMBS	768.6	16.7	120.5	5.0	889.1	21.7
CMBS	223.7	3.0	32.7	2.2	256.4	5.2
Other asset-backed securities	581.4	2.9	34.0	0.5	615.4	3.4
Total temporarily impaired securities	$ 4,668.7	$ 78.1	$ 1,206.7	$ 51.6	$ 5,875.4	$ 129.7

	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
	($ in millions)					
As of December 31, 2017						
Equity securities:						

Common stock	$	145.7	$	3.8	$	-	$	-	$	145.7	$	3.8
Preferred stock		-		-		-		-		-		-
Total equity securities		145.7		3.8		-		-		145.7		3.8
Debt securities:												
U.S. Government obligations		447.8		4.4		416.6		13.2		864.4		17.6
Municipal bonds		240.0		1.5		267.3		5.1		507.3		6.6
Foreign government obligations		321.9		2.7		72.2		2.0		394.1		4.7
U.S. corporate bonds		568.8		6.1		207.3		3.6		776.1		9.7
Foreign corporate bonds		417.4		3.0		159.4		3.5		576.8		6.5
Mortgage and asset-backed securities:												
RMBS		284.2		1.6		131.5		3.0		415.7		4.6
CMBS		112.2		0.5		34.7		1.8		146.9		2.3
Other asset-backed securities		211.1		0.9		65.7		0.4		276.8		1.3
Total debt securities		2,603.4		20.7		1,354.7		32.6		3,958.1		53.3
Total temporarily impaired securities	$	2,749.1	$	24.5	$	1,354.7	$	32.6	$	4,103.8	$	57.1

As of March 31, 2018, Alleghany held a total of 1,820 debt securities that were in an unrealized loss position, of which 390 securities were in an unrealized loss position continuously for 12 months or more. The unrealized losses associated with these debt securities consisted primarily of losses related primarily to U.S. Government obligations, municipal bonds and U.S. corporate bonds.

As of March 31, 2018, the vast majority of Alleghany s debt securities were rated investment grade, with 4.4 percent of debt securities having issuer credit ratings that were below investment grade or not rated, compared with 5.3 percent as of December 31, 2017.

(g) Investments in Certain Other Invested Assets

In December 2012, TransRe obtained an ownership interest in Pillar Capital Holdings Limited (Pillar Holdings), a Bermuda-based insurance asset manager focused on collateralized reinsurance and catastrophe insurance-linked securities. Additionally, TransRe invested $175.0 million and AIHL invested $25.0 million in limited partnership funds managed by Pillar Holdings (the