

AMERICAN FINANCIAL GROUP INC

Form 10-Q

August 08, 2012

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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 Quarterly Period Ended June 30, 2012

Commission File No. 1-13653

AMERICAN FINANCIAL GROUP, INC.

Incorporated under

the Laws of Ohio

301 East Fourth Street, Cincinnati, Ohio 45202

IRS Employer I.D.

No. 31-1544320

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(513) 579-2121

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

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

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company:

Large Accelerated Filer

Accelerated Filer

Non-Accelerated Filer

Smaller Reporting Company

Indicate by check mark whether the Registrant is a shell company. Yes No

As of August 1, 2012, there were 93,867,273 shares of the Registrant's Common Stock outstanding, excluding 14.9 million shares owned by subsidiaries.

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	June 30, 2012	December 31, 2011 (as adjusted)
Assets:		
Cash and cash equivalents	\$ 1,523	\$ 1,324
Investments:		
Fixed maturities, available for sale at fair value (amortized cost \$21,373 and \$20,562)	22,981	21,807
Fixed maturities, trading at fair value	447	440
Equity securities, at fair value (cost \$897 and \$744)	1,121	928
Mortgage loans	488	401
Policy loans	247	252
Real estate and other investments	494	425
Total cash and investments	27,301	25,577
Recoverables from reinsurers	2,740	2,942
Prepaid reinsurance premiums	488	409
Agents' balances and premiums receivable	702	565
Deferred policy acquisition costs	846	901
Assets of managed investment entities	2,825	3,058
Other receivables	673	895
Variable annuity assets (separate accounts)	574	548
Other assets	717	757
Goodwill	186	186
Total assets	\$ 37,052	\$ 35,838
Liabilities and Equity:		
Unpaid losses and loss adjustment expenses	\$ 6,153	\$ 6,520
Unearned premiums	1,661	1,484
Annuity benefits accumulated	16,758	15,420
Life, accident and health reserves	1,750	1,727
Payable to reinsurers	396	475
Liabilities of managed investment entities	2,502	2,787
Long-term debt	1,158	934
Variable annuity liabilities (separate accounts)	574	548
Other liabilities	1,325	1,386
Total liabilities	32,277	31,281

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Shareholders' equity:

Common Stock, no par value		
- 200,000,000 shares authorized		
- 94,959,232 and 97,846,402 shares outstanding	95	98
Capital surplus	1,112	1,121
Retained earnings:		
Appropriated - managed investment entities	127	173
Unappropriated	2,515	2,439
Accumulated other comprehensive income, net of tax	773	580
Total shareholders' equity	4,622	4,411
Noncontrolling interests	153	146
Total equity	4,775	4,557
Total liabilities and equity	\$ 37,052	\$ 35,838

Table of Contents**AMERICAN FINANCIAL GROUP, INC. 10-Q****AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENT OF EARNINGS****CONSOLIDATED STATEMENT OF EARNINGS (UNAUDITED)****(In Millions, Except Per Share Data)**

	Three months ended June 30, 2011 (as adjusted)		Six months ended June 30, 2011 (as adjusted)	
	2012	(as adjusted)	2012	(as adjusted)
Revenues:				
Property and casualty insurance premiums	\$ 640	\$ 609	\$ 1,243	\$ 1,208
Life, accident and health premiums	105	107	210	217
Investment income	332	306	654	606
Realized gains (losses) on:				
Securities (*)	16	19	60	19
Subsidiaries	(1)		(1)	(3)
Income (loss) of managed investment entities:				
Investment income	32	26	61	51
Loss on change in fair value of assets/liabilities	(21)	(22)	(50)	(55)
Other income	47	48	86	89
Total revenues	1,150	1,093	2,263	2,132
Costs and Expenses:				
Property and casualty insurance:				
Losses and loss adjustment expenses	363	413	707	754
Commissions and other underwriting expenses	232	217	443	420
Annuity benefits	147	125	277	241
Life, accident and health benefits	84	89	176	185
Annuity and supplemental insurance acquisition expenses	48	49	95	99
Interest charges on borrowed money	21	21	42	42
Expenses of managed investment entities	20	18	39	36
Other operating and general expenses	99	101	202	193
Total costs and expenses	1,014	1,033	1,981	1,970
Operating earnings before income taxes	136	60	282	162
Provision for income taxes	52	30	110	78
Net earnings, including noncontrolling interests	84	30	172	84
Less: Net earnings (loss) attributable to noncontrolling interests	(15)	(18)	(40)	(52)
Net Earnings Attributable to Shareholders	\$ 99	\$ 48	\$ 212	\$ 136
Earnings Attributable to Shareholders per Common Share:				
Basic	\$ 1.02	\$.47	\$ 2.18	\$ 1.31
Diluted	\$ 1.01	\$.46	\$ 2.15	\$ 1.29

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Average number of Common Shares:

Basic	96.4	102.7	97.0	103.7
Diluted	98.0	104.4	98.7	105.3
Cash dividends per Common Share	\$.175	\$.1625	\$.35	\$.325

(*) Consists of the following:

Realized gains before impairments	\$ 23	\$ 40	\$ 71	\$ 50
Losses on securities with impairment	(7)	(10)	(12)	(17)
Non-credit portion recognized in other comprehensive income (loss)		(11)	1	(14)
Impairment charges recognized in earnings	(7)	(21)	(11)	(31)
Total realized gains on securities	\$ 16	\$ 19	\$ 60	\$ 19

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	Three months ended June 30,		Six months ended June 30,	
	2012	2011	2012	2011
Net earnings, including noncontrolling interests	\$ 84	\$ 30	\$ 172	\$ 84
Other comprehensive income, net of tax:				
Net unrealized gains on securities:				
Unrealized holding gains on securities arising during the period	78	115	236	136
Reclassification adjustment for realized gains included in net earnings	(12)	(17)	(40)	(20)
Total net unrealized gains on securities	66	98	196	116
Foreign currency translation adjustments	(8)	(2)	(1)	5
Pension and other postretirement plans adjustments		1	1	1
Other comprehensive income, net of tax	58	97	196	122
Total comprehensive income, net of tax	142	127	368	206
Less: Comprehensive income (loss) attributable to noncontrolling interests	(16)	(16)	(37)	(50)
Comprehensive income attributable to shareholders	\$ 158	\$ 143	\$ 405	\$ 256

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AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF CHANGES IN EQUITY

CONSOLIDATED STATEMENT OF CHANGES IN EQUITY (UNAUDITED)

(Dollars in Millions)

	Common Stock		Shareholders' Equity		Other Comp Inc.(Loss)	Total	Noncon- trolling Interests	Total Equity
	Common Shares	and Capital Surplus	Retained Earnings Appro.	Unappro.				
Balance at December 31, 2011, as adjusted	97,846,402	\$ 1,219	\$ 173	\$ 2,439	\$ 580	\$ 4,411	\$ 146	\$ 4,557
Net earnings				212		212	(40)	172
Other comprehensive income					193	193	3	196
Allocation of losses of managed investment entities			(46)			(46)	46	
Dividends on Common Stock				(33)		(33)		(33)
Shares issued:								
Exercise of stock options	814,394	21				21		21
Other benefit plans	276,195	5				5		5
Dividend reinvestment plan	7,711							
Stock-based compensation expense		12				12		12
Shares acquired and retired	(3,985,470)	(50)		(103)		(153)		(153)
Other							(2)	(2)
Balance at June 30, 2012	94,959,232	\$ 1,207	\$ 127	\$ 2,515	\$ 773	\$ 4,622	\$ 153	\$ 4,775
Balance at December 31, 2010	105,168,366	\$ 1,271	\$ 197	\$ 2,523	\$ 479	\$ 4,470	\$ 150	\$ 4,620
Cumulative effect of accounting change				(155)	16	(139)		(139)
Balance at December 31, 2010, as adjusted	105,168,366	1,271	197	2,368	495	4,331	150	4,481
Net earnings				136		136	(52)	84
Other comprehensive income					120	120	2	122
Allocation of losses of managed investment entities			(55)			(55)	55	
Dividends on Common Stock				(34)		(34)		(34)
Shares issued:								
Exercise of stock options	654,799	16				16		16
Other benefit plans	357,042	8				8		8
Dividend reinvestment plan	7,870							
Stock-based compensation expense		7				7		7
Shares acquired and retired	(5,167,842)	(63)		(115)		(178)		(178)
Other							(2)	(2)
Balance at June 30, 2011	101,020,235	\$ 1,239	\$ 142	\$ 2,355	\$ 615	\$ 4,351	\$ 153	\$ 4,504

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	Six months ended June 30,	
	2012	2011 (as adjusted)
Operating Activities:		
Net earnings, including noncontrolling interests	\$ 172	\$ 84
Adjustments:		
Depreciation and amortization	83	91
Annuity benefits	277	241
Realized gains on investing activities	(57)	(16)
Net sales of trading securities	5	6
Deferred annuity and life policy acquisition costs	(129)	(119)
Change in:		
Reinsurance and other receivables	212	156
Other assets	50	13
Insurance claims and reserves	(167)	(12)
Payable to reinsurers	(79)	(18)
Other liabilities	(179)	112
Managed investment entities assets/liabilities	40	(12)
Other operating activities, net	(2)	8
Net cash provided by operating activities	226	534
Investing Activities:		
Purchases of:		
Fixed maturities	(1,976)	(2,302)
Equity securities	(194)	(104)
Mortgage loans	(97)	(91)
Real estate, property and equipment	(52)	(57)
Proceeds from:		
Maturities and redemptions of fixed maturities	993	1,106
Repayments of mortgage loans	6	224
Sales of fixed maturities	239	374
Sales of equity securities	107	41
Sales of real estate, property and equipment	3	1
Managed investment entities:		
Purchases of investments	(925)	(681)
Proceeds from sales and redemptions of investments	1,106	754
Other investing activities, net	(36)	(6)
Net cash used in investing activities	(826)	(741)
Financing Activities:		

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Annuity receipts	1,710	1,578
Annuity surrenders, benefits and withdrawals	(696)	(636)
Additional long-term borrowings	223	2
Reductions of long-term debt	(6)	(14)
Issuances of managed investment entities liabilities	359	
Retirement of managed investment entities liabilities	(633)	(8)
Issuances of Common Stock	22	16
Repurchases of Common Stock	(153)	(178)
Cash dividends paid on Common Stock	(33)	(34)
Other financing activities, net	6	11
Net cash provided by financing activities	799	737
Net Change in Cash and Cash Equivalents	199	530
Cash and cash equivalents at beginning of period	1,324	1,099
Cash and cash equivalents at end of period	\$ 1,523	\$ 1,629

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A. Accounting Policies

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

Certain reclassifications have been made to prior periods to conform to the current year's presentation. All significant intercompany balances and transactions have been eliminated. The results of operations of companies since their formation or acquisition are included in the consolidated financial statements. Events or transactions occurring subsequent to June 30, 2012, and prior to the filing date of this Form 10-Q, have been evaluated for potential recognition or disclosure herein.

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

Accounting Standards Adopted in 2012 Effective January 1, 2012, AFG retrospectively adopted Accounting Standards Update (ASU) 2010-26 that addresses which costs related to issuing or renewing insurance contracts qualify for deferral. To qualify for deferral, the guidance specifies that a cost must be directly related to the successful acquisition of an insurance contract. The financial statements for prior periods have been adjusted to reflect the adoption of the new standard.

The impact of adoption on amounts previously reported is shown in the table below (in millions, except per share data):

	December 31, 2011
Deferred policy acquisition costs	
As previously reported	\$ 1,105
As adjusted	901
Net deferred tax liability (included in other liabilities)	
As previously reported	\$ 203
As adjusted	133
Shareholders' equity	
As previously reported	\$ 4,545
As adjusted	4,411

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	1st Quarter	2nd Quarter	2011 3rd Quarter	4th Quarter	Total Year
Net earnings attributable to shareholders					
As previously reported	\$ 83	\$ 55	\$ 96	\$ 109	\$ 343
As adjusted	88	48	97	109	342
Diluted earnings per Common Share					
As previously reported	\$.79	\$.52	\$.94	\$ 1.10	\$ 3.33
As adjusted	.83	.46	.95	1.09	3.32

Effective January 1, 2012, AFG retrospectively adopted ASU 2011-05, which eliminates the option to report other comprehensive income in the Statement of Changes in Equity. As permitted by the standard, comprehensive income is presented herein in a separate statement immediately following the Statement of Earnings. This new presentation does not change the measurement of net earnings, other comprehensive income or earnings per share, and accordingly, had no impact on AFG's results of operations or financial position.

Effective January 1, 2012, AFG adopted ASU 2011-04, which clarifies the application of existing fair value measurement and amends certain disclosure requirements. Disclosures required by the guidance are included in Note D. The impact of adoption was not material to AFG's results of operations or financial position.

Fair Value Measurements Accounting standards define fair value as the price that would be received to sell an asset or paid to transfer a liability (an exit price) in an orderly transaction between market participants on the measurement date. The standards establish a hierarchy of valuation techniques based on whether the assumptions that market participants would use in pricing the asset or liability (inputs) are observable or unobservable. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect AFG's assumptions about the assumptions market participants would use in pricing the asset or liability. AFG did not have any significant nonrecurring fair value measurements of nonfinancial assets and liabilities in the first six months of 2012 or 2011.

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

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

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED

Gains or losses on securities are determined on the specific identification basis. When a decline in the value of a specific investment is considered to be other-than-temporary at the balance sheet date, a provision for impairment is charged to earnings (included in realized gains (losses)) and the cost basis of that investment is reduced. If management can assert that it does not intend to sell an impaired fixed maturity security and it is not more likely than not that it will have to sell the security before recovery of its amortized cost basis, then the other-than-temporary impairment is separated into two components: 1) the amount related to credit losses (recorded in earnings) and 2) the amount related to all other factors (recorded in other comprehensive income). The credit-related portion of an other-than-temporary impairment is measured by comparing a security's amortized cost to the present value of its current expected cash flows discounted at its effective yield prior to the impairment charge. Both components are shown in the Statement of Earnings. If management intends to sell an impaired security, or it is more likely than not that it will be required to sell the security before recovery, an impairment charge to earnings is recorded to reduce the amortized cost of that security to fair value.

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

Goodwill Goodwill represents the excess of cost of subsidiaries over AFG's equity in their underlying net assets. Goodwill is not amortized, but is subject to an impairment test at least annually. Under guidance adopted in 2011, an entity is only required to complete the quantitative annual goodwill impairment test on a reporting unit if the entity determines (through qualitative analysis) that it is more likely than not that the reporting unit's fair value is less than its carrying amount.

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

Certain annuity and supplemental insurance subsidiaries cede life insurance policies to a third party on a funds withheld basis whereby the subsidiaries retain the assets (securities) associated with the reinsurance contracts. Interest is credited to the reinsurer based on the actual investment performance of the retained assets. These reinsurance contracts are considered to contain embedded derivatives (that must be adjusted to fair value) because the yield on the payables is based on specific blocks of the ceding companies' assets, rather than the overall creditworthiness of the ceding company. AFG determined that changes in the fair value of the underlying portfolios of fixed maturity securities is an appropriate measure of the value of the embedded derivative. The securities related to these transactions are classified as trading. The adjustment to fair value on the embedded derivatives offsets the investment income recorded on the adjustment to fair value of the related trading portfolios.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED

Deferred Policy Acquisition Costs (DPAC) Policy acquisition costs (principally commissions, premium taxes and certain underwriting and policy issuance costs) directly related to the successful acquisition or renewal of an insurance contract are deferred. DPAC also includes capitalized costs associated with sales inducements offered to fixed annuity policyholders such as enhanced interest rates and premium and persistency bonuses. As discussed above under Accounting Standards Adopted in 2012, AFG's accounting for DPAC changed effective January 1, 2012, and amounts previously reported have been adjusted retrospectively.

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

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

DPAC related to traditional life and health insurance is amortized over the expected premium paying period of the related policies, in proportion to the ratio of annual premium revenues to total anticipated premium revenues.

DPAC related to annuities is also adjusted, net of tax, for the change in amortization that would have been recorded if the unrealized gains (losses) from securities had actually been realized. This adjustment is included in unrealized gains (losses) on marketable securities, a component of accumulated other comprehensive income in AFG's Balance Sheet.

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

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

Table of Contents**AMERICAN FINANCIAL GROUP, INC. 10-Q****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED**

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

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

The net gain or loss from accounting for the CLO assets and liabilities at fair value is separately presented in AFG's Statement of Earnings. CLO earnings attributable to AFG's shareholders represent the change in fair value of AFG's investments in the CLOs (including distributions) and management fees earned. All other CLO earnings (losses) are not attributable to AFG's shareholders and will ultimately inure to the benefit of the other CLO debt holders. As a result, such CLO earnings (losses) are included in net earnings (loss) attributable to noncontrolling interests in AFG's Statement of Earnings and in appropriated retained earnings managed investment entities in the Balance Sheet. As the CLOs approach maturity (2016 to 2022), it is expected that losses attributable to noncontrolling interests will reduce appropriated retained earnings towards zero as the fair values of the assets and liabilities converge and the CLO assets are used to pay the CLO debt.

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

Loss reserve liabilities are subject to the impact of changes in claim amounts and frequency and other factors. Changes in estimates of the liabilities for losses and loss adjustment expenses are reflected in the Statement of Earnings in the period in which determined. Despite the variability inherent in such estimates, management believes that the liabilities for unpaid losses and loss adjustment expenses are adequate.

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

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED

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

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

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

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

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

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

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

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

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED

AFG records a liability for the inherent uncertainty in quantifying its income tax provisions. Related interest and penalties are recognized as a component of tax expense.

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

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

Earnings Per Share Basic earnings per share is calculated using the weighted average number of shares of common stock outstanding during the period. The calculation of diluted earnings per share includes adjustments to weighted average common shares related to stock-based compensation plans: second quarter 2012 and 2011 1.6 million and 1.7 million; first six months of 2012 and 2011 1.7 million and 1.6 million, respectively.

AFG's weighted average diluted shares outstanding excludes the following anti-dilutive potential common shares related to stock compensation plans: second quarter 2012 and 2011 2.1 million and 2.4 million; first six months of 2012 and 2011 1.8 million and 2.1 million, respectively. Adjustments to net earnings attributable to shareholders in the calculation of diluted earnings per share were nominal in the 2012 and 2011 periods.

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

B. Sale of Operations

B. Sale of Operations In May 2012 AFG reached a definitive agreement to sell its Medicare supplement and critical illness business to Cigna Corporation for approximately \$295 million in cash. The sale is expected to close in the third quarter of 2012, and result in a pretax gain of approximately \$150-\$165 million. Since the transaction will include the ongoing ceding of business to Cigna in a reinsurance transaction, the operations being sold are not reported as discontinued operations. Following the sale, AFG's supplemental insurance operations will consist solely of its run-off long-term care business. Long-term care insurance is highly sensitive to actuarial assumptions and subject to significant uncertainties.

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Summarized financial information for the Medicare supplement and critical illness businesses being sold is shown below (in millions):

	June 30, 2012	December 31, 2011
Assets:		
Cash and investments	\$ 213	\$ 205
Deferred policy acquisition costs	107	110
Other assets	84	88
Total assets	\$ 404	\$ 403
Liabilities:		
Accident and health reserves	\$ 262	\$ 264
Other liabilities	18	15
Total liabilities	\$ 280	\$ 279
	Six months ended June 30,	
	2012	2011
Total revenues	\$ 159	\$ 164
Total costs and expenses	141	154
Operating earnings before income taxes	\$ 18	\$ 10

C. Segments of Operations

AFG manages its business as three segments: (i) property and casualty insurance, (ii) annuity and supplemental insurance and (iii) other, which includes holding company costs and amounts attributable to the noncontrolling interests of the managed investment entities.

AFG reports its property and casualty insurance business in the following Specialty sub-segments: (i) Property and transportation, which includes physical damage and liability coverage for buses, trucks and recreational vehicles, inland and ocean marine, agricultural-related products and other property coverages, (ii) Specialty casualty, which includes primarily excess and surplus, general liability, executive liability, umbrella and excess liability, customized programs for small to mid-sized businesses and workers' compensation, and (iii) Specialty financial, which includes risk management insurance programs for lending and leasing institutions (including collateral and mortgage protection insurance), surety and fidelity products and trade credit insurance. AFG's annuity and supplemental insurance business markets traditional fixed and indexed annuities and a variety of supplemental insurance products such as Medicare supplement. Following the sale of its Medicare supplement and critical illness businesses (see *Note B - Sale of Operations*), AFG's annuity and supplemental insurance business will market solely traditional fixed and indexed annuities and, to a much lesser extent, variable annuities. In addition, this segment will include run-off blocks of long-term care and life insurance.

AFG's reportable segments and their components were determined based primarily upon similar economic characteristics, products and services.

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

	Three months ended June 30,		Six months ended June 30,	
	2012	2011	2012	2011
Revenues				
Property and casualty insurance:				
Premiums earned:				
Specialty				
Property and transportation	\$ 290	\$ 274	\$ 553	\$ 529
Specialty casualty	236	219	456	435
Specialty financial	98	100	201	212
Other	16	16	33	32
Total premiums earned	640	609	1,243	1,208
Investment income	70	75	141	150
Realized gains	13	32	44	32
Other income	18	20	31	35
Total property and casualty insurance	741	736	1,459	1,425
Annuity and supplemental insurance:				
Investment income				
	267	230	519	458
Life, accident and health premiums	105	107	210	217
Realized gains (losses)	2	(13)	15	(16)
Other income	28	28	54	52
Total annuity and supplemental insurance	402	352	798	711
Other	7	5	6	(4)
Total revenues	\$ 1,150	\$ 1,093	\$ 2,263	\$ 2,132
Operating Earnings Before Income Taxes				
Property and casualty insurance:				
Underwriting:				
Specialty				
Property and transportation	\$ 6	(\$3)	\$ 33	\$ 33
Specialty casualty	33	17	37	18
Specialty financial	11	12	27	28
Other	2	3	3	5
Other lines (a)	(7)	(50)	(7)	(50)
Total underwriting	45	(21)	93	34
Investment and other income, net	61	71	116	140
Realized gains	13	32	44	32
Total property and casualty insurance	119	82	253	206

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Annuity and supplemental insurance:				
Operations	76	56	143	110
Realized gains (losses)	2	(13)	15	(16)
Total annuity and supplemental insurance	78	43	158	94
Other (b)	(61)	(65)	(129)	(138)
Total operating earnings before income taxes	\$ 136	\$ 60	\$ 282	\$ 162

- (a) Includes a second quarter 2011 special charge of \$50 million to increase asbestos and environmental reserves.
- (b) Includes holding company expenses and losses of managed investment entities attributable to noncontrolling interests of \$18 million and \$20 million for the second quarter and \$46 million and \$55 million for the first six months of 2012 and 2011, respectively.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED

D. Fair Value Measurements

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

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

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

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

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

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

	Level 1	Level 2	Level 3	Total
June 30, 2012				
Assets:				
Available for sale (AFS) fixed maturities:				
U.S. Government and government agencies	\$ 234	\$ 145	\$	\$ 379
States, municipalities and political subdivisions		3,981	86	4,067
Foreign government		256		256
Residential MBS		3,869	320	4,189
Commercial MBS		2,866	20	2,886
All other corporate	5	10,642	557	11,204
Total AFS fixed maturities	239	21,759	983	22,981
Trading fixed maturities		446	1	447
Equity securities	991	89	41	1,121
Assets of managed investment entities (MIE)	153	2,618	54	2,825
Variable annuity assets (separate accounts) (a)		574		574
Other investments		131		131
Total assets accounted for at fair value	\$ 1,383	\$ 25,617	\$ 1,079	\$ 28,079
Liabilities:				
Liabilities of managed investment entities	\$ 73	\$	\$ 2,429	\$ 2,502
Derivatives in annuity benefits accumulated			512	512
Other liabilities - derivatives		26		26
Total liabilities accounted for at fair value	\$ 73	\$ 26	\$ 2,941	\$ 3,040
December 31, 2011				
Assets:				
Available for sale (AFS) fixed maturities:				
U.S. Government and government agencies	\$ 248	\$ 134	\$	\$ 382
States, municipalities and political subdivisions		3,794	83	3,877
Foreign government		254		254
Residential MBS		3,487	361	3,848
Commercial MBS		2,821	19	2,840
All other corporate	9	10,078	519	10,606
Total AFS fixed maturities	257	20,568	982	21,807
Trading fixed maturities		439	1	440
Equity securities	888	29	11	928
Assets of managed investment entities (MIE)	290	2,724	44	3,058
Variable annuity assets (separate accounts) (a)		548		548
Other investments		71		71

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Total assets accounted for at fair value	\$ 1,435	\$ 24,379	\$ 1,038	\$ 26,852
Liabilities:				
Liabilities of managed investment entities	\$ 194	\$	\$ 2,593	\$ 2,787
Derivatives in annuity benefits accumulated			395	395
Other liabilities derivatives			23	23
Total liabilities accounted for at fair value	\$ 194	\$ 23	\$ 2,988	\$ 3,205

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

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During the first six months of 2012, six preferred stocks with an aggregate fair value of \$35 million were transferred from Level 1 to Level 2. The transfers were due to decreases in trade frequency, resulting in lack of available trade data sufficient to warrant classification in Level 1. Approximately 4% of the total assets accounted for at fair value on June 30, 2012, were Level 3 assets. Approximately 89% (\$952 million) of the Level 3 assets were priced using non-binding broker quotes, for which there is a lack of transparency as to the inputs used to determine fair value. Details as to the quantitative inputs are neither provided by the brokers nor otherwise reasonably obtainable by AFG. Since internally developed Level 3 asset fair values represent less than one-half of 1% of the total assets measured at fair value and less than 2% of AFG's shareholders' equity, changes in unobservable inputs used to determine internally developed fair values would not have a material impact on AFG's financial position.

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

The only significant Level 3 assets or liabilities carried at fair value in the financial statements that were not measured using broker quotes are the derivatives embedded in AFG's indexed annuity liabilities, which are measured using a discounted cash flow approach and had a fair value of \$512 million at June 30, 2012. The following table presents information about the unobservable inputs used by management in determining fair value of these embedded derivatives. See *Note F - Derivatives*.

Unobservable Input	Range
Adjustment for insurance subsidiary's credit risk	0.5% - 2.35% over the risk free rate
Risk margin for uncertainty in cash flows	0.3% reduction in the discount rate
Surrenders	4% - 25% of indexed account value
Partial surrenders	3% - 5% of indexed account value
Annuityizations	1% - 2% of indexed account value
Deaths	1% - 2.5% of indexed account value
Budgeted option costs	2.5% - 4.0% of indexed account value

Increasing the budgeted option cost or risk margin for uncertainty in cash flows assumptions in the table above would increase the fair value of the indexed annuity embedded derivatives, while increasing any of the other unobservable inputs in the table above would decrease the fair value of the embedded derivatives.

Changes in balances of Level 3 financial assets and liabilities carried at fair value during the second quarter and first six months of 2012 and 2011 are presented below (in millions). The transfers into and out of Level 3 were due to changes in the availability of market observable inputs. All transfers are reflected in the table at fair value as of the end of the reporting period.

Balance at March 31, 2012	Net income	Total realized/unrealized gains (losses) included in		Purchases and issuances	Sales and Settlements	Transfer into Level 3	Transfer out of Level 3	Balance at June 30, 2012
		Other comp.	income (loss)					
AFS fixed maturities:								

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State and municipal	\$	72	\$	1	\$	9	\$	5	(\$1)	\$	86			
Residential MBS		314		1		63		(7)		21	(72)	320		
Commercial MBS		20										20		
All other corporate		515		5		8		51		(22)		7	(7)	557
Trading fixed maturities		1												1
Equity securities		24						17						41
Assets of MIE		64						1		(9)		(2)		54
Liabilities of MIE (*)		(2,554)		(19)						144				(2,429)
Embedded derivatives		(483)						(39)		10				(512)

(*) Total realized/unrealized loss included in net income includes losses of \$14 million related to liabilities outstanding as of June 30, 2012. See Note H *Managed Investment Entities*.

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	Total realized/unrealized gains (losses) included in							
	Balance at March 31, 2011	Net income	Other comp. income (loss)	Purchases and Issuances	Sales and Settlements	Transfer into Level 3	Transfer out of Level 3	Balance at June 30, 2011
AFS fixed maturities:								
State and municipal	\$ 21	\$	\$	\$ 53	\$	\$ 10	\$	\$ 84
Residential MBS	271		(2)	17	(7)		(24)	255
Commercial MBS	9					1		10
All other corporate	424	1	6	46	(26)	2	(71)	382
Trading fixed maturities	1							1
Equity securities	21							21
Assets of MIE	54			9	(2)	2	(10)	53
Liabilities of MIE (*)	(2,316)	(10)			4			(2,322)
Embedded derivatives	(234)	(10)		(60)	5			(299)

(*) Total realized/unrealized loss included in net income includes losses of \$10 million related to liabilities outstanding as of June 30, 2011. See Note H *Managed Investment Entities*.

	Total realized/unrealized gains (losses) included in							
	Balance at December 31, 2011	Net income	Other comp. income (loss)	Purchases and Issuances	Sales and Settlements	Transfer into Level 3	Transfer out of Level 3	Balance at June 30, 2012
AFS fixed maturities:								
State and municipal	\$ 83	\$	\$ 1	\$ 19	\$	\$ 5	(\$22)	\$ 86
Residential MBS	361	2		71	(17)	81	(178)	320
Commercial MBS	19		1					20
All other corporate	519	7	11	77	(38)	28	(47)	557
Trading fixed maturities	1							1
Equity securities	11			26		4		41
Assets of MIE	44			13	(12)	14	(5)	54
Liabilities of MIE (*)	(2,593)	(103)		(366)	633			(2,429)
Embedded derivatives	(395)	(62)		(73)	18			(512)

(*) Total realized/unrealized loss included in net income includes losses of \$51 million related to liabilities outstanding as of June 30, 2012. See Note H *Managed Investment Entities*.

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	Balance at December 31, 2010	Net income	Total realized/unrealized gains (losses) included in Other comp. income (loss)	Purchases and Issuances	Sales and Settlements	Transfer into Level 3	Transfer out of Level 3	Balance at June 30, 2011
AFS fixed maturities:								
State and municipal	\$ 20	\$	\$ 1	\$ 53	\$	\$ 10	\$	\$ 84
Residential MBS	312	1	(2)	17	(20)	7	(60)	255
Commercial MBS	6					4		10
All other corporate	436	(1)	6	91	(37)	24	(137)	382
Trading fixed maturities	3						(2)	1
Equity securities	21		2		(2)			21
Assets of MIE	48	(1)		16	(6)	8	(12)	53
Liabilities of MIE (*)	(2,258)	(72)			8			(2,322)
Embedded derivatives	(190)	(29)		(90)	10			(299)

(*) Total realized/unrealized loss included in net income includes losses of \$71 million related to liabilities outstanding as of June 30, 2011. See Note H *Managed Investment Entities*.

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

June 30, 2012	Carrying Value	Fair Value	Level 1	Level 2	Level 3
Financial assets:					
Cash and cash equivalents	\$ 1,523	\$ 1,523	\$ 1,523	\$	\$
Mortgage loans	488	491			491
Policy loans	247	247			247
Total financial assets not accounted for at fair value	\$ 2,258	\$ 2,261	\$ 1,523	\$	\$ 738
Financial liabilities:					
Annuity benefits accumulated (*)	\$ 16,559	\$ 16,773	\$	\$	\$ 16,773
Long-term debt	1,158	1,271		1,158	113
Total financial liabilities not accounted for at fair value	\$ 17,717	\$ 18,044	\$	\$ 1,158	\$ 16,886

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

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

E. Investments

Available for sale fixed maturities and equity securities at June 30, 2012, and December 31, 2011, consisted of the following (in millions):

	June 30, 2012				December 31, 2011			
	Amortized Cost	Fair Value	Gross Unrealized Gains	Losses	Amortized Cost	Fair Value	Gross Unrealized Gains	Losses
Fixed maturities:								
U.S. Government and government agencies	\$ 362	\$ 379	\$ 17	\$	\$ 363	\$ 382	\$ 19	\$
States, municipalities and political subdivisions	3,756	4,067	313	(2)	3,613	3,877	267	(3)
Foreign government	238	256	18		236	254	18	
Residential MBS	4,103	4,189	212	(126)	3,858	3,848	170	(180)
Commercial MBS	2,636	2,886	250		2,628	2,840	218	(6)
All other corporate	10,278	11,204	949	(23)	9,864	10,606	802	(60)

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Total fixed maturities	\$ 21,373	\$ 22,981	\$ 1,759	(\$151)	\$ 20,562	\$ 21,807	\$ 1,494	(\$249)
Common stocks	\$ 726	\$ 945	\$ 236	(\$17)	\$ 610	\$ 797	\$ 207	(\$20)
Perpetual preferred stocks	\$ 171	\$ 176	\$ 8	(\$3)	\$ 134	\$ 131	\$ 5	(\$8)

The non-credit related portion of other-than-temporary impairment charges are included in other comprehensive income. Cumulative charges taken for residential MBS still owned at June 30, 2012 and December 31, 2011, respectively were \$229 million and \$227 million.

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The following tables show gross unrealized losses (in millions) on fixed maturities and equity securities by investment category and length of time that individual securities have been in a continuous unrealized loss position at June 30, 2012 and December 31, 2011.

	Less Than Twelve Months			Twelve Months or More		
	Unrealized Loss	Fair Value	Fair Value as % of Cost	Unrealized Loss	Fair Value	Fair Value as % of Cost
June 30, 2012						
Fixed maturities:						
U.S. Government and government agencies	\$	\$ 26	100%	\$	\$	%
States, municipalities and political subdivisions	(1)	101	99%	(1)	16	94%
Foreign government			%			%
Residential MBS	(22)	696	97%	(104)	602	85%
Commercial MBS		39	99%			%
All other corporate	(10)	408	98%	(13)	166	93%
Total fixed maturities	(\$33)	\$ 1,270	97%	(\$118)	\$ 784	87%
Common stocks	(\$16)	\$ 146	90%	(\$1)	\$ 4	80%
Perpetual preferred stocks	(\$1)	\$ 9	90%	(\$2)	\$ 22	92%
December 31, 2011						
Fixed maturities:						
U.S. Government and government agencies	\$	\$ 2	100%	\$	\$	%
States, municipalities and political subdivisions	(2)	120	98%	(1)	59	98%
Foreign government		1	100%			%
Residential MBS	(59)	1,141	95%	(121)	473	80%
Commercial MBS	(6)	183	97%		18	100%
All other corporate	(43)	940	96%	(17)	114	87%
Total fixed maturities	(\$110)	\$ 2,387	96%	(\$139)	\$ 664	83%
Common stocks	(\$19)	\$ 169	90%	(\$1)	\$ 4	80%
Perpetual preferred stocks	(\$1)	\$ 23	96%	(\$7)	\$ 31	82%

At June 30, 2012, the gross unrealized losses on fixed maturities of \$151 million relate to approximately 625 securities. Investment grade securities (as determined by nationally recognized rating agencies) represented approximately 21% of the gross unrealized loss and 49% of the fair value.

AFG analyzes its MBS securities for other-than-temporary impairment each quarter based upon expected future cash flows. Management estimates expected future cash flows based upon its knowledge of the MBS market, cash flow projections (which reflect loan to collateral values, subordination, vintage and geographic concentration) received from independent sources, implied cash flows inherent in security ratings and analysis of historical payment data. For the first six months of 2012, AFG recorded in earnings \$4 million in other-than-temporary impairment charges related to its residential MBS.

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

	2012	2011
Balance at March 31	\$ 190	\$ 151
Additional credit impairments on:		
Previously impaired securities	1	22
Securities without prior impairments		4
Reductions disposals		(6)
Balance at June 30	\$ 191	\$ 171
Balance at January 1	\$ 187	\$ 143
Additional credit impairments on:		
Previously impaired securities	4	29
Securities without prior impairments		5
Reductions disposals		(6)
Balance at June 30	\$ 191	\$ 171

The table below sets forth the scheduled maturities of available for sale fixed maturities as of June 30, 2012 (in millions). Asset-backed securities and other securities with sinking funds are reported at average maturity. Actual maturities may differ from contractual maturities because certain securities may be called or prepaid by the issuers. MBS had an average life of approximately 4 years at June 30, 2012.

<u>Maturity</u>	Amortized Cost	Fair Value Amount	%
One year or less	\$ 791	\$ 806	3%
After one year through five years	5,374	5,735	25
After five years through ten years	6,399	7,068	31
After ten years	2,070	2,297	10
	14,634	15,906	69
MBS	6,739	7,075	31
Total	\$ 21,373	\$ 22,981	100%

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

There were no investments in individual issuers that exceeded 10% of Shareholders' Equity at June 30, 2012 or December 31, 2011.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED

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

	Pre-tax	Deferred Tax and Amounts Attributable to Noncontrolling Interests	Net
<u>June 30, 2012</u>			
Unrealized gain on:			
Fixed maturities	\$ 1,608	(\$573)	\$ 1,035
Equity securities	224	(79)	145
Deferred policy acquisition costs	(642)	225	(417)
Annuity benefits and other liabilities	13	(5)	8
	\$ 1,203	(\$432)	\$ 771
<u>December 31, 2011</u>			
Unrealized gain on:			
Fixed maturities	\$ 1,245	(\$444)	\$ 801
Equity securities	184	(65)	119
Deferred policy acquisition costs	(537)	188	(349)
Annuity benefits and other liabilities	10	(3)	7
	\$ 902	(\$324)	\$ 578

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

	Fixed Maturities	Equity Securities	Mortgage Loans and Other Investments	Other (a)	Tax Effects	Noncon- trolling Interests	Total
<u>Quarter ended June 30, 2012</u>							
Realized before impairments	\$ 6	\$ 21	(\$4)	\$	(\$8)	(\$1)	\$ 14
Realized impairments		(8)		1	3		(4)
Change in unrealized	231	(30)		(100)	(35)		66
<u>Quarter ended June 30, 2011</u>							
Realized before impairments	\$ 11	\$ 34	(\$5)	\$	(\$15)	(\$1)	\$ 24
Realized impairments	(26)		(1)	6	8		(13)
Change in unrealized	208	(15)		(42)	(53)	(2)	96

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Six months ended June 30, 2012

Realized before impairments	\$ 20	\$ 56	(\$3)	(\$2)	(\$25)	(\$1)	\$ 45
Realized impairments	(4)	(10)		3	4		(7)
Change in unrealized	363	40		(102)	(105)	(3)	193

Six months ended June 30, 2011

Realized before impairments	\$ 24	\$ 35	(\$7)	(\$2)	(\$18)	(\$1)	\$ 31
Realized impairments	(37)		(4)	10	11		(20)
Change in unrealized	245	(2)		(64)	(63)	(2)	114

(a) Primarily adjustments to deferred policy acquisition costs related to annuities.

Table of Contents**AMERICAN FINANCIAL GROUP, INC. 10-Q****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED**

Realized gains (losses) on securities includes net losses of \$1 million in the second quarter and net gains of \$3 million in the first six months of 2012 compared to net losses of less than \$1 million in the second quarter and \$3 million in the first six months of 2011 from the mark-to-market of certain MBS, primarily interest-only securities with interest rates that float inversely with short-term rates. Gross realized gains and losses (excluding impairment writedowns and mark-to-market of derivatives) on available for sale fixed maturity and equity security investment transactions included in the Statement of Cash Flows consisted of the following (in millions):

	Six months ended	
	June 30,	
	2012	2011
Fixed maturities:		
Gross gains	\$ 18	\$ 29
Gross losses	(1)	(2)
Equity securities:		
Gross gains	57	36
Gross losses	(1)	

F. Derivatives

As discussed under *Derivatives* in Note A, AFG uses derivatives in certain areas of its operations. AFG's derivatives do not qualify for hedge accounting under GAAP; changes in the fair value of derivatives are included in earnings.

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

Derivative	Balance Sheet Line	June 30, 2012		December 31, 2011	
		Asset	Liability	Asset	Liability
MBS with embedded derivatives	Fixed maturities	\$ 97	\$	\$ 99	\$
Interest rate swaptions	Other investments	2		5	
Indexed annuities (embedded derivative)	Annuity benefits accumulated		512		395
Equity index call options	Other investments	129		66	
Reinsurance contracts (embedded derivative)	Other liabilities		26		23
		\$ 228	\$ 538	\$ 170	\$ 418

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

AFG has entered into \$1 billion notional amount of pay-fixed interest rate swaptions (options to enter into pay-fixed/receive floating interest rate swaps at future dates expiring between 2012 and 2015) to mitigate interest rate risk in its annuity operations. AFG paid \$29 million to purchase these swaptions, which represents its maximum potential economic loss over the life of the contracts.

Table of Contents**AMERICAN FINANCIAL GROUP, INC. 10-Q****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED**

AFG's indexed annuities, which represented approximately one-third of annuity benefits accumulated at June 30, 2012, provide policyholders with a crediting rate tied, in part, to the performance of an existing stock market index. AFG attempts to mitigate the risk in the index-based component of these products through the purchase of call options on the appropriate index. AFG's strategy is designed so that an increase in the liabilities, due to an increase in the market index, will be generally offset by unrealized and realized gains on the call options purchased by AFG. Both the index-based component of the annuities and the related call options are considered derivatives. As shown in the table below, the embedded derivative remained relatively flat while the call options declined in value during the second quarter of 2012. The decline in fair value of the options reflects the decline in the stock market during the quarter. However, the negative impact of lower interest rates more than offset the positive impact of the stock market performance on the fair value of the indexed annuity embedded derivative.

As discussed under *Reinsurance* in Note A, certain reinsurance contracts in AFG's annuity and supplemental insurance business are considered to contain embedded derivatives.

The following table summarizes the gain (loss) included in the Statement of Earnings for changes in the fair value of these derivatives for the second quarter and first six months of 2012 and 2011 (in millions):

Derivative	Statement of Earnings Line	Three months ended		Six months ended	
		June 30, 2012	June 30, 2011	June 30, 2012	June 30, 2011
MBS with embedded derivatives	Realized gains	(\$1)	\$	\$ 3	(\$3)
Interest rate swaptions	Realized gains	(3)	(5)	(3)	(7)
Indexed annuities (embedded derivative)	Annuity benefits		(10)	(62)	(29)
Equity index call options	Annuity benefits	(20)	2	37	20
Reinsurance contracts (embedded derivative)	Investment income	(4)	(4)	(3)	(4)
		(\$28)	(\$17)	(\$28)	(\$23)

G. Deferred Policy Acquisition Costs

Deferred policy acquisition costs consisted of the following (in millions):

	June 30, 2012	December 31, 2011
Property and casualty insurance	\$ 198	\$ 189
Annuity and supplemental insurance:		
Policy acquisition costs	955	898
Policyholder sales inducements	200	207
Present value of future profits (PVFP)	135	144
Impact of unrealized gains and losses on securities	(642)	(537)
Total annuity and supplemental	648	712
	\$ 846	\$ 901

See *Accounting Standards Adopted in 2012 under Note A Accounting Policies.*

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The PVFP amounts in the table above are net of \$204 million and \$195 million of accumulated amortization at June 30, 2012 and December 31, 2011, respectively.

Amortization of deferred acquisition costs for the second quarter and first six months of 2012 and 2011 were as follows (in millions):

	Three months ended June 30,		Six months ended June 30,	
	2012	2011	2012	2011
Property and casualty insurance	\$ 111	\$ 108	\$ 212	\$ 208
Annuity and supplemental insurance:				
Policy acquisition costs	31	30	59	62
Policyholder sales inducements	8	7	16	14
PVFP	4	5	9	11
 Total annuity and supplemental	 43	 42	 84	 87
	\$ 154	\$ 150	\$ 296	\$ 295

Table of Contents**AMERICAN FINANCIAL GROUP, INC. 10-Q****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED****H. Managed Investment Entities**

AFG is the investment manager and has investments ranging from 7.5% to 51.2% of the most subordinate debt tranche of eight collateralized loan obligation entities or CLOs, which are considered variable interest entities. Upon formation between 2004 and 2012, these entities issued securities in various senior and subordinate classes and invested the proceeds primarily in secured bank loans, which serve as collateral for the debt securities issued by each particular CLO. None of the collateral was purchased from AFG. AFG's investments in the subordinate debt tranches of these entities receive residual income from the CLOs only after the CLOs pay operating expenses (including management fees to AFG), interest on and returns of capital to senior levels of debt securities. There are no contractual requirements for AFG to provide additional funding for these entities. AFG has not provided and does not intend to provide any financial support to these entities.

AFG's maximum ultimate exposure to economic loss on its CLOs is limited to its investment in the CLOs, which had an aggregate fair value of \$196 million at June 30, 2012, and \$98 million at December 31, 2011.

In February 2012, one of the AFG CLOs was substantially liquidated at the instruction of the holder of the majority of the most subordinate debt tranche, as permitted by the CLO indentures. In March 2012, AFG formed a new CLO, which issued \$410 million face amount of liabilities (including \$39 million face amount purchased by subsidiaries of AFG).

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

	Three months ended		Six months ended	
	June 30,		June 30,	
	2012	2011	2012	2011
Gains (losses) on change in fair value of assets/liabilities (a):				
Assets	(\$2)	(\$12)	\$ 53	\$ 17
Liabilities	(19)	(10)	(103)	(72)
Management fees paid to AFG	4	5	8	8
CLO earnings (losses) attributable to:				
AFG shareholders (b)	5	1	10	7
Noncontrolling interests (b)	(18)	(20)	(46)	(55)

(a) Included in AFG's Revenues.

(b) Included in AFG's Operating earnings before income taxes.

The aggregate unpaid principal balance of the CLOs' fixed maturity investments exceeded the fair value of the investments by \$66 million and \$120 million at June 30, 2012 and December 31, 2011. The aggregate unpaid principal balance of the CLOs' debt exceeded its fair value by \$203 million and \$306 million at those dates. The CLO assets include \$5 million and \$2 million in loans (aggregate unpaid principal balance of \$12 million and \$7 million, respectively) at June 30, 2012 and December 31, 2011, for which the CLOs are not accruing interest because the loans are in default.

Table of Contents**AMERICAN FINANCIAL GROUP, INC. 10-Q****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED****I. Goodwill and Other Intangibles**

There were no changes in the goodwill balance of \$186 million during the six months ended June 30, 2012. Included in other assets in AFG's Balance Sheet is \$35 million at June 30, 2012 and \$41 million at December 31, 2011, in amortizable intangible assets related to property and casualty insurance acquisitions. These amounts are net of accumulated amortization of \$54 million and \$47 million, respectively. Amortization of these intangibles was \$3 million in each of the second quarters of 2012 and 2011 and \$7 million and \$6 million in the first six months of 2012 and 2011, respectively. Other assets also include \$8 million in non-amortizable intangible assets related to property and casualty insurance acquisitions.

J. Long-Term Debt

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

	June 30, 2012	December 31, 2011
Direct obligations of AFG:		
9-7/8% Senior Notes due June 2019	\$ 350	\$ 350
6-3/8% Senior Notes due June 2042	230	
7% Senior Notes due September 2050	132	132
7-1/8% Senior Debentures due February 2034	115	115
Other	3	3
	830	600
Subsidiaries:		
Obligations of AAG Holding (guaranteed by AFG):		
7-1/2% Senior Debentures due November 2033(*)	112	112
7-1/4% Senior Debentures due January 2034(*)	86	86
Notes payable secured by real estate due 2012 through 2016	64	64
Secured borrowings (\$16 and \$17 guaranteed by AFG)	24	30
National Interstate bank credit facility	22	22
	308	314
Payable to Subsidiary Trusts:		
AAG Holding Variable Rate Subordinated Debentures due May 2033	20	20
	\$ 1,158	\$ 934

(*) Called for redemption on July 13, 2012 at par value.

Scheduled principal payments on debt for the balance of 2012 and the subsequent five years were as follows: 2012 \$28 million; 2013 \$20 million; 2014 \$2 million; 2015 \$14 million; 2016 \$45 million and 2017 none.

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

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	June 30, 2012	December 31, 2011
Unsecured obligations	\$ 1,070	\$ 840
Obligations secured by real estate	64	64
Other secured borrowings	24	30
	\$ 1,158	\$ 934

AFG can borrow up to \$500 million under its revolving credit facility which expires in August 2013. Amounts borrowed under this agreement bear interest at rates ranging from 1.75% to 3.00% (currently 2%) over LIBOR based on AFG's credit rating. No amounts were borrowed under this facility at June 30, 2012.

Table of Contents**AMERICAN FINANCIAL GROUP, INC. 10-Q****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED**

In June 2012, AFG issued \$230 million in 6-3/8% Senior Notes due 2042 and used the proceeds to redeem the outstanding AAG Holding Company, Inc. (a subsidiary of AFG) 7-1/2% Senior Debentures due 2033 and 7-1/4% Senior Debentures due 2034 at par value in July 2012.

K. Shareholders Equity

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

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

	AOCI Beginning Balance	Pre- tax	Tax	OCI Non- controlling interests	Net	AOCI Ending Balance
Quarter ended June 30, 2012						
Net unrealized gains on securities	\$ 705(a)	\$ 101	(\$35)	\$	\$ 66	\$ 771(a)
Foreign currency translation adjustments	16	(8)		1	(7)	9
Pension and other postretirement plans adjustments	(7)					(7)
Total	\$ 714	\$ 93	(\$35)	\$ 1	\$ 59	\$ 773
Quarter ended June 30, 2011						
Net unrealized gains on securities	\$ 509	\$ 151	(\$53)	(\$2)	\$ 96	\$ 605
Foreign currency translation adjustments	19	(2)			(2)	17
Pension and other postretirement plans adjustments	(8)	1			1	(7)
Total	\$ 520	\$ 150	(\$53)	(\$2)	\$ 95	\$ 615
Six months ended June 30, 2012						
Net unrealized gains on securities	\$ 578(a)	\$ 301	(\$105)	(\$3)	\$ 193	\$ 771(a)
Foreign currency translation adjustments	10	(1)			(1)	9
Pension and other postretirement plans adjustments	(8)	1			1	(7)
Total	\$ 580	\$ 301	(\$105)	(\$3)	\$ 193	\$ 773
Six months ended June 30, 2011						
Net unrealized gains on securities	\$ 491	\$ 179	(\$63)	(\$2)	\$ 114	\$ 605
Foreign currency translation adjustments	12	5			5	17
Pension and other postretirement plans adjustments	(8)	1			1	(7)
Total	\$ 495	\$ 185	(\$63)	(\$2)	\$ 120	\$ 615

- (a) Includes net unrealized losses of \$1 million at June 30, 2012, \$8 million at March 31, 2012 and \$16 million at December 31, 2011 related to securities for which only the credit portion of an other-than-temporary impairment has been recorded in earnings.

Stock Based Compensation Under AFG's Stock Incentive Plan, employees of AFG and its subsidiaries are eligible to receive equity awards in the form of stock options, stock appreciation rights, restricted stock awards, restricted stock units and stock awards. In the first six months of 2012, AFG issued 131,731 shares of restricted Common Stock (fair value of \$38.11 per share) and granted stock options for 1.1 million shares of Common Stock (at an average exercise price of \$38.11) under the Stock Incentive Plan. In addition, AFG issued 111,270 shares of Common Stock (fair value of \$38.38 per share) in the first quarter of 2012 under its Annual Co-CEO Equity Bonus Plan.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED

AFG uses the Black-Scholes option pricing model to calculate the fair value of its option grants. Expected volatility is based on historical volatility over a period equal to the expected term. The expected term was estimated based on historical exercise patterns and post vesting cancellations. The weighted average fair value of options granted during 2012 was \$13.02 per share based on the following assumptions: expected dividend yield 1.8%; expected volatility 39%; expected term 7.3 years; risk-free rate 1.4%.

Total compensation expense related to stock incentive plans of AFG and its subsidiaries was \$9 million and \$5 million in the second quarter and \$15 million and \$10 million in the first six months of 2012 and 2011, respectively.

L. Income Taxes

Income (losses) attributable to noncontrolling interests related to AFG's managed investment entities are non-taxable (non-deductible). Operating earnings before income taxes includes \$18 million and \$20 million in the second quarter of 2012 and 2011, respectively, and \$46 million and \$55 million in the first six months of 2012 and 2011, respectively, of such non-deductible losses, thereby increasing AFG's effective tax rate.

AFG has been involved in litigation with the IRS regarding the calculation of tax reserves for certain annuity reserves pursuant to Actuarial Guideline 33. In 2010, the U.S. District Court in Southern Ohio issued a final summary judgment in favor of AFG. The IRS appealed the District Court decision to the Sixth Circuit Court of Appeals, which heard oral arguments on March 7, 2012. Resolution of the case and closure of subsequent tax years could result in a decrease in the liability for unrecognized tax benefits by up to \$36 million and a decrease in related accrued interest of \$16 million. These amounts do not include tax and interest paid to the IRS in 2005 and 2006, for which the suit was filed, totaling \$17 million. On May 4, 2012, the Sixth Circuit Court of Appeals affirmed the summary judgment of the District Court in favor of AFG. See *Note N - Subsequent Event*.

During the first six months of 2012, there were no material changes to AFG's liability for uncertain tax positions, which is discussed in *Note L - Income Taxes*, to AFG's 2011 Form 10-K.

M. Contingencies

There have been no significant changes to the matters discussed and referred to in *Note M - Contingencies* of AFG's 2011 Form 10-K covering property and casualty insurance reserves for claims related to environmental exposures, asbestos and other mass tort claims as well as environmental and occupational injury and disease claims of former subsidiary railroad and manufacturing operations.

N. Subsequent Event

N. Subsequent Event As discussed in *Note L - Income Taxes*, AFG was involved in litigation with the IRS regarding the calculation of tax reserves for certain annuity liabilities. On August 2, 2012, the 90 day period for the IRS to seek a discretionary appeal of the Sixth District Court of Appeals decision in this case expired and the decision in favor of AFG became final. As a result, AFG recorded net earnings of approximately \$28 million in the third quarter of 2012 representing the refund of taxes and interest paid to the IRS in 2005 and 2006 as well as a decrease in the liability for unrecognized tax benefits and related accrued interest. AFG expects to record additional amounts as subsequent tax years are closed.

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AMERICAN FINANCIAL GROUP, INC. 10-Q

ITEM 2

Management's Discussion and Analysis

of Financial Condition and Results of Operations

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FORWARD-LOOKING STATEMENTS

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

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

- changes in financial, political and economic conditions, including changes in interest and inflation rates, currency fluctuations and extended economic recessions or expansions in the U.S. and abroad;

- performance of securities markets;

- AFG's ability to estimate accurately the likelihood, magnitude and timing of any losses in connection with investments in the non-agency residential mortgage market;

- new legislation or declines in credit quality or credit ratings that could have a material impact on the valuation of securities in AFG's investment portfolio;

- the availability of capital;

- regulatory actions (including changes in statutory accounting rules);

changes in the legal environment affecting AFG or its customers;

tax law and accounting changes;

levels of natural catastrophes and severe weather, terrorist activities (including any nuclear, biological, chemical or radiological events), incidents of war or losses resulting from civil unrest and other major losses;

development of insurance loss reserves and establishment of other reserves, particularly with respect to amounts associated with asbestos and environmental claims;

availability of reinsurance and ability of reinsurers to pay their obligations;

the unpredictability of possible future litigation if certain settlements of current litigation do not become effective;

trends in persistency, mortality and morbidity;

competitive pressures, including those in the bank annuity distribution channels, the ability to obtain adequate rates and policy terms;
and

changes in AFG's credit ratings or the financial strength ratings assigned by major ratings agencies to AFG's operating subsidiaries. The forward-looking statements herein are made only as of the date of this report. The Company assumes no obligation to publicly update any forward-looking statements.

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AMERICAN FINANCIAL GROUP, INC. 10-Q

Management's Discussion and Analysis

of Financial Condition and Results of Operations – Continued

OVERVIEW

Financial Condition

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

Results of Operations

Through the operations of its subsidiaries, AFG is engaged primarily in property and casualty insurance, focusing on specialized commercial products for businesses and in the sale of traditional fixed and indexed annuities and a variety of supplemental insurance products such as Medicare supplement (in May 2012, AFG reached a definitive agreement to sell its core supplemental insurance operations in a transaction expected to close in the third quarter of 2012).

Net earnings attributable to AFG's shareholders for the second quarter and first six months of 2012 were \$99 million (\$1.01 per share, diluted) and \$212 million (\$2.15 per share diluted), respectively, compared to \$48 million (\$.46 per share, diluted) and \$136 million (\$1.29 per share, diluted) reported in the same periods of 2011. Improved operating results in the annuity and supplemental insurance group and improved underwriting results in the property and casualty insurance operations were offset somewhat by lower investment income in AFG's property and casualty insurance operations. Results for the second quarter and first six months of 2011 include a special charge of \$38 million (\$.37 per share) to strengthen reserves for asbestos and other environmental (A&E) exposures, primarily within the property and casualty run-off operations.

CRITICAL ACCOUNTING POLICIES

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

the establishment of insurance reserves, especially asbestos and environmental-related reserves and reserves for AFG's closed block of long-term care business,

the recoverability of reinsurance,

the recoverability of deferred acquisition costs,

the establishment of asbestos and environmental reserves of former railroad and manufacturing operations, and

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the valuation of investments, including the determination of other-than-temporary impairments.
For a discussion of these policies, see *Management's Discussion and Analysis - Critical Accounting Policies* in AFG's 2011 Form 10-K.

Table of Contents**AMERICAN FINANCIAL GROUP, INC. 10-Q****Management's Discussion and Analysis****of Financial Condition and Results of Operations - Continued****LIQUIDITY AND CAPITAL RESOURCES**

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

	June 30, 2012(*)	December 31,	
		2011	2010
Long-term debt	\$ 1,158	\$ 934	\$ 952
Total capital	5,180	4,860	4,894
Ratio of debt to total capital:			
Including debt secured by real estate	22.4%	19.2%	19.5%
Excluding debt secured by real estate	21.4%	18.2%	18.4%

(*) Long-term debt and total capital include \$199 million principal amount of subsidiary debt that was called for redemption in July 2012. The ratios of debt to total capital at June 30, 2012, excluding the debt called for redemption, were 19.3% including debt secured by real estate and 18.2% excluding debt secured by real estate. See *Note J - Long-Term Debt*.

The ratio of debt to total capital is a non-GAAP measure that management believes is useful for investors, analysts and independent ratings agencies to evaluate AFG's financial strength and liquidity and to provide insight into how AFG finances its operations. It is calculated by dividing AFG's long-term debt by its total capital, which includes long-term debt, noncontrolling interests and shareholders' equity (excluding unrealized gains (losses) related to fixed maturity investments and appropriated retained earnings related to managed investment entities).

AFG's ratio of earnings to fixed charges, including annuity benefits as a fixed charge, was 2.00 for the six months ended June 30, 2012 and 1.95 for the entire year of 2011. Excluding annuity benefits, this ratio was 7.29 and 6.59, respectively. Although the ratio excluding annuity benefits is not required or encouraged to be disclosed under Securities and Exchange Commission rules, it is presented because interest credited to annuity policyholder accounts is not always considered a borrowing cost for an insurance company.

Parent and Subsidiary Liquidity

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

AFG can borrow up to \$500 million under its revolving credit facility which expires in August 2013. There were no borrowings under this agreement, or under any other parent company short-term borrowing arrangements, during 2012. In June 2012, AFG issued \$230 million of 6-3/8% Senior Notes due 2042 and used the proceeds to redeem the outstanding AAG Holding Company, Inc. (a subsidiary of AFG) 7-1/2% Senior Debentures due 2033 and 7-1/4% Senior Debentures due 2034 at par value in July 2012.

During the first six months of 2012, AFG repurchased 4.0 million shares of its Common Stock for \$153 million. In July 2012, AFG repurchased approximately 1.1 million additional shares of its Common Stock for \$42 million. During 2011, AFG repurchased 9.3 million shares of its Common Stock for \$315 million.

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Management's Discussion and Analysis

of Financial Condition and Results of Operations - Continued

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

Subsidiary Liquidity Great American Life Insurance Company (GALIC), a wholly-owned annuity and supplemental insurance subsidiary, is a member of the Federal Home Loan Bank of Cincinnati (FHLB). The FHLB makes advances and provides other banking services to member institutions, which provides the annuity and supplemental insurance operations with a substantial additional source of liquidity. In the fourth quarter of 2011 the FHLB advanced GALIC \$240 million at interest rates ranging from .02% to .03% over LIBOR (average rate of .26% at June 30, 2012). While these advances must be repaid within 5 to 7 years, GALIC has the option to prepay all or a portion of the advances on a monthly basis. GALIC has invested the proceeds from the advances in fixed maturity securities for the purpose of earning a spread over the interest payments due to the FHLB.

National Interstate Corporation, a 52%-owned property and casualty insurance subsidiary, can borrow up to \$75 million, subject to certain conditions, under an unsecured credit agreement expiring in December 2012. Amounts borrowed bear interest at rates ranging from .45% to .9% (currently .65%) over LIBOR based on National Interstate's credit rating. There was \$22 million outstanding under this agreement at June 30, 2012. National Interstate expects to successfully replace this credit agreement prior to its expiration.

The liquidity requirements of AFG's insurance subsidiaries relate primarily to the liabilities associated with their products as well as operating costs and expenses, payments of dividends and taxes to AFG and contributions of capital to their subsidiaries. Historically, cash flows from premiums and investment income have generally provided more than sufficient funds to meet these requirements without requiring a sale of investments or contributions from AFG. Funds received in excess of cash requirements are generally invested in additional marketable securities. In addition, the insurance subsidiaries generally hold a significant amount of highly liquid, short-term investments.

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

In the annuity business, where profitability is largely dependent on earning a spread between invested assets and annuity liabilities, the duration of investments is generally maintained close to that of liabilities. In a rising interest rate environment, significant protection from withdrawals exists in the form of temporary and permanent surrender charges on AFG's annuity products. With declining rates, AFG receives some protection (from spread compression) due to the ability to lower crediting rates, subject to contractually guaranteed minimum interest rates (GMIRs). AFG began selling new policies with GMIRs below 2% in 2003; almost all new business since late 2010 has been issued with a 1% GMIR. At June 30, 2012, the average crediting rate on AFG's annuities was approximately 2.9%, while the average GMIR was approximately 2.3%. This margin provides AFG the flexibility to decrease its crediting rates by up to 60 basis points (on a weighted average basis) on its \$15 billion in annuities should market interest rates continue to remain low for a long period of time. The vast majority of such decreases can be made within the next 12 months if necessary.

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

Investments AFG's investment portfolio at June 30, 2012, contained \$23.0 billion in Fixed maturities classified as available for sale and \$1.1 billion in Equity securities, all carried at fair value with unrealized gains and losses included in a separate component of shareholders' equity on an after-tax basis. In addition, \$447 million in fixed maturities were classified as trading with changes in unrealized holding gains or losses included in investment income.

Fair values for AFG's portfolio are determined by AFG's internal investment professionals using data from nationally recognized pricing services as well as non-binding broker quotes. Fair values of equity securities are generally based on closing prices obtained from the pricing services. For mortgage-backed securities (MBS), which comprise approximately 30% of AFG's fixed maturities, prices for each security are generally obtained from both pricing services and broker quotes. For the remainder of AFG's fixed maturity portfolio, approximately 92% are priced using pricing services and the balance is priced primarily by using non-binding broker quotes. When prices obtained for the same security vary, AFG's internal investment professionals select the price they believe is most indicative of an exit price.

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

Valuation techniques utilized by pricing services and prices obtained from external sources are reviewed by AFG's internal investment professionals who are familiar with the securities being priced and the markets in which they trade to ensure the fair value determination is representative of an exit price. To validate the appropriateness of the prices obtained, these investment managers consider widely published indices (as benchmarks), recent trades, changes in interest rates, general economic conditions and the credit quality of the specific issuers. In addition, AFG communicates directly with the pricing service regarding the methods and assumptions used in pricing, including verifying, on a test basis, the inputs used by the service to value specific securities. Prices obtained from a broker or pricing service are adjusted only in cases where they are deemed not to be representative of an appropriate exit price (fewer than 1% of the securities).

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In general, the fair value of AFG's fixed maturity investments is inversely correlated to changes in interest rates. The following table demonstrates the sensitivity of such fair values to reasonably likely changes in interest rates by illustrating the estimated effect on AFG's fixed maturity portfolio that an immediate increase of 100 basis points in the interest rate yield curve would have at June 30, 2012 (dollars in millions). Increases or decreases from the 100 basis points illustrated would be approximately proportional.

Fair value of fixed maturity portfolio	\$ 23,428
Pretax impact on fair value of 100 bps increase in interest rates	(\$1,031)
Pretax impact as % of total fixed maturity portfolio	4.4%

Approximately 87% of the fixed maturities held by AFG at June 30, 2012, were rated investment grade (credit rating of AAA to BBB) by nationally recognized rating agencies. Investment grade securities generally bear lower yields and lower degrees of risk than those that are unrated and noninvestment grade. Management believes that the high quality investment portfolio should generate a stable and predictable investment return.

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

Summarized information for AFG's MBS (including those classified as trading) at June 30, 2012, is shown (in millions) in the table below. Agency-backed securities are those issued by a U.S. government-backed agency; Alt-A mortgages are those with risk profiles between prime and subprime. The majority of the Alt-A securities and substantially all of the subprime securities are backed by fixed-rate mortgages. The average life of both the residential and commercial MBS is approximately 4 years.

Collateral type	Amortized Cost	Fair Value	Fair Value as % of Cost	Unrealized Gain (Loss)	% Rated Investment Grade
Residential:					
Agency-backed	\$ 268	\$ 281	105%	\$ 13	100%
Non-agency prime	2,296	2,393	104	97	53
Alt-A	844	820	97	(24)	37
Subprime	701	698	100	(3)	27
Commercial	2,667	2,917	109	250	99
Other	25	28	112	3	61
	\$ 6,801	\$ 7,137	105%	\$ 336	69%

The National Association of Insurance Commissioners (NAIC) assigns creditworthiness designations on a scale of 1 to 6 with 1 being the highest quality and 6 being the lowest quality. The NAIC retained a third-party investment management firm to assist in the determination of appropriate NAIC designations for mortgage-backed securities based not only on the probability of loss (which is the primary basis of ratings by the major ratings firms), but also on the severity of loss and statutory carrying value. At June 30, 2012, 97% (based on statutory carrying value of \$6.7 billion) of AFG's MBS securities had an NAIC designation of 1 or 2.

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Municipal bonds represented approximately 18% of AFG's fixed maturity portfolio at June 30, 2012. AFG's municipal bond portfolio is high quality, with 99% of the securities rated investment grade at that date. The portfolio is well diversified across the states of issuance and individual issuers. At June 30, 2012, approximately 77% of the municipal bond portfolio was held in revenue bonds, with the remaining 23% held in general obligation bonds. State general obligation securities of California, Illinois, New Jersey and New York collectively represented only 2% of this portfolio.

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Summarized information for the unrealized gains and losses recorded in AFG's Balance Sheet at June 30, 2012, is shown in the following table (dollars in millions). Approximately \$129 million of available for sale Fixed maturities and \$72 million of Equity securities had no unrealized gains or losses at June 30, 2012.

	Securities With Unrealized Gains	Securities With Unrealized Losses
<u>Available for Sale Fixed Maturities</u>		
Fair value of securities	\$ 20,798	\$ 2,054
Amortized cost of securities	\$ 19,039	\$ 2,205
Gross unrealized gain (loss)	\$ 1,759	(\$151)
Fair value as % of amortized cost	109%	93%
Number of security positions	4,105	625
Number individually exceeding \$2 million gain or loss	163	4
Concentration of gains (losses) by type or industry (exceeding 5% of unrealized):		
Mortgage-backed securities	\$ 462	(\$126)
States and municipalities	313	(2)
Gas and electric services	175	(2)
Banks, savings and credit institutions	122	(5)
Percentage rated investment grade	91%	49%
<u>Equity Securities</u>		
Fair value of securities	\$ 868	\$ 181
Cost of securities	\$ 624	\$ 201
Gross unrealized gain (loss)	\$ 244(*)	(\$20)
Fair value as % of cost	139%	90%
Number of security positions	181	62
Number individually exceeding \$2 million gain or loss	19	2

(*) Includes \$98 million on AFG's investment in Verisk Analytics, Inc.

The table below sets forth the scheduled maturities of AFG's available for sale fixed maturity securities at June 30, 2012, based on their fair values. Asset-backed securities and other securities with sinking funds are reported at average maturity. Actual maturities may differ from contractual maturities because certain securities may be called or prepaid by the issuers.

Securities With Unrealized Gains	Securities With Unrealized Losses
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<u>Maturity</u>		
One year or less	4%	1%
After one year through five years	26	14
After five years through ten years	33	13
After ten years	10	7
	73	35
Mortgage-backed securities (average life of approximately four years)	27	65
	100%	100%

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

	Aggregate Fair Value	Aggregate Unrealized Gain (Loss)	Fair Value as % of Cost Basis
<u>Fixed Maturities at June 30, 2012</u>			
Securities with unrealized gains:			
Exceeding \$500,000 (1,008 securities)	\$ 11,838	\$ 1,310	112%
\$500,000 or less (3,097 securities)	8,960	449	105
	\$ 20,798	\$ 1,759	109%
Securities with unrealized losses:			
Exceeding \$500,000 (87 securities)	\$ 470	(\$95)	83%
\$500,000 or less (538 securities)	1,584	(56)	97
	\$ 2,054	(\$151)	93%

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

	Aggregate Fair Value	Aggregate Unrealized Loss	Fair Value as % of Cost Basis
<u>Securities with Unrealized Losses at June 30, 2012</u>			
Investment grade fixed maturities with losses for:			
Less than one year (139 securities)	\$ 669	(\$9)	99%
One year or longer (115 securities)	332	(23)	94
	\$ 1,001	(\$32)	97%
Non-investment grade fixed maturities with losses for:			
Less than one year (168 securities)	\$ 601	(\$24)	96%
One year or longer (203 securities)	452	(95)	83
	\$ 1,053	(\$119)	90%

Common equity securities with losses for:

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Less than one year (49 securities)	\$ 146	(\$16)	90%
One year or longer (3 securities)	4	(1)	80
	\$ 150	(\$17)	90%
Perpetual preferred equity securities with losses for:			
Less than one year (5 securities)	\$ 9	(\$1)	90%
One year or longer (5 securities)	22	(2)	92
	\$ 31	(\$3)	91%

When a decline in the value of a specific investment is considered to be other-than-temporary, a provision for impairment is charged to earnings (accounted for as a realized loss) and the cost basis of that investment is reduced by the amount of the charge. The determination of whether unrealized losses are other-than-temporary requires judgment based on subjective as well as objective factors as detailed in AFG's 2011 Form 10-K under *Management's Discussion and Analysis - Investments*.

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Based on its analysis, management believes (i) AFG will recover its cost basis in the securities with unrealized losses and (ii) that AFG has the ability and intent to hold the securities until they recover in value and had no intent to sell them at June 30, 2012. Although AFG has the ability to continue holding its investments with unrealized losses, its intent to hold them may change due to deterioration in the issuers' creditworthiness, decisions to lessen exposure to a particular issuer or industry, asset/liability management decisions, market movements, changes in views about appropriate asset allocation or the desire to offset taxable realized gains. Should AFG's ability or intent change with regard to a particular security, a charge for impairment would likely be required. While it is not possible to accurately predict if or when a specific security will become impaired, charges for other-than-temporary impairment could be material to results of operations in future periods. Significant declines in the fair value of AFG's investment portfolio could have a significant adverse effect on AFG's liquidity.

Uncertainties Management believes that the areas posing the greatest risk of material loss are the adequacy of reserves in its insurance operations and contingencies arising out of its former railroad and manufacturing operations. See *Management's Discussion and Analysis – Uncertainties* in AFG's 2011 Form 10-K. AFG conducts comprehensive studies of its asbestos and environmental reserves with the aid of outside actuarial and engineering firms and specialty outside counsel every two years with an in-depth internal review during the intervening years. AFG has scheduled its 2012 internal review of these liabilities to be completed in the third quarter of 2012 (instead of the second quarter) in order to conform to the practice of most of its peers. See *Management's Discussion and Analysis – Results of Operations – Asbestos and Environmental Reserve Charges* in AFG's 2011 Form 10-K.

AFG, as well as other companies that sell long-term care products, have accumulated relatively limited claims, lapse and mortality experience, making it difficult to predict future claims. Long-term care claims tend to be much higher in dollar amount and longer in duration than other health care products such as Medicare supplement. In addition, long-term care claims are incurred much later in the life of a policy than most other health products. These factors make it difficult to appropriately price this product and were instrumental in AFG's decision to stop writing new policies after December 2009. AFG's outstanding long-term care policies have level premiums and are guaranteed renewable. Premium rates can potentially be increased in reaction to adverse experience, however, any rate increases would require regulatory approval.

Reserves for future policy benefits under long-term care policies are established (and related acquisition costs are amortized) over the life of the policies based on policy benefit assumptions as of the date of issuance, including investment yields, mortality, morbidity, persistency and expenses. Once these assumptions are established for a given policy or group of policies, they are not changed over the life of the policy unless a loss recognition event (premium deficiency) occurs. Loss recognition occurs when, based on current expectations as of the measurement date, the existing contract liabilities plus the present value of future premiums (including reasonably expected rate increases), are not expected to cover the present value of future claims payments, related settlement and maintenance costs, and unamortized acquisition costs. Based on loss recognition testing at December 31, 2011, AFG's long-term care reserves plus the present value of future premiums exceeded claims costs and unamortized acquisition expenses by approximately \$30 million. Adverse changes in any of the reserve assumptions in future periods could result in loss recognition for AFG's long-term care business. For example, a 1% change in claims costs or a 0.1% change in investment yields in all future periods (excluding their effect on the ability to achieve future rate increases), would each impact the December 31, 2011, excess described above by approximately \$10 million. Once the excess is reduced to zero, the impact of adverse changes in assumptions is recorded as a charge to earnings as either a reduction in unamortized acquisition costs or an increase to contract reserves, net of any reinsurance recoverable.

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Through June 30, 2012, experience on AFG's long-term care business has generally emerged consistent with the assumptions from year-end 2011. Although investment purchases have exceeded our expected yields in the first half of 2012, yields on future purchases could fall short of expectations if the recent declines in market yields were to persist. Even though AFG's new claims experience has been reasonably consistent with current assumptions, the small size of the long-term care block, combined with its lack of maturity can cause significant period fluctuations. Furthermore, AFG has incurred only a small portion of the claims that it will ultimately receive over the lifetime of these policies, and when combined with the block's limited claims history, AFG's 2012 experience may not be indicative of future trends. AFG has engaged an external actuarial consulting firm to supplement its regular internal analysis of claim experience relative to broader industry trends, and expects to complete that analysis in the third or fourth quarter of 2012.

At year end 2011, AFG's long-term care and annuity actuarial assumptions related to future interest rates were based on a beginning 10-year U.S. Treasury rate of 2.00%, and a beginning 30-year U.S. Treasury rate of 3.00%. It was assumed that these rates would gradually increase each subsequent year. Through July 31, 2012, these rates have decreased by approximately 0.50%. Even though AFG has been able to maintain adequate investment yields to date, if this low interest rate environment persists, and if it is forecasted to remain lower in the future than previously expected, AFG would likely have a material charge to earnings.

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

CONDENSED CONSOLIDATING BALANCE SHEET

	Before CLO Consolidation	Managed Investment Entities	Consol. Entries	Consolidated As Reported
June 30, 2012				
Assets:				
Cash and investments	\$ 27,497	\$	(\$196)(a)	\$ 27,301
Assets of managed investment entities		2,825		2,825
Other assets	6,926			6,926
Total assets	\$ 34,423	\$ 2,825	(\$196)	\$ 37,052
Liabilities:				
Unpaid losses and loss adjustment expenses and unearned premiums	\$ 7,814	\$	\$	\$ 7,814
Annuity, life, accident and health benefits and reserves	18,508			18,508
Liabilities of managed investment entities		2,698	(196)(a)	2,502
Long-term debt and other liabilities	3,453			3,453
Total liabilities	29,775	2,698	(196)	32,277
Shareholders' Equity:				
Common Stock and Capital surplus	1,207			1,207
Retained earnings:				
Appropriated – managed investment entities		127		127
Unappropriated	2,515			2,515
Accumulated other comprehensive income	773			773
Total shareholders' equity	4,495	127		4,622
Noncontrolling interests	153			153
Total equity	4,648	127		4,775
Total liabilities and equity	\$ 34,423	\$ 2,825	(\$196)	\$ 37,052
December 31, 2011				
Assets:				
Cash and investments	\$ 25,675	\$	(\$98)(a)	\$ 25,577
Assets of managed investment entities		3,058		3,058

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Other assets		7,203			7,203			
Total assets	\$	32,878	\$	3,058	(\$98)	\$	35,838	
Liabilities:								
Unpaid losses and loss adjustment expenses and unearned premiums	\$	8,004	\$		\$		\$	8,004
Annuity, life, accident and health benefits and reserves		17,147						17,147
Liabilities of managed investment entities				2,885	(98)(a)			2,787
Long-term debt and other liabilities		3,343						3,343
Total liabilities		28,494		2,885	(98)			31,281
Shareholders' equity:								
Common Stock and Capital surplus		1,219						1,219
Retained earnings:								
Appropriated - managed investment entities				173				173
Unappropriated		2,439						2,439
Accumulated other comprehensive income		580						580
Total shareholders' equity		4,238		173				4,411
Noncontrolling interests		146						146
Total equity		4,384		173				4,557
Total liabilities and equity	\$	32,878	\$	3,058	(\$98)		\$	35,838

(a) Elimination of the fair value of AFG's investment in CLOs.

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	Before CLO Consolidation (a)	Managed Investment Entities	Consol. Entries	Consolidated As Reported
<u>Six months ended June 30, 2012</u>				
Revenues:				
Insurance premiums	\$ 1,453	\$	\$	\$ 1,453
Investment income	664		(10)(b)	654
Realized gains (losses) on securities	60			60
Realized gains (losses) on subsidiaries	(1)			(1)
Income (loss) of managed investment entities:				
Investment income		61		61
Loss on change in fair value of assets/liabilities		(54)	4 (b)	(50)
Other income	94		(8)(c)	86
Total revenues	2,270	7	(14)	2,263
Costs and Expenses:				
Insurance benefits and expenses	1,698			1,698
Expenses of managed investment entities		53	(14)(b)(c)	39
Interest on borrowed money and other expenses	244			244
Total costs and expenses	1,942	53	(14)	1,981
Operating earnings before income taxes	328	(46)		282
Provision for income taxes	110			110
Net earnings, including noncontrolling interests	218	(46)		172
Less: Net earnings (loss) attributable to noncontrolling interests	6		(46)(d)	(40)
Net Earnings Attributable to Shareholders	\$ 212	(\$46)	\$ 46	\$ 212
<u>Six months ended June 30, 2011</u>				
Revenues:				
Insurance premiums	\$ 1,425	\$	\$	\$ 1,425
Investment income	613		(7)(b)	606
Realized gains (losses) on securities	19			19
Realized gains (losses) on subsidiaries	(3)			(3)
Income (loss) of managed investment entities:				
Investment income		51		51
Loss on change in fair value of assets/liabilities		(57)	2 (b)	(55)
Other income	97		(8)(c)	89
Total revenues	2,151	(6)	(13)	2,132

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Costs and Expenses:				
Insurance benefits and expenses	1,699			1,699
Expenses of managed investment entities		49	(13)(b)(c)	36
Interest on borrowed money and other expenses	235			235
Total costs and expenses	1,934	49	(13)	1,970
Operating earnings before income taxes	217	(55)		162
Provision for income taxes	78			78
Net earnings, including noncontrolling interests	139	(55)		84
Less: Net earnings (loss) attributable to noncontrolling interests	3		(55)(d)	(52)
Net Earnings Attributable to Shareholders	\$ 136	(\$55)	\$ 55	\$ 136

- (a) Includes \$10 million and \$7 million for the first six months of 2012 and 2011, respectively, in investment income representing the change in fair value of AFG's CLO investments plus \$8 million for each of the same periods in CLO management fees earned.
- (b) Elimination of the change in fair value of AFG's investments in the CLOs, including \$6 million and \$5 million in the first six months of 2012 and 2011, respectively, in distributions recorded as interest expense by the CLOs.
- (c) Elimination of management fees earned by AFG.
- (d) Allocate losses of CLOs attributable to other debt holders to noncontrolling interests.

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General Results of operations as shown in the accompanying financial statements are prepared in accordance with U.S. generally accepted accounting principles (GAAP).

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

	Three months ended		Six months ended	
	June 30,		June 30,	
	2012	2011	2012	2011
Core net operating earnings	\$ 90	\$ 74	\$ 175	\$ 165
Special A&E charge (*)		(38)		(38)
Realized gains (losses) (*)	9	12	37	9
Net earnings attributable to shareholders	\$ 99	\$ 48	\$ 212	\$ 136
Diluted per share amounts:				
Core net operating earnings	\$.91	\$.72	\$ 1.77	\$ 1.57
Special A&E charge		(.37)		(.37)
Realized gains (losses)	.10	.11	.38	.09
Net earnings attributable to shareholders	\$ 1.01	\$.46	\$ 2.15	\$ 1.29

(*) The tax effects of reconciling items are shown below (in millions):

Special A&E charge	\$	\$ 21	\$	\$ 21
Realized gains (losses)	(5)	(7)	(21)	(7)

In addition, realized gains (losses) are shown net of noncontrolling interests of (\$1 million) in the second quarter and first six months of 2012.

Net earnings attributable to shareholders and core net operating earnings increased in the second quarter and first six months of 2012 compared to the same periods in 2011. Increased earnings in the annuity and supplemental insurance operations and improved underwriting results in the property and casualty operations were partially offset by lower investment income in the property and casualty insurance operations. Net earnings attributable to shareholders in 2011 was impacted by the second quarter special A&E charge. Both periods reflect the effect of share repurchases.

Property and Casualty Insurance - Underwriting AFG reports its Specialty insurance business in the following sub-segments: (i) Property and transportation, (ii) Specialty casualty and (iii) Specialty financial.

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Performance measures such as underwriting profit or loss and related combined ratios are often used by property and casualty insurers to help users of their financial statements better understand the company's performance. See *Note C Segments of Operations* for detail of AFG's operating profit by significant business segment.

Underwriting profitability is measured by the combined ratio, which is a sum of the ratios of losses, loss adjustment expenses, underwriting expenses and policyholder dividends to premiums. A combined ratio under 100% indicates an underwriting profit. The combined ratio does not reflect investment income, other income or federal income taxes.

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Premiums, combined ratios and prior year development for AFG's property and casualty insurance operations were as follows (dollars in millions):

	Three months ended		Six months ended	
	June 30,		June 30,	
	2012	2011	2012	2011
<u>Gross Written Premiums</u>				
Property and transportation	\$ 531	\$ 496	\$ 859	\$ 814
Specialty casualty	358	323	724	642
Specialty financial	134	129	263	245
Other	1	1	1	1
	\$ 1,024	\$ 949	\$ 1,847	\$ 1,702
<u>Net Written Premiums</u>				
Property and transportation	\$ 369	\$ 346	\$ 619	\$ 600
Specialty casualty	244	211	491	425
Specialty financial	102	96	195	194
Other	17	16	34	34
	\$ 732	\$ 669	\$ 1,339	\$ 1,253
<u>Combined Ratios</u>				
Property and transportation	98.1%	101.2%	94.0%	93.7%
Specialty casualty	86.1	92.1	91.8	95.8
Specialty financial	88.5	88.5	86.6	87.1
Total Specialty	91.8	95.2	91.9	93.1
Aggregate (including discontinued lines)	92.9%	103.4%	92.5%	97.2%
<u>Favorable (Unfavorable) Prior Year Development</u>				
Property and transportation	\$ 2	\$ 4	\$ 12	\$ 26
Specialty casualty	27	27	28	27
Specialty financial	4	4	11	
Other specialty	1	2	2	5
	34	37	53	58
Other (primarily asbestos and environmental charges)	(8)	(50)	(8)	(50)
Aggregate (including discontinued lines)	\$ 26	(\$13)	\$ 45	\$ 8