

AMERICAN FINANCIAL GROUP INC

Form 10-Q

August 08, 2011

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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, 2011**

**Commission File No. 1-13653  
AMERICAN FINANCIAL GROUP, INC.**

**Incorporated under the Laws of Ohio**

**IRS Employer I.D. No. 31-1544320**

**One East Fourth Street, Cincinnati, Ohio 45202  
(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, 2011, there were 100,516,338 shares of the Registrant's Common Stock outstanding, excluding 14.9 million shares owned by subsidiaries.

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|   | June 30,<br>2011 | December 31,<br>2010 |
|---|------------------|----------------------|
| <b>Assets:</b>  |                  |                      |
| Cash and cash equivalents   | \$ 1,629         | \$ 1,099             |
| Investments:  |                  |                      |
| Fixed maturities, available for sale at fair value (amortized cost \$19,417 and \$18,490) | 20,500           | 19,328               |
| Fixed maturities, trading at fair value   | 395              | 393                  |
| Equity securities, at fair value (cost \$549 and \$458)                                   | 779              | 690                  |
| Mortgage loans  | 340              | 468                  |
| Policy loans  | 255              | 264                  |
| Real estate and other investments   | 470              | 428                  |
| <br>Total cash and investments  | <br>24,368       | <br>22,670           |
| <br>Recoverables from reinsurers  | <br>2,866        | <br>2,964            |
| Prepaid reinsurance premiums  | 439              | 422                  |
| Agents' balances and premiums receivable  | 705              | 535                  |
| Deferred policy acquisition costs   | 1,198            | 1,244                |
| Assets of managed investment entities   | 2,591            | 2,537                |
| Other receivables   | 438              | 674                  |
| Variable annuity assets (separate accounts)   | 624              | 616                  |
| Other assets  | 638              | 606                  |
| Goodwill  | 186              | 186                  |
| <br>Total assets  | <br>\$ 34,053    | <br>\$ 32,454        |
| <br><b>Liabilities and Equity:</b>  |                  |                      |
| Unpaid losses and loss adjustment expenses  | \$ 6,345         | \$ 6,413             |
| Unearned premiums   | 1,555            | 1,534                |
| Annuity benefits accumulated  | 14,123           | 12,905               |
| Life, accident and health reserves  | 1,685            | 1,650                |
| Payable to reinsurers   | 302              | 320                  |
| Liabilities of managed investment entities  | 2,430            | 2,323                |
| Long-term debt  | 940              | 952                  |
| Variable annuity liabilities (separate accounts)  | 624              | 616                  |
| Other liabilities   | 1,424            | 1,121                |
| <br>Total liabilities   | <br>29,428       | <br>27,834           |

|  |           |           |
|--|-----------|-----------|
| Shareholders' equity:                              |           |           |
| Common Stock, no par value                         |           |           |
| - 200,000,000 shares authorized                    |           |           |
| - 101,020,235 and 105,168,366 shares outstanding   | 101       | 105       |
| Capital surplus                                    | 1,138     | 1,166     |
| Retained earnings:                                 |           |           |
| Appropriated - managed investment entities         | 142       | 197       |
| Unappropriated                                     | 2,512     | 2,523     |
| Accumulated other comprehensive income, net of tax | 579       | 479       |
| Total shareholders' equity                         | 4,472     | 4,470     |
| Noncontrolling interests                           | 153       | 150       |
| Total equity                                       | 4,625     | 4,620     |
| Total liabilities and equity                       | \$ 34,053 | \$ 32,454 |

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

|  | Three months ended<br>June 30, |               | Six months ended<br>June 30, |               |
|--|--------------------------------|---------------|------------------------------|---------------|
|  | 2011                           | 2010          | 2011                         | 2010          |
| <b>Revenues:</b>   |                                |               |                              |               |
| Property and casualty insurance premiums                           | \$ 609                         | \$ 572        | \$ 1,208                     | \$ 1,151      |
| Life, accident and health premiums                                 | 107                            | 113           | 217                          | 228           |
| Investment income  | 306                            | 294           | 606                          | 589           |
| Realized gains (losses) on:  |                                |               |                              |               |
| Securities (*)   | 19                             | 11            | 19                           | 15            |
| Subsidiaries   |                                |               | (3)                          |               |
| Income (loss) of managed investment entities:                      |                                |               |                              |               |
| Investment income  | 26                             | 23            | 51                           | 45            |
| Loss on change in fair value of assets/liabilities                 | (22)                           | (15)          | (55)                         | (40)          |
| Other income   | 48                             | 54            | 89                           | 98            |
| <b>Total revenues</b>  | <b>1,093</b>                   | <b>1,052</b>  | <b>2,132</b>                 | <b>2,086</b>  |
| <b>Costs and Expenses:</b>   |                                |               |                              |               |
| Property and casualty insurance:                                   |                                |               |                              |               |
| Losses and loss adjustment expenses                                | 413                            | 302           | 754                          | 606           |
| Commissions and other underwriting expenses                        | 207                            | 207           | 419                          | 411           |
| Annuity benefits   | 125                            | 118           | 241                          | 226           |
| Life, accident and health benefits                                 | 89                             | 93            | 185                          | 189           |
| Annuity and supplemental insurance acquisition expenses            | 52                             | 54            | 105                          | 103           |
| Interest charges on borrowed money                                 | 21                             | 18            | 42                           | 36            |
| Expenses of managed investment entities                            | 18                             | 14            | 36                           | 23            |
| Other operating and general expenses                               | 99                             | 88            | 186                          | 187           |
| <b>Total costs and expenses</b>                                    | <b>1,024</b>                   | <b>894</b>    | <b>1,968</b>                 | <b>1,781</b>  |
| <b>Operating earnings before income taxes</b>                      | <b>69</b>                      | <b>158</b>    | <b>164</b>                   | <b>305</b>    |
| Provision for income taxes   | 32                             | 58            | 78                           | 117           |
| <b>Net earnings, including noncontrolling interests</b>            | <b>37</b>                      | <b>100</b>    | <b>86</b>                    | <b>188</b>    |
| Less: Net earnings (loss) attributable to noncontrolling interests | (18)                           | (8)           | (52)                         | (26)          |
| <b>Net Earnings Attributable to Shareholders</b>                   | <b>\$ 55</b>                   | <b>\$ 108</b> | <b>\$ 138</b>                | <b>\$ 214</b> |

**Earnings Attributable to Shareholders per  
Common Share:**

|         |    |     |    |     |    |      |    |      |
|---------|----|-----|----|-----|----|------|----|------|
| Basic   | \$ | .53 | \$ | .98 | \$ | 1.33 | \$ | 1.92 |
| Diluted | \$ | .52 | \$ | .97 | \$ | 1.31 | \$ | 1.90 |

Average number of Common Shares:

|         |       |       |       |       |
|---------|-------|-------|-------|-------|
| Basic   | 102.7 | 110.2 | 103.7 | 111.1 |
| Diluted | 104.4 | 111.8 | 105.3 | 112.5 |

|                                 |    |       |    |       |    |      |    |      |
|---------------------------------|----|-------|----|-------|----|------|----|------|
| Cash dividends per Common Share | \$ | .1625 | \$ | .1375 | \$ | .325 | \$ | .275 |
|---------------------------------|----|-------|----|-------|----|------|----|------|

(\*) Consists of the following:

|   |    |      |    |      |    |      |    |      |
|---|----|------|----|------|----|------|----|------|
| Realized gains before impairments                                     | \$ | 40   | \$ | 27   | \$ | 50   | \$ | 52   |
| Losses on securities with impairment                                  |    | (10) |    | (20) |    | (17) |    | (34) |
| Non-credit portion recognized in other<br>comprehensive income (loss) |    | (11) |    | 4    |    | (14) |    | (3)  |
| Impairment charges recognized in earnings                             |    | (21) |    | (16) |    | (31) |    | (37) |
| Total realized gains (losses) on securities                           | \$ | 19   | \$ | 11   | \$ | 19   | \$ | 15   |

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**AMERICAN FINANCIAL GROUP, INC. 10-Q**  
**AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENT OF CHANGES IN EQUITY (UNAUDITED)**  
**(Dollars in Millions)**

|   | Common      |                                   | Shareholders      |          | Equity                                    |          |                                  |                 |
|---|-------------|-----------------------------------|-------------------|----------|---|----------|----------------------------------|-----------------|
|   | Common      | Common<br>Stock<br>and<br>Capital | Retained Earnings |          | Accum.<br>Other<br>Comp<br>Inc.<br>(Loss) | Total    | Noncon-<br>trolling<br>Interests | Total<br>Equity |
|   | Shares      | Surplus                           | Appro.            | Unappro. | (Loss)                                    | Total    | Interests                        | Equity          |
| <b>Balance at<br/>December 31, 2010</b>                                 | 105,168,366 | \$ 1,271                          | \$ 197            | \$ 2,523 | \$ 479                                    | \$ 4,470 | \$ 150                           | \$ 4,620        |
| Net earnings  |             |                                   |                   | 138      |   | 138      | (52)                             | 86              |
| Other<br>comprehensive<br>income (loss), net of<br>tax:                 |             |                                   |                   |          |   |          |                                  |                 |
| Change in unrealized<br>gain (loss) on<br>securities                    |             |                                   |                   |          | 94  | 94       | 2                                | 96              |
| Change in foreign<br>currency translation                               |             |                                   |                   |          | 5   | 5        |                                  | 5               |
| Change in unrealized<br>pension and other<br>postretirement<br>benefits |             |                                   |                   |          | 1   | 1        |                                  | 1               |
| Total comprehensive<br>income (loss)                                    |             |                                   |                   |          |   | 238      | (50)                             | 188             |
| Allocation of losses<br>of managed<br>investment entities               |             |                                   | (55)              |          |   | (55)     | 55                               |                 |
| Dividends on<br>Common Stock  |             |                                   |                   | (34)     |   | (34)     |                                  | (34)            |
| Shares issued:  |             |                                   |                   |          |   |          |                                  |                 |
| Exercise of stock<br>options  | 654,799     | 16                                |                   |          |   | 16       |                                  | 16              |
| Other benefit plans   | 357,042     | 8                                 |                   |          |   | 8        |                                  | 8               |
| Dividend<br>reinvestment plan   | 7,870       |                                   |                   |          |   |          |                                  |                 |
| Stock-based<br>compensation<br>expense                                  |             | 7                                 |                   |          |   | 7        |                                  | 7               |
|   | (5,167,842) | (63)                              |                   | (115)    |   | (178)    |                                  | (178)           |



|   |             |          |        |          |        |          |        |  |          |
|---|-------------|----------|--------|----------|--------|----------|--------|--|----------|
| Shares acquired and retired                         |             |          |        |          |        |          |        |  |          |
| Other   |             |          |        |          |        |          | (2)    |  | (2)      |
| <b>Balance at June 30, 2011</b>                     | 101,020,235 | \$ 1,239 | \$ 142 | \$ 2,512 | \$ 579 | \$ 4,472 | \$ 153 |  | \$ 4,625 |
| <b>Balance at December 31, 2009</b>                 | 113,386,343 | \$ 1,344 | \$     | \$ 2,274 | \$ 163 | \$ 3,781 | \$ 138 |  | \$ 3,919 |
| Cumulative effect of accounting change              |             |          | 261    | 4        | (4)    | 261      |        |  | 261      |
| Net earnings  |             |          |        | 214      |        | 214      | (26)   |  | 188      |
| Other comprehensive income (loss), net of tax:      |             |          |        |          |        |          |        |  |          |
| Change in unrealized gain (loss) on securities      |             |          |        |          | 240    | 240      | 2      |  | 242      |
| Change in foreign currency translation              |             |          |        |          | (1)    | (1)      |        |  | (1)      |
| Total comprehensive income (loss)                   |             |          |        |          |        | 453      | (24)   |  | 429      |
| Allocation of losses of managed investment entities |             |          | (33)   |          |        | (33)     | 33     |  |          |
| Dividends on Common Stock                           |             |          |        | (31)     |        | (31)     |        |  | (31)     |
| Shares issued:                                      |             |          |        |          |        |          |        |  |          |
| Exercise of stock options                           | 523,671     | 11       |        |          |        | 11       |        |  | 11       |
| Other benefit plans                                 | 371,186     | 5        |        |          |        | 5        |        |  | 5        |
| Dividend reinvestment plan                          | 8,672       |          |        |          |        |          |        |  |          |
| Stock-based compensation expense                    |             | 6        |        |          |        | 6        |        |  | 6        |
| Shares acquired and retired                         | (5,642,355) | (66)     |        | (85)     |        | (151)    |        |  | (151)    |
| Other   |             | (1)      |        |          |        | (1)      | (1)    |  | (2)      |
| <b>Balance at June 30, 2010</b>                     | 108,647,517 | \$ 1,299 | \$ 228 | \$ 2,376 | \$ 398 | \$ 4,301 | \$ 146 |  | \$ 4,447 |



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**AMERICAN FINANCIAL GROUP, INC. 10-Q**  
**AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENT OF CASH FLOWS (UNAUDITED)**  
**(In Millions)**

|  | Six months ended<br>June 30, |         |
|--|------------------------------|---------|
|  | 2011                         | 2010    |
| <b>Operating Activities:</b>                       |                              |         |
| Net earnings, including noncontrolling interests   | \$ 86                        | \$ 188  |
| Adjustments:                                       |                              |         |
| Depreciation and amortization                      | 96                           | 97      |
| Annuity benefits                                   | 241                          | 226     |
| Realized gains on investing activities             | (16)                         | (15)    |
| Net (purchases) sales of trading securities        | 6                            | (9)     |
| Deferred annuity and life policy acquisition costs | (126)                        | (97)    |
| Change in:   |                              |         |
| Reinsurance and other receivables                  | 156                          | 571     |
| Other assets                                       | 12                           | 10      |
| Insurance claims and reserves                      | (12)                         | (329)   |
| Payable to reinsurers                              | (18)                         | (185)   |
| Other liabilities                                  | 113                          | (28)    |
| Other operating activities, net                    | (4)                          | 32      |
| Net cash provided by operating activities          | 534                          | 461     |
| <b>Investing Activities:</b>                       |                              |         |
| Purchases of:                                      |                              |         |
| Fixed maturities                                   | (2,302)                      | (2,353) |
| Equity securities                                  | (104)                        | (24)    |
| Mortgage loans                                     | (91)                         | (137)   |
| Real estate, property and equipment                | (57)                         | (54)    |
| Proceeds from:                                     |                              |         |
| Maturities and redemptions of fixed maturities     | 1,106                        | 970     |
| Repayments of mortgage loans                       | 224                          | 27      |
| Sales of fixed maturities                          | 374                          | 932     |
| Sales of equity securities                         | 41                           | 8       |
| Sales of real estate, property and equipment       | 1                            | 1       |
| Managed investment entities:                       |                              |         |
| Purchases of investments                           | (681)                        | (394)   |
| Proceeds from sales and redemptions of investments | 754                          | 441     |
| Other investing activities, net                    | (6)                          | (124)   |
| Net cash used in investing activities              | (741)                        | (707)   |
| <b>Financing Activities:</b>                       |                              |         |
| Annuity receipts                                   | 1,578                        | 945     |

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|   |            |              |
|---|------------|--------------|
| Annuity surrenders, benefits and withdrawals          | (636)      | (617)        |
| Additional long-term borrowings                       | 2          | 30           |
| Reductions of long-term debt                          | (14)       | (6)          |
| Managed investment entities retirement of liabilities | (8)        | (39)         |
| Issuances of Common Stock                             | 16         | 11           |
| Repurchases of Common Stock                           | (178)      | (151)        |
| Cash dividends paid on Common Stock                   | (34)       | (31)         |
| Other financing activities, net                       | 11         | (5)          |
| Net cash provided by financing activities             | 737        | 137          |
| <b>Net Change in Cash and Cash Equivalents</b>        | <b>530</b> | <b>(109)</b> |
| Cash and cash equivalents at beginning of period      | 1,099      | 1,120        |
| Cash and cash equivalents at end of period            | \$ 1,629   | \$ 1,011     |

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**AMERICAN FINANCIAL GROUP, INC. 10-Q  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
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**M. Contingencies**

**N. Condensed Consolidating Information**

**A. Accounting Policies**

**Basis of Presentation** The accompanying consolidated financial statements for American Financial Group, Inc. ( AFG ) and 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, 2011, 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.

**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. In the first six months of 2011, AFG did not have any significant nonrecurring fair value measurements of nonfinancial assets and liabilities.

**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 (loss) 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.

**Table of Contents****AMERICAN FINANCIAL GROUP, INC. 10-Q****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 (loss)). 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.

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

**Deferred Policy Acquisition Costs ( DPAC )** Policy acquisition costs (principally commissions, premium taxes and other marketing and underwriting expenses) related to the production of new business 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.

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, unamortized acquisition costs and policy maintenance 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 on marketable securities, a component of accumulated other comprehensive income in AFG's Balance Sheet.

New accounting guidance issued in October 2010 specifies that a cost must be directly related to the successful acquisition of an insurance contract to qualify for deferral. The guidance is effective January 1, 2012, with retrospective application permitted, but not required. This guidance will result in fewer acquisition costs being capitalized by AFG. Management continues assessing the impact of adoption and expects that adoption will be reported retrospectively.

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.



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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED**

**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.

AFG manages, and has minor investments in, six 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 subordinated 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. As permitted under accounting guidance adopted on January 1, 2010, the assets and liabilities of the CLOs are included in AFG's Balance Sheet at fair value. Prior to adoption of this guidance, the CLOs were not consolidated. Upon adoption of the guidance, the \$261 million excess of fair value of the CLOs' assets over the fair value of the liabilities was recorded in AFG's Balance Sheet as appropriated retained earnings—managed investment entities, representing the cumulative effect of adopting the new guidance that ultimately will inure to the benefit of the CLO debt holders.

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 net gain or loss from accounting for the CLO assets and liabilities at fair value subsequent to January 1, 2010, 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 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.

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**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.

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.

**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.

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**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. Deferred tax assets are recognized if it is more likely than not that a benefit will be realized.

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 2011 and 2010 1.7 million and 1.6 million; first six months of 2011 and 2010 1.6 million and 1.4 million, respectively. AFG's weighted average diluted shares outstanding excludes the following anti-dilutive potential common shares related to stock compensation plans: second quarter 2011 and 2010 2.4 million and 3.8 million; first six months of 2011 and 2010 2.1 million and 4.3 million, respectively. Adjustments to net earnings attributable to shareholders in the calculation of diluted earnings per share were nominal in the 2011 and 2010 periods.

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**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. Acquisition**

**Vanliner Group, Inc. ( Vanliner )** In July 2010, National Interstate ( NATL ), a 52%-owned subsidiary of AFG, completed the acquisition of Vanliner, a market leader in providing insurance for the moving and storage industry, for \$114 million (including post-closing adjustments). Vanliner's moving and storage insurance premiums associated with policies in force as of December 31, 2010, totaled approximately \$90 million, representing approximately 78% of its total business.

**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 operations 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 California 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. 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<br>June 30, |          | Six months ended<br>June 30, |          |
|--|--------------------------------|----------|------------------------------|----------|
|  | 2011                           | 2010     | 2011                         | 2010     |
| <b>Revenues</b>                          |                                |          |                              |          |
| Property and casualty insurance:         |                                |          |                              |          |
| Premiums earned:                         |                                |          |                              |          |
| Specialty                                |                                |          |                              |          |
| Property and transportation              | \$ 274                         | \$ 209   | \$ 529                       | \$ 425   |
| Specialty casualty                       | 219                            | 219      | 435                          | 437      |
| Specialty financial                      | 100                            | 127      | 212                          | 255      |
| Other                                    | 16                             | 17       | 32                           | 34       |
| Total premiums earned                    | 609                            | 572      | 1,208                        | 1,151    |
| Investment income                        | 75                             | 85       | 148                          | 177      |
| Realized gains (losses)                  | 32                             | 13       | 32                           | 23       |
| Other income                             | 20                             | 21       | 35                           | 36       |
| Total property and casualty insurance    | 736                            | 691      | 1,423                        | 1,387    |
| Annuity and supplemental insurance:      |                                |          |                              |          |
| Investment income                        | 230                            | 208      | 456                          | 410      |
| Life, accident and health premiums       | 107                            | 113      | 217                          | 228      |
| Realized gains (losses)                  | (13)                           | (2)      | (16)                         | (8)      |
| Other income                             | 27                             | 33       | 50                           | 58       |
| Total annuity and supplemental insurance | 351                            | 352      | 707                          | 688      |
| Other                                    | 6                              | 9        | 2                            | 11       |
| Total revenues                           | \$ 1,093                       | \$ 1,052 | \$ 2,132                     | \$ 2,086 |

**Operating Earnings Before Income Taxes**

|                                  |      |      |       |       |
|----------------------------------|------|------|-------|-------|
| Property and casualty insurance: |      |      |       |       |
| Underwriting income (loss):      |      |      |       |       |
| Specialty                        |      |      |       |       |
| Property and transportation      | \$   | \$ 8 | \$ 33 | \$ 40 |
| Specialty casualty               | 21   | 23   | 23    | 41    |
| Specialty financial              | 13   | 33   | 23    | 54    |
| Other                            | 5    | 4    | 6     | 10    |
| Other lines (a)                  | (50) | (5)  | (50)  | (11)  |
| Total underwriting               | (11) | 63   | 35    | 134   |
| Investment and other income, net | 70   | 81   | 138   | 162   |
| Realized gains (losses)          | 32   | 13   | 32    | 23    |

|  |       |        |        |        |
|--|-------|--------|--------|--------|
| Total property and casualty insurance        | 91    | 157    | 205    | 319    |
| Annuity and supplemental insurance:          |       |        |        |        |
| Operations                                   | 56    | 46     | 108    | 90     |
| Realized gains (losses)                      | (13)  | (2)    | (16)   | (8)    |
| Total annuity and supplemental insurance     | 43    | 44     | 92     | 82     |
| Other (b)                                    | (65)  | (43)   | (133)  | (96)   |
|  |       |        |        |        |
| Total operating earnings before income taxes | \$ 69 | \$ 158 | \$ 164 | \$ 305 |

- (a) Includes a second quarter 2011 special charge of \$50 million to increase asbestos and environmental reserves.
- (b) Includes a second quarter 2011 special charge of \$9 million to increase asbestos and environmental reserves and the following earnings (losses) of managed investment entities for the second quarter and first six months of 2011 and 2010 (in millions):

|   |         |         |         |         |  |
|---|---------|---------|---------|---------|--|
| Attributable to:                            |         |         |         |         |  |
| AFG shareholders, including management fees | \$ 6    | \$ 7    | \$ 15   | \$ 15   |  |
| Noncontrolling interests                    | \$ (20) | \$ (13) | \$ (55) | \$ (33) |  |

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**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. 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.

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.

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Assets and liabilities measured at fair value are summarized below (in millions):

|   | Level 1  | Level 2   | Level 3  | Total     |
|---|----------|-----------|----------|-----------|
| June 30, 2011                                     |          |           |          |           |
| Assets:   |          |           |          |           |
| Available for sale ( AFS ) fixed maturities:      |          |           |          |           |
| U.S. Government and government agencies           | \$ 242   | \$ 163    | \$       | \$ 405    |
| States, municipalities and political subdivisions |          | 3,391     | 84       | 3,475     |
| Foreign government                                |          | 271       |          | 271       |
| Residential MBS                                   |          | 3,587     | 255      | 3,842     |
| Commercial MBS                                    |          | 2,361     | 10       | 2,371     |
| All other corporate                               | 10       | 9,744     | 382      | 10,136    |
| Total AFS fixed maturities                        | 252      | 19,517    | 731      | 20,500    |
| Trading fixed maturities                          |          | 394       | 1        | 395       |
| Equity securities                                 | 629      | 129       | 21       | 779       |
| Assets of managed investment entities ( MIE )     | 125      | 2,413     | 53       | 2,591     |
| Variable annuity assets (separate accounts) (a)   |          | 624       |          | 624       |
| Other investments                                 |          | 113       |          | 113       |
| Total assets accounted for at fair value          | \$ 1,006 | \$ 23,190 | \$ 806   | \$ 25,002 |
| Liabilities:                                      |          |           |          |           |
| Liabilities of managed investment entities        | \$ 108   | \$        | \$ 2,322 | \$ 2,430  |
| Derivatives in annuity benefits accumulated       |          |           | 299      | 299       |
| Total liabilities accounted for at fair value     | \$ 108   | \$        | \$ 2,621 | \$ 2,729  |
| December 31, 2010                                 |          |           |          |           |
| Assets:   |          |           |          |           |
| Available for sale ( AFS ) fixed maturities:      |          |           |          |           |
| U.S. Government and government agencies           | \$ 249   | \$ 218    | \$       | \$ 467    |
| States, municipalities and political subdivisions |          | 2,919     | 20       | 2,939     |
| Foreign government                                |          | 278       |          | 278       |
| Residential MBS                                   |          | 3,563     | 312      | 3,875     |
| Commercial MBS                                    |          | 2,117     | 6        | 2,123     |
| All other corporate                               | 9        | 9,201     | 436      | 9,646     |
| Total AFS fixed maturities                        | 258      | 18,296    | 774      | 19,328    |
| Trading fixed maturities                          |          | 390       | 3        | 393       |
| Equity securities                                 | 461      | 208       | 21       | 690       |
| Assets of managed investment entities ( MIE )     | 96       | 2,393     | 48       | 2,537     |
| Variable annuity assets (separate accounts) (a)   |          | 616       |          | 616       |



|   |    |     |    |        |    |       |    |        |
|---|----|-----|----|--------|----|-------|----|--------|
| Other investments                             |    |     | 98 |        | 98 |       |    |        |
| Total assets accounted for at fair value      | \$ | 815 | \$ | 22,001 | \$ | 846   | \$ | 23,662 |
| Liabilities:                                  |    |     |    |        |    |       |    |        |
| Liabilities of managed investment entities    | \$ | 65  | \$ |        | \$ | 2,258 | \$ | 2,323  |
| Derivatives in annuity benefits accumulated   |    |     |    |        |    | 190   |    | 190    |
| Total liabilities accounted for at fair value | \$ | 65  | \$ |        | \$ | 2,448 | \$ | 2,513  |

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

During the second quarter of 2011, there were no significant transfers between Level 1 and Level 2.

Approximately 3% of the total assets measured at fair value on June 30, 2011, were Level 3 assets.

Approximately 33% of these assets were MBS whose fair values were determined primarily using non-binding broker quotes; the balance was primarily private placement debt securities whose fair values were determined internally using significant unobservable inputs, including the evaluation of underlying collateral and issuer creditworthiness, as well as certain Level 2 inputs such as comparable yields and multiples on similar publicly traded issues. The fair values of the liabilities of managed investment entities were determined using non-binding broker quotes, which were reviewed by AFG's investment professionals.

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Changes in balances of Level 3 financial assets and liabilities during the second quarter and first six months of 2011 and 2010 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<br>at<br>March<br>31,<br>2011 | Total<br>realized/unrealized<br>gains (losses)<br>included in<br>Other<br>comp.<br>income<br>(loss) | Purchases<br>and<br>issuances | Sales and<br>Settlements | Transfer<br>into<br>Level<br>3 | Transfer<br>out of<br>Level 3 | Balance<br>at<br>June 30,<br>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   | 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*.

|                       | Balance<br>at<br>March 31,<br>2010 | Total<br>realized/unrealized<br>gains (losses)<br>included in<br>Other<br>comp.<br>income<br>(loss) | Purchases,<br>sales,<br>issuances<br>and<br>settlements | Transfer<br>into<br>Level 3 | Transfer<br>out of<br>Level 3 | Balance<br>at<br>June 30,<br>2010 |
|-----------------------|------------------------------------|---|---|-----------------------------|-------------------------------|-----------------------------------|
| AFS fixed maturities: |                                    |   |   |                             |                               |                                   |
| State and municipal   | \$ 6                               | \$ 1  | (\$3)   | \$ 17                       | \$                            | \$ 21                             |
| Residential MBS       | 372                                | 1   | 10  | (12)                        | (47)                          | 326                               |

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|                          |         |      |   |      |    |      |         |
|--------------------------|---------|------|---|------|----|------|---------|
| Commercial MBS           | 6       |      |   |      |    |      | 6       |
| All other corporate      | 356     | (11) | 9 | 42   | 46 | (16) | 426     |
| Trading fixed maturities | 4       |      |   |      |    | (3)  | 1       |
| Equity securities        | 24      |      |   |      |    |      | 24      |
| Assets of MIE            | 100     | 1    |   | (10) | 7  | (52) | 46      |
| Liabilities of MIE       | (2,178) | 16   |   | 10   |    |      | (2,152) |
| Embedded derivatives     | (131)   | 13   |   | (10) |    |      | (128)   |

|                             | Total<br>realized/unrealized<br>gains (losses)<br>included in<br>Other |                             |                               |                               |                          |                                |                               |                                       |
|-----------------------------|--|-----------------------------|-------------------------------|-------------------------------|--------------------------|--------------------------------|-------------------------------|---------------------------------------|
|                             | Balance<br>at<br>Dec. 31,<br><br>2010                                  | Net<br>income<br><br>income | comp.<br>income<br><br>(loss) | Purchases<br>and<br>issuances | Sales and<br>Settlements | Transfer<br>into<br>Level<br>3 | Transfer<br>out of<br>Level 3 | Balance<br>at<br>June 30,<br><br>2011 |
| AFS fixed<br>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<br>maturities | 3  |                             |                               |                               |                          |                                | (2)                           | 1                                     |
| Equity securities           | 21   |                             | 2                             |                               | (2)                      |                                |                               | 21                                    |
| Assets of MIE               | 48   | (1)                         |                               | 16                            | (6)                      | 8                              | (12)                          | 53                                    |
| Liabilities of MIE<br>(*)   | (2,258)  | (72)                        |                               |                               | 8                        |                                |                               | (2,322)                               |
| Embedded<br>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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|                          | Balance<br>at<br>Dec. 31,<br>2009 | Consolidate<br>Managed<br>Inv.<br>Entities | Total<br>realized/unrealized<br>gains (losses)<br>included in<br>Net<br>income | Other<br>comp.<br>income<br>(loss) | Purchases,<br>sales,<br>issuances<br>and<br>settlements | Transfer<br>into<br>Level<br>3 | Transfer<br>out of<br>Level 3 | Balance<br>at<br>June 30,<br>2010 |
|--------------------------|-----------------------------------|--|--|------------------------------------|---|--------------------------------|-------------------------------|-----------------------------------|
| AFS fixed maturities:    |                                   |  |  |                                    |   |                                |                               |                                   |
| State and municipal      | \$ 23                             | \$   | \$   | \$ 1                               | (\$3)   | \$ 17                          | (\$17)                        | \$ 21                             |
| Residential MBS          | 435                               |  | 2  | 11                                 | 6   | 2                              | (130)                         | 326                               |
| Commercial MBS           |                                   |  |  |                                    | 6   |                                |                               | 6                                 |
| All other corporate      | 311                               | (6)  | (12)   | 8                                  | 87  | 69                             | (31)                          | 426                               |
| Trading fixed maturities | 1                                 |  |  |                                    | 4   |                                | (4)                           | 1                                 |
| Equity securities        | 25                                |  |  | (1)                                |   |                                |                               | 24                                |
| Assets of MIE            |                                   | 90   | 5  |                                    | (4)   | 7                              | (52)                          | 46                                |
| Liabilities of MIE       |                                   | (2,100)                                    | (90)   |                                    | 38  |                                |                               | (2,152)                           |
| Embedded derivatives     | (113)                             |  | 1  |                                    | (16)  |                                |                               | (128)                             |

**Fair Value of Financial Instruments** The following table presents (in millions) the carrying value and estimated fair value of AFG's financial instruments at June 30, 2011 and December 31, 2010.

|  | June 30, 2011  |            | December 31, 2010 |            |
|--|----------------|------------|-------------------|------------|
|  | Carrying Value | Fair Value | Carrying Value    | Fair Value |
| <b>Assets:</b>                                   |                |            |                   |            |
| Cash and cash equivalents                        | \$ 1,629       | \$ 1,629   | \$ 1,099          | \$ 1,099   |
| Fixed maturities                                 | 20,895         | 20,895     | 19,721            | 19,721     |
| Equity securities                                | 779            | 779        | 690               | 690        |
| Mortgage loans                                   | 340            | 349        | 468               | 469        |
| Policy loans                                     | 255            | 255        | 264               | 264        |
| Other investments derivatives                    | 113            | 113        | 98                | 98         |
| Assets of managed investment entities            | 2,591          | 2,591      | 2,537             | 2,537      |
| Variable annuity assets (separate accounts)      | 624            | 624        | 616               | 616        |
| <b>Liabilities:</b>                              |                |            |                   |            |
| Annuity benefits accumulated(*)                  | \$ 13,915      | \$ 13,512  | \$ 12,696         | \$ 12,233  |
| Long-term debt                                   | 940            | 1,033      | 952               | 1,023      |
| Liabilities of managed investment entities       | 2,430          | 2,430      | 2,323             | 2,323      |
| Variable annuity liabilities (separate accounts) | 624            | 624        | 616               | 616        |
| Other liabilities derivatives                    | 18             | 18         | 14                | 14         |

(\*) 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.

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**E. Investments**

Available for sale fixed maturities and equity securities at June 30, 2011, and December 31, 2010, consisted of the following (in millions):

|   | June 30, 2011     |               |                |                      | December 31, 2010 |               |                |                      |
|---|-------------------|---------------|----------------|----------------------|-------------------|---------------|----------------|----------------------|
|   | Amortized<br>Cost | Fair<br>Value | Gross<br>Gains | Unrealized<br>Losses | Amortized<br>Cost | Fair<br>Value | Gross<br>Gains | Unrealized<br>Losses |
| Fixed maturities:   |                   |               |                |                      |                   |               |                |                      |
| U.S. Government and<br>government agencies<br>States, municipalities<br>and political<br>subdivisions | \$ 391            | \$ 405        | \$ 14          | \$                   | \$ 453            | \$ 467        | \$ 15          | \$ (1)               |
| Foreign government  | 3,378             | 3,475         | 112            | (15)                 | 2,927             | 2,939         | 53             | (41)                 |
| Residential MBS   | 260               | 271           | 11             |                      | 269               | 278           | 9              |                      |
| Commercial MBS  | 3,735             | 3,842         | 224            | (117)                | 3,781             | 3,875         | 222            | (128)                |
| All other corporate   | 2,183             | 2,371         | 190            | (2)                  | 1,972             | 2,123         | 153            | (2)                  |
|   | 9,470             | 10,136        | 693            | (27)                 | 9,088             | 9,646         | 602            | (44)                 |
| Total fixed maturities  | \$ 19,417         | \$ 20,500     | \$ 1,244       | \$ (161)             | \$ 18,490         | \$ 19,328     | \$ 1,054       | \$ (216)             |
| Common stocks   | \$ 407            | \$ 633        | \$ 231         | \$ (5)               | \$ 312            | \$ 543        | \$ 232         | \$ (1)               |
| Perpetual preferred<br>stocks   | \$ 142            | \$ 146        | \$ 8           | \$ (4)               | \$ 146            | \$ 147        | \$ 6           | \$ (5)               |

The non-credit related portion of other-than-temporary impairment charges are included in other comprehensive income (loss). Such charges taken for residential MBS still owned at June 30, 2011 and December 31, 2010, respectively were \$238 million and \$258 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, 2011 and December 31, 2010.

|  | Less Than Twelve Months |               |                               | Twelve Months or More |               |                               |
|--|-------------------------|---------------|-------------------------------|-----------------------|---------------|-------------------------------|
|  | Unrealized<br>Loss      | Fair<br>Value | Fair Value<br>as<br>% of Cost | Unrealized<br>Loss    | Fair<br>Value | Fair Value<br>as<br>% of Cost |
| <b>June 30, 2011</b>                                 |                         |               |                               |                       |               |                               |
| Fixed maturities:                                    |                         |               |                               |                       |               |                               |
| U.S. Government and<br>government agencies           | \$                      | \$ 38         | 100%                          | \$                    | \$            | %                             |
| States, municipalities and<br>political subdivisions | (12)                    | 665           | 98%                           | (3)                   | 46            | 94%                           |
| Foreign government                                   |                         | 1             | 100%                          |                       |               | %                             |
| Residential MBS                                      | (20)                    | 629           | 97%                           | (97)                  | 466           | 83%                           |
| Commercial MBS                                       | (1)                     | 102           | 99%                           | (1)                   | 11            | 92%                           |
| All other corporate                                  | (19)                    | 1,066         | 98%                           | (8)                   | 116           | 94%                           |
| <br>Total fixed maturities                           | <br>\$ (52)             | <br>\$ 2,501  | <br>98%                       | <br>\$ (109)          | <br>\$ 639    | <br>85%                       |
| <br>Common Stocks                                    | <br>\$ (5)              | <br>\$ 47     | <br>90%                       | <br>\$                | <br>\$        | <br>%                         |
| <br>Perpetual Preferred Stocks                       | <br>\$                  | <br>\$ 5      | <br>100%                      | <br>\$ (4)            | <br>\$ 41     | <br>91%                       |
| <br><b>December 31, 2010</b>                         |                         |               |                               |                       |               |                               |
| Fixed maturities:                                    |                         |               |                               |                       |               |                               |
| U.S. Government and<br>government agencies           | \$ (1)                  | \$ 86         | 99%                           | \$                    | \$            | %                             |
| States, municipalities and<br>political subdivisions | (38)                    | 1,180         | 97%                           | (3)                   | 40            | 93%                           |
| Foreign government                                   |                         | 37            | 99%                           |                       |               | %                             |
| Residential MBS                                      | (11)                    | 412           | 97%                           | (117)                 | 551           | 82%                           |
| Commercial MBS                                       | (2)                     | 83            | 98%                           |                       | 15            | 97%                           |
| All other corporate                                  | (24)                    | 1,020         | 98%                           | (20)                  | 275           | 93%                           |
| <br>Total fixed maturities                           | <br>\$ (76)             | <br>\$ 2,818  | <br>97%                       | <br>\$ (140)          | <br>\$ 881    | <br>86%                       |
| <br>Common Stocks                                    | <br>\$                  | <br>\$ 21     | <br>99%                       | <br>\$ (1)            | <br>\$ 4      | <br>88%                       |

|                            |    |    |    |     |    |     |    |    |     |
|----------------------------|----|----|----|-----|----|-----|----|----|-----|
| Perpetual Preferred Stocks | \$ | \$ | 22 | 98% | \$ | (5) | \$ | 37 | 88% |
|----------------------------|----|----|----|-----|----|-----|----|----|-----|

At June 30, 2011 the gross unrealized losses on fixed maturities of \$161 million relate to approximately 900 securities. Investment grade securities (as determined by nationally recognized rating agencies) represented approximately 49% of the gross unrealized loss and 79% of the fair value.

**Gross Unrealized Losses on MBS** At June 30, 2011, gross unrealized losses on AFG's residential MBS represented 73% of the total gross unrealized loss on fixed maturity securities (and 90% of the twelve months or more ). Of the residential MBS that have been in an unrealized loss position (impaired) for 12 months or more (237 securities), approximately 35% of the unrealized losses and 51% of the fair value relate to investment grade rated securities. 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 2011, AFG recorded in earnings \$34 million in other-than-temporary impairment charges related to its residential MBS.

**Gross Unrealized Losses on All Other Corporates** For the first six months of 2011, AFG recorded in earnings \$2 million in other-than-temporary charges on all other corporate securities. Management concluded that no additional charges for other-than-temporary impairments were required based on many factors, including AFG's ability and intent to hold the investments for a period of time sufficient to allow for anticipated recovery of its amortized cost, the length of time and the extent to which fair value has been below cost, analysis of historical and projected company-specific financial data, the outlook for industry sectors, and credit ratings.



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The following tables progress 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 (loss) (in millions).

|                                      | 2011   | 2010   |
|--------------------------------------|--------|--------|
| Balance at March 31                  | \$ 151 | \$ 122 |
| Additional credit impairments on:    |        |        |
| Previously impaired securities       | 22     | 4      |
| Securities without prior impairments | 4      | 3      |
| Reductions disposals                 | (6)    | (8)    |
| Balance at June 30                   | \$ 171 | \$ 121 |
| Balance at January 1                 | \$ 143 | \$ 99  |
| Additional credit impairments on:    |        |        |
| Previously impaired securities       | 29     | 23     |
| Securities without prior impairments | 5      | 7      |
| Reductions disposals                 | (6)    | (8)    |
| Balance at June 30                   | \$ 171 | \$ 121 |

The table below sets forth the scheduled maturities of available for sale fixed maturities as of June 30, 2011 (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, 2011.

| Maturity                           | Amortized<br>Cost | Fair Value<br>Amount | %    |
|------------------------------------|-------------------|----------------------|------|
| One year or less                   | \$ 457            | \$ 471               | 2%   |
| After one year through five years  | 5,154             | 5,475                | 27   |
| After five years through ten years | 5,904             | 6,287                | 31   |
| After ten years                    | 1,984             | 2,054                | 10   |
|                                    | 13,499            | 14,287               | 70   |
| MBS                                | 5,918             | 6,213                | 30   |
| Total                              | \$ 19,417         | \$ 20,500            | 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, 2011 or December 31, 2010.



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**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 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<br>Amounts<br>Attributable<br>to Noncontrolling<br>Interests | Net    |
|--|----------|---|--------|
| June 30, 2011                          |          |   |        |
| Unrealized gain on:                    |          |   |        |
| Fixed maturity securities              | \$ 1,083 | \$ (384)  | \$ 699 |
| Equity securities                      | 230      | (81)  | 149    |
| Deferred policy acquisition costs      | (434)    | 152   | (282)  |
| Annuity benefits and other liabilities | 6        | (2)   | 4      |
|  | \$ 885   | \$ (315)  | \$ 570 |
| December 31, 2010                      |          |   |        |
| Unrealized gain on:                    |          |   |        |
| Fixed maturity securities              | \$ 838   | \$ (295)  | \$ 543 |
| Equity securities                      | 232      | (82)  | 150    |
| Deferred policy acquisition costs      | (340)    | 118   | (222)  |
| Annuity benefits and other liabilities | 6        | (2)   | 4      |
|  | \$ 736   | \$ (261)  | \$ 475 |

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

|                                | Fixed<br>Maturities | Equity<br>Securities | Mortgage<br>Loans<br>and Other<br>Investments | Other(a) | Tax<br>Effects | Noncon-<br>trolling<br>Interests | Total |
|--------------------------------|---------------------|----------------------|---|----------|----------------|----------------------------------|-------|
| Quarter ended June 30,<br>2011 |                     |                      |   |          |                |                                  |       |
| Realized before<br>impairments | \$ 11               | \$ 34                | \$ (5)  | \$       | \$ (15)        | \$ (1)                           | \$ 24 |
| Realized impairments           | (26)                |                      | (1)   | 6        | 8              |                                  | (13)  |
| Change in Unrealized           | 208                 | (15)                 |   | (70)     | (44)           | (2)                              | 77    |
| Quarter ended June 30,<br>2010 |                     |                      |   |          |                |                                  |       |

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|                                |    |      |    |   |    |     |    |       |    |      |    |     |    |      |
|--------------------------------|----|------|----|---|----|-----|----|-------|----|------|----|-----|----|------|
| Realized before<br>impairments | \$ | 35   | \$ | 1 | \$ | (7) | \$ | (2)   | \$ | (10) | \$ | (1) | \$ | 16   |
| Realized impairments           |    | (22) |    |   |    | (1) |    | 7     |    | 6    |    |     |    | (10) |
| Change in Unrealized           |    | 283  |    | 2 |    |     |    | (110) |    | (62) |    |     |    | 113  |

Six months ended

June 30, 2011

|                                |    |      |    |     |    |     |    |      |    |      |    |     |    |      |
|--------------------------------|----|------|----|-----|----|-----|----|------|----|------|----|-----|----|------|
| Realized before<br>impairments | \$ | 24   | \$ | 35  | \$ | (7) | \$ | (2)  | \$ | (18) | \$ | (1) | \$ | 31   |
| Realized impairments           |    | (37) |    |     |    | (4) |    | 10   |    | 11   |    |     |    | (20) |
| Change in Unrealized           |    | 245  |    | (2) |    |     |    | (94) |    | (53) |    | (2) |    | 94   |

Six months ended

June 30, 2010

|                                |    |      |    |     |    |      |    |       |    |       |    |     |    |      |
|--------------------------------|----|------|----|-----|----|------|----|-------|----|-------|----|-----|----|------|
| Realized before<br>impairments | \$ | 69   | \$ | 2   | \$ | (14) | \$ | (5)   | \$ | (18)  | \$ | (1) | \$ | 33   |
| Realized impairments           |    | (50) |    |     |    | (3)  |    | 16    |    | 13    |    |     |    | (24) |
| Change in Unrealized           |    | 633  |    | (3) |    |      |    | (257) |    | (131) |    | (2) |    | 240  |

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

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Realized gains (losses) on securities includes net losses of less than \$1 million in the second quarter and \$3 million in the first six months of 2011 compared to net gains of \$9 million and \$26 million in the second quarter and first six months of 2010 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<br>June 30, |       |
|--------------------|------------------------------|-------|
|                    | 2011                         | 2010  |
| Fixed maturities:  |                              |       |
| Gross gains        | \$ 29                        | \$ 52 |
| Gross losses       | (2)                          | (9)   |
| Equity securities: |                              |       |
| Gross gains        | 36                           | 2     |
| Gross losses       |                              |       |

**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):

|   |                              | June 30, 2011 |           | December 31, 2010 |           |
|---|------------------------------|---------------|-----------|-------------------|-----------|
| Derivative                                  | Balance Sheet Line           | Asset         | Liability | Asset             | Liability |
| MBS with embedded derivatives               | Fixed maturities             | \$ 93         | \$        | \$ 101            | \$        |
| Interest rate swaptions                     | Other investments            | 21            |           | 21                |           |
| Indexed annuities (embedded derivative)     | Annuity benefits accumulated |               | 299       |                   | 190       |
| Equity index call options                   | Other investments            | 92            |           | 77                |           |
| Reinsurance contracts (embedded derivative) | Other liabilities            |               | 18        |                   | 14        |
|   |                              | \$ 206        | \$ 317    | \$ 199            | \$ 204    |

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.

AFG's indexed annuities, which represented 30% of annuity benefits accumulated at June 30, 2011, 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.

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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 2011 and 2010 (in millions):

| Derivative                                  | Statement of Earnings Line | Three months ended June 30, |         | Six months ended June 30, |        |
|---|----------------------------|-----------------------------|---------|---------------------------|--------|
|   |                            | 2011                        | 2010    | 2011                      | 2010   |
| MBS with embedded derivatives               | Realized gains             | \$                          | \$ 9    | \$ (3)                    | \$ 26  |
| Interest rate swaptions                     | Realized gains             | (5)                         | (6)     | (7)                       | (14)   |
| Indexed annuities (embedded derivative)     | Annuity benefits           | (10)                        | 13      | (29)                      | 1      |
| Equity index call options                   | Annuity benefits           | 2                           | (23)    | 20                        | (12)   |
| Reinsurance contracts (embedded derivative) | Investment income          | (4)                         | (5)     | (4)                       | (10)   |
|   |                            | \$ (17)                     | \$ (12) | \$ (23)                   | \$ (9) |

**G. Deferred Policy Acquisition Costs**

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

|   | June 30, 2011 | December 31, 2010 |
|---|---------------|-------------------|
| Property and casualty insurance                     | \$ 331        | \$ 324            |
| Annuity and supplemental insurance:                 |               |                   |
| Policy acquisition costs                            | 940           | 892               |
| Policyholder sales inducements                      | 208           | 204               |
| Present value of future profits ( PVFP )            | 153           | 164               |
| Impact of unrealized gains and losses on securities | (434)         | (340)             |
| Total annuity and supplemental                      | 867           | 920               |
|   | \$ 1,198      | \$ 1,244          |

The PVFP amounts in the table above are net of \$185 million and \$174 million of accumulated amortization at June 30, 2011 and December 31, 2010, respectively. Amortization of the PVFP was \$5 million in the second quarter and \$11 million during the first six months of 2011 and \$10 million in the second quarter and \$16 million in the first six months of 2010, respectively.

**H. Managed Investment Entities**

AFG is the investment manager and has investments ranging from 7.5% to 24.4% of the most subordinate debt tranche of six collateralized loan obligation entities or CLOs, which are considered variable interest entities. Upon formation between 2004 and 2007, 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 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. One of the CLOs is expected to be liquidated in August 2011, resulting in a reduction in assets and liabilities of managed investment entities of approximately \$498 million and \$480 million, respectively, and an \$18 million reduction in appropriated retained earnings. The impact on net income attributable to shareholders is not expected to be material.



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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 \$19 million at June 30, 2011.

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<br>June 30, |         | Six months ended<br>June 30, |       |
|---|--------------------------------|---------|------------------------------|-------|
|   | 2011                           | 2010    | 2011                         | 2010  |
| Gains (losses) on change in fair value of assets/liabilities (a): |                                |         |                              |       |
| Assets  | \$ (12)                        | \$ (31) | \$ 17                        | \$ 50 |
| Liabilities   | (10)                           | 16      | (72)                         | (90)  |
| Management fees paid to AFG                                       | 5                              | 4       | 8                            | 8     |
| CLO earnings (losses) attributable to:                            |                                |         |                              |       |
| AFG shareholders (b)  | 1                              | 3       | 7                            | 7     |
| Noncontrolling interests (b)                                      | (20)                           | (13)    | (55)                         | (33)  |

(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 \$60 million and \$69 million at June 30, 2011 and December 31, 2010. The aggregate unpaid principal balance of the CLOs' debt exceeded its fair value by \$229 million and \$301 million at those dates. The CLO assets include \$6 million in loans at both June 30, 2011 and December 31, 2010, (aggregate unpaid principal balance of \$18 million and \$12 million, respectively) for which the CLOs are not accruing interest because the loans are in default.

**I. Goodwill and Other Intangibles**

There were no changes in the goodwill balance of \$186 million during the six months ended June 30, 2011.

Included in other assets in AFG's Balance Sheet is \$43 million at June 30, 2011 and \$49 million at December 31, 2010, in amortizable intangible assets related to property and casualty insurance acquisitions. These amounts are net of accumulated amortization of \$41 million and \$35 million, respectively. Amortization of these intangibles was \$3 million in the second quarter and \$6 million during the first six months of both 2011 and 2010.

Other assets also include \$8 million in non-amortizable intangible assets related to insurance licenses acquired in the acquisition of Vanliner in 2010.

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

**J. Long-Term Debt**

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

|  | June 30,<br>2011 | December 31,<br>2010 |
|--|------------------|----------------------|
| <b>Direct obligations of AFG:</b>                              |                  |                      |
| 9-7/8% Senior Notes due June 2019                              | \$ 350           | \$ 350               |
| 7% Senior Notes due September 2050                             | 132              | 132                  |
| 7-1/8% Senior Debentures due February 2034                     | 115              | 115                  |
| Other  | 3                | 3                    |
|  | 600              | 600                  |
| <b>Subsidiaries:</b>   |                  |                      |
| 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 2011 through 2016     | 65               | 65                   |
| Secured borrowings (\$17 and \$18 guaranteed by AFG)           | 35               | 41                   |
| National Interstate bank credit facility                       | 22               | 20                   |
| American Premier 10-7/8% Subordinated Notes                    |                  | 8                    |
|  | 320              | 332                  |
| <b>Payable to Subsidiary Trusts:</b>                           |                  |                      |
| AAG Holding Variable Rate Subordinated Debentures due May 2033 | 20               | 20                   |
|  | \$ 940           | \$ 952               |

Scheduled principal payments on debt for the balance of 2011 and the subsequent five years were as follows: 2011 \$6 million; 2012 \$34 million; 2013 \$20 million; 2014 \$2 million; 2015 \$14 million and 2016 \$45 million.

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

|                                    | June 30,<br>2011 | December 31,<br>2010 |
|------------------------------------|------------------|----------------------|
| Unsecured obligations              | \$ 840           | \$ 846               |
| Obligations secured by real estate | 65               | 65                   |
| Other secured borrowings           | 35               | 41                   |
|                                    | \$ 940           | \$ 952               |

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, 2011.

In May 2011, American Premier paid \$8 million to redeem its outstanding 10-7/8% Subordinated Notes at maturity.

In June 2010, National Interstate borrowed \$30 million under its bank credit facility in connection with the July acquisition of Vanliner. In September 2010, AFG issued \$132 million of 7% Senior Notes due in 2050.

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

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

|  | Pretax<br>Net<br>Unrealized<br>Gains<br>(Losses)<br>on<br>Securities | Foreign<br>Currency<br>Translation<br>Adjustment | Pension<br>and<br>Other<br>Postretirement<br>Plans<br>Adjustment | Tax<br>Effects | Noncon-<br>trolling<br>Interests | Accumulated<br>Other<br>Comprehensive<br>Income<br>(Loss) |
|--|--|--|--|----------------|----------------------------------|---|
| <b>Balance at December 31, 2010</b>                              | \$ 736(a)  | \$ 9   | \$ (13)  | \$ (253)       | \$                               | \$ 479(a)   |
| Unrealized holding gains on securities arising during the period | 179  |  |  | (63)           | (3)                              | 113   |
| Realized gains included in net income                            | (30)   |  |  | 10             | 1                                | (19)  |
| Foreign currency translation gains                               |  | 5  |  |                |                                  | 5   |
| Other  |  |  | 1  |                |                                  | 1   |
| <b>Balance at June 30, 2011</b>                                  | \$ 885(a)  | \$ 14  | \$ (12)  | \$ (306)       | \$ (2)                           | \$ 579(a)   |
| <b>Balance at December 31, 2009</b>                              | \$ 258   | \$ 1   | \$ (13)  | \$ (86)        | \$ 3                             | \$ 163  |
| Unrealized holding gains on securities arising during the period | 405  |  |  | (142)          | (3)                              | 260   |
| Realized gains included in net income                            | (32)   |  |  | 11             | 1                                | (20)  |
| Foreign currency translation losses                              |  | (1)  |  |                |                                  | (1)   |
| Other  | (6)  |  | 1  | 1              |                                  | (4)   |
| <b>Balance at June 30, 2010</b>                                  | \$ 625   | \$   | \$ (12)  | \$ (216)       | \$ 1                             | \$ 398  |

- (a) Includes a net pretax unrealized gain of \$1 million at June 30, 2011 compared to a net pretax unrealized loss of \$17 million at December 31, 2010 (\$11 million net of tax) 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 2011, AFG issued 131,955 shares of restricted Common Stock (fair value of \$34.34 per share) and granted stock options for 1.1 million shares of Common Stock (at an average exercise price of \$34.34) under the Stock Incentive Plan. In addition, AFG issued 188,302 shares of Common Stock (fair value of \$33.99 per share) in the first quarter of 2011 under its Annual Co-CEO Equity Bonus Plan.

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 2011 was \$12.49 per share based on the following assumptions: expected dividend yield 1.9%; expected volatility 38%; expected term 7.3 years; risk-free rate 3.04%.

Total compensation expense related to stock incentive plans of AFG and its subsidiaries was \$5 million in the second quarter and \$10 million during the first six months of both 2011 and 2010.

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

**L. Income Taxes**

Operating earnings before income taxes includes \$20 million and \$13 million in the second quarter of 2011 and 2010, respectively, and \$55 million and \$33 million in the first six months of 2011 and 2010, respectively, in non-deductible losses of managed investment entities attributable to noncontrolling interests, thereby increasing AFG's effective tax rate.

There have been no material changes to AFG's liability for uncertain tax positions, which is discussed in *Note L - Income Taxes*, to AFG's 2010 Form 10-K.

**M. Contingencies**

Except as discussed in *Management's Discussion and Analysis - Special Asbestos and Environmental Reserve Charge*, there have been no significant changes to the matters discussed and referred to in *Note M*

*Contingencies* of AFG's 2010 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.

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

**N. Condensed Consolidating Information**

**N. Condensed Consolidating Information** AFG has guaranteed all of the outstanding debt of Great American Financial Resources, Inc. ( GAFRI ) and GAFRI 's wholly-owned subsidiary, AAG Holding Company, Inc. In addition, GAFRI guarantees AAG Holding 's public debt. The AFG and GAFRI guarantees are full and unconditional and joint and several. Condensed consolidating financial statements for AFG are as follows:

**CONDENSED CONSOLIDATING BALANCE SHEET**

(In millions)

|  | AFG             | GAFRI           | AAG Holding     | All Other Subs   | Consol. Entries   | Consolidated     |
|--|-----------------|-----------------|-----------------|------------------|-------------------|------------------|
| <b>JUNE 30, 2011</b>   |                 |                 |                 |                  |                   |                  |
| <b>Assets:</b>   |                 |                 |                 |                  |                   |                  |
| Cash and investments   | \$ 358          | \$ 37           | \$              | \$ 23,974        | \$ (1)            | \$ 24,368        |
| Recoverables from reinsurers and prepaid reinsurance premiums    |                 |                 |                 | 3,305            |                   | 3,305            |
| Agents' balances and premiums receivable                         |                 |                 |                 | 705              |                   | 705              |
| Deferred policy acquisition costs                                |                 |                 |                 | 1,198            |                   | 1,198            |
| Assets of managed investment entities                            |                 |                 |                 | 2,591            |                   | 2,591            |
| Other assets   | 80              | 8               | 8               | 1,806            | (16)              | 1,886            |
| Investment in subsidiaries and affiliates                        | 4,838           | 2,021           | 2,116           | 656              | (9,631)           |                  |
| <b>Total assets</b>  | <b>\$ 5,276</b> | <b>\$ 2,066</b> | <b>\$ 2,124</b> | <b>\$ 34,235</b> | <b>\$ (9,648)</b> | <b>\$ 34,053</b> |
| <b>Liabilities and Equity:</b>                                   |                 |                 |                 |                  |                   |                  |
| Unpaid losses and loss adjustment expenses and unearned premiums | \$              | \$              | \$              | \$ 7,900         | \$                | \$ 7,900         |
| Annuity, life, accident and health benefits and reserves         |                 |                 |                 | 15,809           | (1)               | 15,808           |
| Liabilities of managed investment entities                       |                 |                 |                 | 2,430            |                   | 2,430            |
| Long-term debt   | 600             |                 | 219             | 121              |                   | 940              |
| Other liabilities  | 204             | 20              | 112             | 2,159            | (145)             | 2,350            |
| <b>Total liabilities</b>   | <b>804</b>      | <b>20</b>       | <b>331</b>      | <b>28,419</b>    | <b>(146)</b>      | <b>29,428</b>    |
| <b>Total shareholders' equity</b>                                | <b>4,472</b>    | <b>2,046</b>    | <b>1,793</b>    | <b>5,663</b>     | <b>(9,502)</b>    | <b>4,472</b>     |
| <b>Noncontrolling interests</b>                                  |                 |                 |                 | <b>153</b>       |                   | <b>153</b>       |
| <b>Total liabilities and equity</b>                              | <b>\$ 5,276</b> | <b>\$ 2,066</b> | <b>\$ 2,124</b> | <b>\$ 34,235</b> | <b>\$ (9,648)</b> | <b>\$ 34,053</b> |

**DECEMBER 31, 2010****Assets:**

|   |                 |                 |                 |                  |                   |                  |
|---|-----------------|-----------------|-----------------|------------------|-------------------|------------------|
| Cash and investments  | \$ 412          | \$ 33           | \$              | \$ 22,228        | \$ (3)            | \$ 22,670        |
| Recoverables from reinsurers and prepaid reinsurance premiums |                 |                 |                 | 3,386            |                   | 3,386            |
| Agents' balances and premiums receivable                      |                 |                 |                 | 535              |                   | 535              |
| Deferred policy acquisition costs                             |                 |                 |                 | 1,244            |                   | 1,244            |
| Assets of managed investment entities                         |                 |                 |                 | 2,537            |                   | 2,537            |
| Other assets  | 36              | 6               | 5               | 2,050            | (15)              | 2,082            |
| Investment in subsidiaries and affiliates                     | 4,816           | 1,899           | 1,996           | 671              | (9,382)           |                  |
| <b>Total assets</b>   | <b>\$ 5,264</b> | <b>\$ 1,938</b> | <b>\$ 2,001</b> | <b>\$ 32,651</b> | <b>\$ (9,400)</b> | <b>\$ 32,454</b> |

**Liabilities and Equity:**

|  |                 |                 |                 |                  |                   |                  |
|--|-----------------|-----------------|-----------------|------------------|-------------------|------------------|
| Unpaid losses and loss adjustment expenses and unearned premiums | \$              | \$              | \$              | \$ 7,947         | \$                | \$ 7,947         |
| Annuity, life, accident and health benefits and reserves         |                 |                 |                 | 14,556           | (1)               | 14,555           |
| Liabilities of managed investment entities                       |                 |                 |                 | 2,323            |                   | 2,323            |
| Long-term debt   | 600             | 1               | 219             | 133              | (1)               | 952              |
| Other liabilities  | 194             | 19              | 110             | 1,888            | (154)             | 2,057            |
| <b>Total liabilities</b>   | <b>794</b>      | <b>20</b>       | <b>329</b>      | <b>26,847</b>    | <b>(156)</b>      | <b>27,834</b>    |
| <b>Total shareholders' equity</b>                                | <b>4,470</b>    | <b>1,918</b>    | <b>1,672</b>    | <b>5,654</b>     | <b>(9,244)</b>    | <b>4,470</b>     |
| <b>Noncontrolling interests</b>                                  |                 |                 |                 | <b>150</b>       |                   | <b>150</b>       |
| <b>Total liabilities and equity</b>                              | <b>\$ 5,264</b> | <b>\$ 1,938</b> | <b>\$ 2,001</b> | <b>\$ 32,651</b> | <b>\$ (9,400)</b> | <b>\$ 32,454</b> |



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**AMERICAN FINANCIAL GROUP, INC. 10-Q**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED**  
**CONDENSED CONSOLIDATING STATEMENT OF EARNINGS**  
(In millions)

|  | AFG   | GAFRI | AAG Holding | All Other Subs | Consol. Entries | Consolidated |
|--|-------|-------|-------------|----------------|-----------------|--------------|
| <b>FOR THE THREE MONTHS ENDED JUNE 30, 2011</b>                    |       |       |             |                |                 |              |
| <b>Revenues:</b>   |       |       |             |                |                 |              |
| Property and casualty insurance premiums                           | \$    | \$    | \$          | \$ 609         | \$              | \$ 609       |
| Life, accident and health premiums                                 |       |       |             | 107            |                 | 107          |
| Realized gains (losses)  |       |       |             | 20             | (1)             | 19           |
| Income (loss) of managed investment entities                       |       |       |             | 4              |                 | 4            |
| Investment and other income  |       | 2     |             | 359            | (7)             | 354          |
| Equity in earnings of subsidiaries                                 | 118   | 40    | 48          |                | (206)           |              |
| Total revenues   | 118   | 42    | 48          | 1,099          | (214)           | 1,093        |
| <b>Costs and Expenses:</b>   |       |       |             |                |                 |              |
| Insurance benefits and expenses                                    |       |       |             | 886            |                 | 886          |
| Interest charges on borrowed money                                 | 16    |       | 7           | 4              | (6)             | 21           |
| Expenses of managed investment entities                            |       |       |             | 18             |                 | 18           |
| Other operating and general expenses                               | 15    | 6     | 1           | 79             | (2)             | 99           |
| Total costs and expenses   | 31    | 6     | 8           | 987            | (8)             | 1,024        |
| Operating earnings before income taxes                             | 87    | 36    | 40          | 112            | (206)           | 69           |
| Provision (credit) for income taxes                                | 32    | 12    | 14          | 46             | (72)            | 32           |
| Net earnings, including noncontrolling interests                   | 55    | 24    | 26          | 66             | (134)           | 37           |
| Less: Net earnings (loss) attributable to noncontrolling interests |       |       |             | (18)           |                 | (18)         |
| <b>Net Earnings Attributable to Shareholders</b>                   | \$ 55 | \$ 24 | \$ 26       | \$ 84          | \$ (134)        | \$ 55        |

|  | AFG | GAFRI | AAG Holding | All Other Subs | Consol. Entries | Consolidated |
|--|-----|-------|-------------|----------------|-----------------|--------------|
|--|-----|-------|-------------|----------------|-----------------|--------------|

**FOR THE THREE MONTHS  
ENDED  
JUNE 30, 2010**

**Revenues:**

|  |     |    |    |  |    |       |       |  |    |       |
|--|-----|----|----|--|----|-------|-------|--|----|-------|
| Property and casualty insurance premiums     | \$  |    | \$ |  | \$ | 572   | \$    |  | \$ | 572   |
| Life, accident and health premiums           |     |    |    |  |    | 113   |       |  |    | 113   |
| Realized gains (losses)                      |     |    |    |  |    | 11    |       |  |    | 11    |
| Income (loss) of managed investment entities |     |    |    |  |    | 8     |       |  |    | 8     |
| Investment and other income                  | (1) | 3  |    |  |    | 352   | (6)   |  |    | 348   |
| Equity in earnings of subsidiaries           | 187 | 41 | 47 |  |    |       | (275) |  |    |       |
| Total revenues                               | 186 | 44 | 47 |  |    | 1,056 | (281) |  |    | 1,052 |

**Costs and Expenses:**

|   |    |   |   |  |  |     |     |  |  |     |
|---|----|---|---|--|--|-----|-----|--|--|-----|
| Insurance benefits and expenses         |    |   |   |  |  | 774 |     |  |  | 774 |
| Interest charges on borrowed money      | 13 |   | 7 |  |  | 4   | (6) |  |  | 18  |
| Expenses of managed investment entities |    |   |   |  |  | 14  |     |  |  | 14  |
| Other operating and general expenses    | 7  | 3 | 1 |  |  | 74  | 3   |  |  | 88  |
| Total costs and expenses                | 20 | 3 | 8 |  |  | 866 | (3) |  |  | 894 |

|  |     |    |    |  |  |     |       |  |  |     |
|--|-----|----|----|--|--|-----|-------|--|--|-----|
| Operating earnings before income taxes | 166 | 41 | 39 |  |  | 190 | (278) |  |  | 158 |
| Provision (credit) for income taxes    | 58  | 15 | 14 |  |  | 67  | (96)  |  |  | 58  |

|  |     |    |    |  |  |     |       |  |  |     |
|--|-----|----|----|--|--|-----|-------|--|--|-----|
| Net earnings, including noncontrolling interests                   | 108 | 26 | 25 |  |  | 123 | (182) |  |  | 100 |
| Less: Net earnings (loss) attributable to noncontrolling interests |     |    |    |  |  | (8) |       |  |  | (8) |

**Net Earnings Attributable to  
Shareholders**

|    |     |    |    |    |    |    |     |    |       |    |     |
|----|-----|----|----|----|----|----|-----|----|-------|----|-----|
| \$ | 108 | \$ | 26 | \$ | 25 | \$ | 131 | \$ | (182) | \$ | 108 |
|----|-----|----|----|----|----|----|-----|----|-------|----|-----|

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**AMERICAN FINANCIAL GROUP, INC. 10-Q**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED**  
**CONDENSED CONSOLIDATING STATEMENT OF EARNINGS**  
(In millions)

|  | AFG    | GAFRI | AAG Holding | All Other Subs | Consol. Entries | Consolidated |
|--|--------|-------|-------------|----------------|-----------------|--------------|
| <b>FOR THE SIX MONTHS ENDED JUNE 30, 2011</b>                      |        |       |             |                |                 |              |
| <b>Revenues:</b>   |        |       |             |                |                 |              |
| Property and casualty insurance premiums                           | \$     | \$    | \$          | \$ 1,208       | \$              | \$ 1,208     |
| Life, accident and health premiums                                 |        |       |             | 217            |                 | 217          |
| Realized gains (losses)  |        |       |             | 17             | (1)             | 16           |
| Income (loss) of managed investment entities                       |        |       |             | (4)            |                 | (4)          |
| Investment and other income  | 2      | 5     |             | 702            | (14)            | 695          |
| Equity in earnings of subsidiaries                                 | 278    | 89    | 105         |                | (472)           |              |
| Total revenues   | 280    | 94    | 105         | 2,140          | (487)           | 2,132        |
| <b>Costs and Expenses:</b>   |        |       |             |                |                 |              |
| Insurance benefits and expenses                                    |        |       |             | 1,704          |                 | 1,704        |
| Interest charges on borrowed money                                 | 32     |       | 13          | 8              | (11)            | 42           |
| Expenses of managed investment entities                            |        |       |             | 36             |                 | 36           |
| Other operating and general expenses                               | 32     | 9     | 2           | 146            | (3)             | 186          |
| Total costs and expenses   | 64     | 9     | 15          | 1,894          | (14)            | 1,968        |
| Operating earnings before income taxes                             | 216    | 85    | 90          | 246            | (473)           | 164          |
| Provision (credit) for income taxes                                | 78     | 30    | 32          | 104            | (166)           | 78           |
| Net earnings, including noncontrolling interests                   | 138    | 55    | 58          | 142            | (307)           | 86           |
| Less: Net earnings (loss) attributable to noncontrolling interests |        |       |             | (52)           |                 | (52)         |
| <b>Net Earnings Attributable to Shareholders</b>                   | \$ 138 | \$ 55 | \$ 58       | \$ 194         | \$ (307)        | \$ 138       |

|  | AFG | GAFRI | AAG Holding | All Other Subs | Consol. Entries | Consolidated |
|--|-----|-------|-------------|----------------|-----------------|--------------|
|--|-----|-------|-------------|----------------|-----------------|--------------|

**FOR THE SIX MONTHS ENDED  
JUNE 30, 2010**
**Revenues:**

|  |     |    |    |    |       |       |    |       |
|--|-----|----|----|----|-------|-------|----|-------|
| Property and casualty insurance premiums     | \$  | \$ | \$ | \$ | 1,151 | \$    | \$ | 1,151 |
| Life, accident and health premiums           |     |    |    |    | 228   |       |    | 228   |
| Realized gains (losses)                      |     |    |    |    | 15    |       |    | 15    |
| Income (loss) of managed investment entities |     |    |    |    | 5     |       |    | 5     |
| Investment and other income                  |     | 5  |    |    | 693   | (11)  |    | 687   |
| Equity in earnings of subsidiaries           | 379 | 81 | 96 |    |       | (556) |    |       |
| Total revenues                               | 379 | 86 | 96 |    | 2,092 | (567) |    | 2,086 |

**Costs and Expenses:**

|  |     |    |    |  |       |       |  |       |
|--|-----|----|----|--|-------|-------|--|-------|
| Insurance benefits and expenses                                    |     |    |    |  | 1,535 |       |  | 1,535 |
| Interest charges on borrowed money                                 | 27  |    | 13 |  | 7     | (11)  |  | 36    |
| Expenses of managed investment entities                            |     |    |    |  | 23    |       |  | 23    |
| Other operating and general expenses                               | 21  | 7  | 3  |  | 156   |       |  | 187   |
| Total costs and expenses   | 48  | 7  | 16 |  | 1,721 | (11)  |  | 1,781 |
| Operating earnings before income taxes                             | 331 | 79 | 80 |  | 371   | (556) |  | 305   |
| Provision (credit) for income taxes                                | 117 | 28 | 28 |  | 139   | (195) |  | 117   |
| Net earnings, including noncontrolling interests                   | 214 | 51 | 52 |  | 232   | (361) |  | 188   |
| Less: Net earnings (loss) attributable to noncontrolling interests |     |    |    |  | (26)  |       |  | (26)  |

**Net Earnings Attributable to  
Shareholders**

|    |     |    |    |    |    |    |     |    |       |    |     |
|----|-----|----|----|----|----|----|-----|----|-------|----|-----|
| \$ | 214 | \$ | 51 | \$ | 52 | \$ | 258 | \$ | (361) | \$ | 214 |
|----|-----|----|----|----|----|----|-----|----|-------|----|-----|

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**AMERICAN FINANCIAL GROUP, INC. 10-Q**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED**  
**CONDENSED CONSOLIDATING STATEMENT OF CASH FLOWS**  
(In millions)

|   | AFG    | GAFRI | AAG<br>Holding | All Other<br>Subs | Consol.<br>Entries | Consolidated |
|---|--------|-------|----------------|-------------------|--------------------|--------------|
| <b>FOR THE SIX MONTHS<br/>ENDED<br/>JUNE 30, 2011</b>           |        |       |                |                   |                    |              |
| <b>Operating Activities:</b>                                    |        |       |                |                   |                    |              |
| Net earnings, including noncontrolling interests                | \$ 138 | \$ 55 | \$ 58          | \$ 142            | \$ (307)           | \$ 86        |
| Adjustments:  |        |       |                |                   |                    |              |
| Equity in net earnings of subsidiaries                          | (181)  | (58)  | (68)           |                   | 307                |              |
| Dividends from subsidiaries                                     | 190    |       |                |                   | (190)              |              |
| Other operating activities, net                                 | (18)   | (1)   | 1              | 466               |                    | 448          |
| Net cash provided by (used in) operating activities             | 129    | (4)   | (9)            | 608               | (190)              | 534          |
| <b>Investing Activities:</b>                                    |        |       |                |                   |                    |              |
| Purchases of investments, property and equipment                | (25)   |       |                | (2,529)           |                    | (2,554)      |
| Returns of capital from (capital contributions to) subsidiaries | 29     | (10)  | (1)            |                   | (18)               |              |
| Proceeds from maturities and redemptions of investments         | 2      | 8     |                | 1,320             |                    | 1,330        |
| Proceeds from sales of investments, property and equipment      | 5      |       |                | 411               |                    | 416          |
| Managed investment entities:                                    |        |       |                |                   |                    |              |
| Purchases of investments  |        |       |                | (681)             |                    | (681)        |
| Proceeds from sales and redemptions of investments              |        |       |                | 754               |                    | 754          |
| Other investing activities, net                                 |        |       |                | (6)               |                    | (6)          |
| Net cash provided by (used in) investing activities             | 11     | (2)   | (1)            | (731)             | (18)               | (741)        |
| <b>Financing Activities:</b>                                    |        |       |                |                   |                    |              |
| Annuity receipts  |        |       |                | 1,578             |                    | 1,578        |
| Annuity surrenders, benefits and withdrawals                    |        |       |                | (636)             |                    | (636)        |
|   |        |       |                | 2                 |                    | 2            |

|   |        |       |    |          |     |          |
|---|--------|-------|----|----------|-----|----------|
| Additional long-term borrowings                           |        |       |    |          |     |          |
| Reductions of long-term debt                              |        |       |    | (14)     |     | (14)     |
| Managed investment entities retirement of liabilities     |        |       |    | (8)      |     | (8)      |
| Issuances of Common Stock                                 | 16     |       |    |          |     | 16       |
| Capital contributions from (returns of capital to) parent |        | 8     | 10 | (36)     | 18  |          |
| Repurchases of Common Stock                               | (178)  |       |    |          |     | (178)    |
| Cash dividends paid                                       | (34)   |       |    | (190)    | 190 | (34)     |
| Other financing activities, net                           |        |       |    | 11       |     | 11       |
| Net cash provided by (used in) financing activities       | (196)  | 8     | 10 | 707      | 208 | 737      |
| <b>Net change in cash and cash equivalents</b>            | (56)   | 2     |    | 584      |     | 530      |
| Cash and cash equivalents at beginning of period          | 370    | 20    |    | 709      |     | 1,099    |
| Cash and cash equivalents at end of period                | \$ 314 | \$ 22 | \$ | \$ 1,293 | \$  | \$ 1,629 |

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**AMERICAN FINANCIAL GROUP, INC. 10-Q**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED**  
**CONDENSED CONSOLIDATING STATEMENT OF CASH FLOWS**  
(In millions)

|  | AFG    | GAFRI | AAG<br>Holding | All Other<br>Subs | Consol.<br>Entries | Consolidated |
|--|--------|-------|----------------|-------------------|--------------------|--------------|
| <b>FOR THE SIX MONTHS<br/>ENDED<br/>JUNE 30, 2010</b>              |        |       |                |                   |                    |              |
| <b>Operating Activities:</b>                                       |        |       |                |                   |                    |              |
| Net earnings, including<br>noncontrolling interests                | \$ 214 | \$ 51 | \$ 52          | \$ 232            | \$ (361)           | \$ 188       |
| Adjustments:   |        |       |                |                   |                    |              |
| Equity in net earnings of<br>subsidiaries                          | (246)  | (53)  | (63)           |                   | 362                |              |
| Dividends from subsidiaries  | 204    |       | 16             |                   | (220)              |              |
| Other operating activities, net                                    | (61)   | (2)   | 3              | 334               | (1)                | 273          |
| Net cash provided by (used in)<br>operating activities             | 111    | (4)   | 8              | 566               | (220)              | 461          |
| <b>Investing Activities:</b>                                       |        |       |                |                   |                    |              |
| Purchases of investments,<br>property and equipment                | (3)    |       |                | (2,565)           |                    | (2,568)      |
| Returns of capital from (capital<br>contributions to) subsidiaries | (8)    | 8     |                |                   |                    |              |
| Proceeds from maturities and<br>redemptions of investments         |        | 4     |                | 993               |                    | 997          |
| Proceeds from sales of<br>investments, property and<br>equipment   |        |       |                | 941               |                    | 941          |
| Managed investment entities:<br>Purchases of investments           |        |       |                | (394)             |                    | (394)        |
| Proceeds from sales and<br>redemptions of investments              |        |       |                | 441               |                    | 441          |
| Other investing activities, net                                    |        |       |                | (124)             |                    | (124)        |
| Net cash provided by (used in)<br>investing activities             | (11)   | 12    |                | (708)             |                    | (707)        |
| <b>Financing Activities:</b>                                       |        |       |                |                   |                    |              |
| Annuity receipts   |        |       |                | 945               |                    | 945          |
| Annuity surrenders, benefits<br>and withdrawals                    |        |       |                | (617)             |                    | (617)        |
|  |        |       |                | 30                |                    | 30           |

|   |             |           |     |             |     |              |
|---|-------------|-----------|-----|-------------|-----|--------------|
| Additional long-term borrowings                           |             |           |     |             |     |              |
| Reductions of long-term debt                              |             |           |     | (6)         |     | (6)          |
| Managed investment entities retirement of liabilities     |             |           |     | (39)        |     | (39)         |
| Issuances of Common Stock                                 | 11          |           |     |             |     | 11           |
| Capital contributions from (returns of capital to) parent |             | 8         | (8) |             |     |              |
| Repurchases of Common Stock                               | (151)       |           |     |             |     | (151)        |
| Cash dividends paid                                       | (31)        |           |     | (220)       | 220 | (31)         |
| Other financing activities, net                           | (2)         |           |     | (3)         |     | (5)          |
| Net cash provided by (used in) financing activities       | (173)       | 8         | (8) | 90          | 220 | 137          |
| <b>Net change in cash and cash equivalents</b>            | <b>(73)</b> | <b>16</b> |     | <b>(52)</b> |     | <b>(109)</b> |
| Cash and cash equivalents at beginning of period          | 197         | 12        |     | 911         |     | 1,120        |
| Cash and cash equivalents at end of period                | \$ 124      | \$ 28     | \$  | \$ 859      | \$  | \$ 1,011     |



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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, may, should, will or the negative version of these 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 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;

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 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.

Net earnings attributable to AFG's shareholders for the second quarter and first six months of 2011 were \$55 million (\$.52 per share, diluted) and \$138 million (\$1.31 per share diluted), respectively, compared to \$108 million (\$.97 per share, diluted) and \$214 million (\$1.90 per share, diluted) reported in the same periods of 2010. Improved operating results in the annuity and supplemental insurance group were more than offset by a second quarter 2011 special charge to strengthen reserves for asbestos and other environmental exposures, primarily within the property and casualty run-off operations, and lower underwriting profit and investment income in the on-going property and casualty insurance 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,

the recoverability of reinsurance,

the recoverability of deferred acquisition costs,

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

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 2010 Form 10-K.



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**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,<br>2011 | December 31,<br>2010 | December 31,<br>2009 |
|---------------------------------------|------------------|----------------------|----------------------|
| Long-term debt                        | \$ 940           | \$ 952               | \$ 828               |
| Total capital                         | 5,002            | 5,050                | 4,698                |
| Ratio of debt to total capital:       |                  |                      |                      |
| Including debt secured by real estate | 18.8%            | 18.9%                | 17.6%                |
| Excluding debt secured by real estate | 17.7%            | 17.8%                | 16.4%                |

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 1.76 for the six months ended June 30, 2011 and 2.41 for the entire year of 2010. Excluding annuity benefits, this ratio was 5.42 and 9.09, 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 2011. In September 2010, AFG issued \$132 million of 7% Senior Notes due 2050.

During the first six months of 2011, AFG repurchased 5.2 million shares of its Common Stock for \$178 million. In addition, in July 2011, AFG repurchased 534,800 shares of its Common Stock for \$18 million. During 2010, AFG repurchased 10.3 million shares of its Common Stock for \$292 million.

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.

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**AMERICAN FINANCIAL GROUP, INC. 10-Q  
Management's Discussion and Analysis  
of Financial Condition and Results of Operations Continued**

**Subsidiary Liquidity** Great American Life Insurance Company ( GALIC ), a wholly-owned annuity and supplemental insurance subsidiary, became a member of the Federal Home Loan Bank of Cincinnati ( FHLB ) in 2009. The FHLB makes loans and provides other banking services to member institutions. Members are required to purchase stock in the FHLB in addition to maintaining collateral deposits that back any funds borrowed. GALIC's \$17 million investment in FHLB capital stock at June 30, 2011 is included in other investments at cost. Membership in the FHLB provides the annuity and supplemental insurance operations with a substantial additional source of liquidity. No funds have been borrowed from the FHLB.

National Interstate, 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, 2011.

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. With declining rates, AFG receives some protection (from spread compression) due to the ability to lower crediting rates, subject to guaranteed minimums. 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.

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, 2011, contained \$20.5 billion in Fixed maturities classified as available for sale and \$779 million 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, \$395 million in fixed maturities were classified as trading with changes in unrealized holding gains or losses included in investment income.

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**AMERICAN FINANCIAL GROUP, INC. 10-Q**  
**Management's Discussion and Analysis**  
**of Financial Condition and Results of Operations**    **Continued**

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 93% are priced using pricing services and the balance is priced internally or 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. 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).

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, 2011 (dollars in millions). Increases or decreases from the 100 basis points illustrated would be approximately proportional.

|   |           |
|---|-----------|
| Fair value of fixed maturity portfolio                            | \$ 20,895 |
| Pretax impact on fair value of 100 bps increase in interest rates | \$ (919)  |
| Pretax impact as % of total fixed maturity portfolio              | (4.4%)    |

Approximately 91% of the fixed maturities held by AFG at June 30, 2011, 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.

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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.

Summarized information for AFG's MBS (including those classified as trading) at June 30, 2011, 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 the residential and commercial MBS is approximately 4 and 5 years, respectively.

|                  | Amortized |            | Fair Value |        | Unrealized | % Rated |
|------------------|-----------|------------|------------|--------|------------|---------|
| Collateral type  | Cost      | Fair Value | % of Cost  | Gain   | Investment |         |
| Residential:     |           |            |            | (Loss) | Grade      |         |
| Agency-backed    | \$ 405    | \$ 421     | 104%       | \$ 16  | 100%       |         |
| Non-agency prime | 2,066     | 2,167      | 105        | 101    | 75         |         |
| Alt-A            | 728       | 718        | 99         | (10)   | 52         |         |
| Subprime         | 549       | 546        | 99         | (3)    | 32         |         |
| Commercial       | 2,221     | 2,409      | 108        | 188    | 100        |         |
| Other            | 24        | 27         | 113        | 3      | 48         |         |
|                  | \$ 5,993  | \$ 6,288   | 105%       | \$ 295 | 80%        |         |

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, 2011, 98% (based on statutory carrying value of \$5.9 billion) of AFG's MBS securities had an NAIC designation of 1 or 2.

Municipal bonds represented approximately 17% of AFG's fixed maturity portfolio at June 30, 2011. 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, 2011, approximately 75% of the municipal bond portfolio was held in revenue bonds, with the remaining 25% 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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**AMERICAN FINANCIAL GROUP, INC. 10-Q**  
**Management's Discussion and Analysis**  
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Summarized information for the unrealized gains and losses recorded in AFG's Balance Sheet at June 30, 2011, is shown in the following table (dollars in millions). Approximately \$274 million of available for sale Fixed maturities and \$34 million of Equity securities had no unrealized gains or losses at June 30, 2011.

|   | Securities<br>With<br>Unrealized<br>Gains | Securities<br>With<br>Unrealized<br>Losses |
|---|---|--|
| Available for Sale Fixed Maturities   |   |  |
| Fair value of securities  | \$ 17,086                                 | \$ 3,140                                   |
| Amortized cost of securities  | \$ 15,842                                 | \$ 3,301                                   |
| Gross unrealized gain (loss)  | \$ 1,244                                  | \$ (161)                                   |
| Fair value as % of amortized cost   | 108%                                      | 95%  |
| Number of security positions  | 3,550                                     | 893  |
| Number individually exceeding \$2 million gain or loss                            | 106                                       | 2  |
| Concentration of gains (losses) by type or industry (exceeding 5% of unrealized): |   |  |
| Mortgage-backed securities  | \$ 414                                    | \$ (119)                                   |
| States and municipalities   | 112                                       | (15)                                       |
| Banks, savings and credit institutions  | 104                                       | (7)  |
| Gas and electric services   | 133                                       | (2)  |
| Percentage rated investment grade   | 94%                                       | 79%  |
| Equity Securities   |   |  |
| Fair value of securities  | \$ 652                                    | \$ 93                                      |
| Cost of securities  | \$ 413                                    | \$ 102                                     |
| Gross unrealized gain (loss)  | \$ 239(*)                                 | \$ (9)                                     |
| Fair value as % of cost   | 158%                                      | 91%  |
| Number of security positions  | 120                                       | 32   |
| Number individually exceeding \$2 million gain or loss                            | 12  |  |

(\*) Includes \$138 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, 2011, 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<br>With<br>Unrealized<br>Gains | Securities<br>With<br>Unrealized<br>Losses |
|------------------------------------|---|--|
| Maturity                           |   |  |
| One year or less                   | 3%  | 1%   |
| After one year through five years  | 30  | 11   |
| After five years through ten years | 31  | 29   |
| After ten years                    | 8   | 21   |
|                                    | 72  | 62   |

|   |      |      |
|---|------|------|
| Mortgage-backed securities (average life of approximately four years) | 28   | 38   |
|   | 100% | 100% |

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**AMERICAN FINANCIAL GROUP, INC. 10-Q**  
**Management's Discussion and Analysis**  
**of Financial Condition and Results of Operations** **Continued**

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

|   | Aggregate<br>Fair<br>Value | Aggregate<br>Unrealized<br>Gain (Loss) | Fair<br>Value as<br>% of Cost<br>Basis |
|---|----------------------------|--|--|
| Fixed Maturities at June 30, 2011         |                            |  |  |
| <b>Securities with unrealized gains:</b>  |                            |  |  |
| Exceeding \$500,000 (719 issues)          | \$ 8,934                   | \$ 903                                 | 111%                                   |
| \$500,000 or less (2,831 issues)          | 8,152                      | 341                                    | 104                                    |
|   | \$ 17,086                  | \$ 1,244                               | 108%                                   |
| <b>Securities with unrealized losses:</b> |                            |  |  |
| Exceeding \$500,000 (84 issues)           | \$ 451                     | \$ (79)                                | 85%                                    |
| \$500,000 or less (809 issues)            | 2,689                      | (82)                                   | 97                                     |
|   | \$ 3,140                   | \$ (161)                               | 95%                                    |

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<br>Fair<br>Value | Aggregate<br>Unrealized<br>Loss | Fair<br>Value as<br>% of Cost<br>Basis |
|---|----------------------------|---------------------------------|--|
| Securities with Unrealized<br>Losses at June 30, 2011         |                            |                                 |  |
| <b>Investment grade fixed maturities with losses for:</b>     |                            |                                 |  |
| Less than one year (469 issues)                               | \$ 2,134                   | \$ (41)                         | 98%                                    |
| One year or longer (143 issues)                               | 346                        | (38)                            | 90                                     |
|   | \$ 2,480                   | \$ (79)                         | 97%                                    |
| <b>Non-investment grade fixed maturities with losses for:</b> |                            |                                 |  |
| Less than one year (128 issues)                               | \$ 368                     | \$ (12)                         | 97%                                    |
| One year or longer (153 issues)                               | 292                        | (70)                            | 81                                     |
|   | \$ 660                     | \$ (82)                         | 89%                                    |
| <b>Common equity securities with losses for:</b>              |                            |                                 |  |
| Less than one year (17 issues)                                | \$ 47                      | \$ (5)                          | 90%                                    |
| One year or longer (4 issues)                                 |                            |                                 |  |

|    |    |    |     |     |
|----|----|----|-----|-----|
| \$ | 47 | \$ | (5) | 90% |
|----|----|----|-----|-----|

**Perpetual preferred equity securities with losses for:**

|                              |    |   |    |  |      |
|------------------------------|----|---|----|--|------|
| Less than one year (1 issue) | \$ | 5 | \$ |  | 100% |
|------------------------------|----|---|----|--|------|

|                                |  |    |     |  |    |
|--------------------------------|--|----|-----|--|----|
| One year or longer (10 issues) |  | 41 | (4) |  | 91 |
|--------------------------------|--|----|-----|--|----|

|    |    |    |     |     |
|----|----|----|-----|-----|
| \$ | 46 | \$ | (4) | 92% |
|----|----|----|-----|-----|

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**Management's Discussion and Analysis**

**of Financial Condition and Results of Operations Continued**

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 2010 Form 10-K under *Management's Discussion and Analysis - Investments*.

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, at June 30, 2011, had no intent to sell them. 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 its insurance reserves and contingencies arising out of its former railroad and manufacturing operations. AFG has conducted 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. The outcome of the 2011 study with the assistance of outside firms is included in AFG's second quarter results. See *Results of Operations - Special Asbestos and Environmental Reserve Charge* below and *Management's Discussion and Analysis - Uncertainties* in AFG's 2010 Form 10-K.

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**MANAGED INVESTMENT ENTITIES**

Accounting standards require AFG to consolidate its investments in six 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<br>Consolidation | Managed<br>Investment<br>Entities | Consol.<br>Entries | Consolidated<br>As Reported |
|---|-----------------------------|-----------------------------------|--------------------|-----------------------------|
| June 30, 2011   |                             |                                   |                    |                             |
| Assets:   |                             |                                   |                    |                             |
| Cash and other investments                                    | \$ 24,387                   | \$                                | \$ (19)(a)         | \$ 24,368                   |
| Assets of managed investment entities                         |                             | 2,591                             |                    | 2,591                       |
| Other assets  | 7,094                       |                                   |                    | 7,094                       |
| Total assets  | \$ 31,481                   | \$ 2,591                          | \$ (19)            | \$ 34,053                   |
| Liabilities:  |                             |                                   |                    |                             |
| Unpaid losses, loss adjustment expenses and unearned premiums | \$ 7,900                    | \$                                | \$                 | \$ 7,900                    |
| Annuity, life, accident and health benefits and reserves      | 15,808                      |                                   |                    | 15,808                      |
| Liabilities of managed investment entities                    |                             | 2,449                             | (19)(a)            | 2,430                       |
| Long-term debt and other liabilities                          | 3,290                       |                                   |                    | 3,290                       |
| Total liabilities   | 26,998                      | 2,449                             | (19)               | 29,428                      |
| Shareholders' Equity:   |                             |                                   |                    |                             |
| Common Stock and Capital surplus                              | 1,239                       |                                   |                    | 1,239                       |
| Retained earnings:  |                             |                                   |                    |                             |
| Appropriated managed investment entities                      |                             | 142                               |                    | 142                         |
| Unappropriated  | 2,512                       |                                   |                    | 2,512                       |
| Accumulated other comprehensive income                        | 579                         |                                   |                    | 579                         |
| Total shareholders' equity                                    | 4,330                       | 142                               |                    | 4,472                       |
| Noncontrolling interests                                      | 153                         |                                   |                    | 153                         |
| Total equity  | 4,483                       | 142                               |                    | 4,625                       |
| Total liabilities and equity                                  | \$ 31,481                   | \$ 2,591                          | \$ (19)            | \$ 34,053                   |

December 31, 2010

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Assets:

|                                       |    |        |    |       |    |         |    |        |
|---------------------------------------|----|--------|----|-------|----|---------|----|--------|
| Cash and other investments            | \$ | 22,687 | \$ |       | \$ | (17)(a) | \$ | 22,670 |
| Assets of managed investment entities |    |        |    | 2,537 |    |         |    | 2,537  |
| Other assets                          |    | 7,247  |    |       |    |         |    | 7,247  |
| Total assets                          | \$ | 29,934 | \$ | 2,537 | \$ | (17)    | \$ | 32,454 |

Liabilities:

|   |    |        |    |       |    |         |    |        |
|---|----|--------|----|-------|----|---------|----|--------|
| Unpaid losses, loss adjustment expenses and unearned premiums | \$ | 7,947  | \$ |       | \$ |         | \$ | 7,947  |
| Annuity, life, accident and health benefits and reserves      |    | 14,555 |    |       |    |         |    | 14,555 |
| Liabilities of managed investment entities                    |    |        |    | 2,340 |    | (17)(a) |    | 2,323  |
| Long-term debt and other liabilities                          |    | 3,009  |    |       |    |         |    | 3,009  |
| Total liabilities   |    | 25,511 |    | 2,340 |    | (17)    |    | 27,834 |

Shareholders' equity:

|  |    |        |    |       |    |      |    |        |
|--|----|--------|----|-------|----|------|----|--------|
| Common Stock and Capital surplus           |    | 1,271  |    |       |    |      |    | 1,271  |
| Retained earnings:                         |    |        |    |       |    |      |    |        |
| Appropriated - managed investment entities |    |        |    | 197   |    |      |    | 197    |
| Unappropriated                             |    | 2,523  |    |       |    |      |    | 2,523  |
| Accumulated other comprehensive income     |    | 479    |    |       |    |      |    | 479    |
| Total shareholders' equity                 |    | 4,273  |    | 197   |    |      |    | 4,470  |
| Noncontrolling interests                   |    | 150    |    |       |    |      |    | 150    |
| Total equity                               |    | 4,423  |    | 197   |    |      |    | 4,620  |
| Total liabilities and equity               | \$ | 29,934 | \$ | 2,537 | \$ | (17) | \$ | 32,454 |

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

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**CONDENSED CONSOLIDATING STATEMENT OF EARNINGS**

|  | Before CLO       | Managed    | Consol.    | Consolidated |
|--|------------------|------------|------------|--------------|
|  | Consolidation(a) | Investment | Entries    | As           |
|  |                  | Entities   |            | Reported     |
| Six months ended June 30, 2011                                     |                  |            |            |              |
| Revenues:  |                  |            |            |              |
| Insurance premiums   | \$ 1,425         | \$         | \$         | \$ 1,425     |
| Investment income  | 606              |            |            | 606          |
| Realized gains (losses) on securities                              | 26               |            | (7)(b)     | 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        |
| Costs and Expenses:  |                  |            |            |              |
| Insurance benefits and expenses                                    | 1,704            |            |            | 1,704        |
| Expenses of managed investment entities                            |                  | 49         | (13)(b)(c) | 36           |
| Interest on borrowed money and other expenses                      | 228              |            |            | 228          |
| Total costs and expenses   | 1,932            | 49         | (13)       | 1,968        |
| Operating earnings before income taxes                             | 219              | (55)       |            | 164          |
| Provision for income taxes   | 78               |            |            | 78           |
| Net earnings, including noncontrolling interests                   | 141              | (55)       |            | 86           |
| Less: Net earnings (loss) attributable to noncontrolling interests | 3                |            | (55)(d)    | (52)         |
| Net Earnings Attributable to Shareholders                          | \$ 138           | \$ (55)    | \$ 55      | \$ 138       |
| Six months ended June 30, 2010                                     |                  |            |            |              |
| Revenues:  |                  |            |            |              |
| Insurance premiums   | \$ 1,379         | \$         | \$         | \$ 1,379     |
| Investment income  | 589              |            |            | 589          |
| Realized gains (losses) on securities                              | 22               |            | (7)(b)     | 15           |
| Income (loss) of managed investment entities:                      |                  |            |            |              |



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|  |        |         |            |        |
|--|--------|---------|------------|--------|
| Investment income  |        | 45      |            | 45     |
| Loss on change in fair value of assets/liabilities                 |        | (45)    | 5(b)       | (40)   |
| Other income   | 106    |         | (8)(c)     | 98     |
| Total revenues   | 2,096  |         | (10)       | 2,086  |
| Costs and Expenses:  |        |         |            |        |
| Insurance benefits and expenses                                    | 1,535  |         |            | 1,535  |
| Expenses of managed investment entities                            |        | 33      | (10)(b)(c) | 23     |
| Interest on borrowed money and other expenses                      | 223    |         |            | 223    |
| Total costs and expenses   | 1,758  | 33      | (10)       | 1,781  |
| Operating earnings before income taxes                             | 338    | (33)    |            | 305    |
| Provision for income taxes   | 117    |         |            | 117    |
| Net earnings, including noncontrolling interests                   | 221    | (33)    |            | 188    |
| Less: Net earnings (loss) attributable to noncontrolling interests | 7      |         | (33)(d)    | (26)   |
| Net Earnings Attributable to Shareholders                          | \$ 214 | \$ (33) | \$ 33      | \$ 214 |

- (a) Includes \$7 million for each of the first six months of both 2011 and 2010 in realized gains 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 \$5 million and \$2 million for the first six months of 2011 and 2010, 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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**RESULTS OF OPERATIONS**

**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<br>June 30, |               | Six months ended<br>June 30, |                |
|--|--------------------------------|---------------|------------------------------|----------------|
|  | 2011                           | 2010          | 2011                         | 2010           |
| Core net operating earnings                          | \$ 81                          | \$ 102        | \$ 167                       | \$ 205         |
| Special asbestos and environmental ( A&E ) charge(*) | (38)                           |               | (38)                         |                |
| Realized gains (*)                                   | 12                             | 6             | 9                            | 9              |
| <b>Net earnings attributable to shareholders</b>     | <b>\$ 55</b>                   | <b>\$ 108</b> | <b>\$ 138</b>                | <b>\$ 214</b>  |
| Diluted per share amounts:                           |                                |               |                              |                |
| Core net operating earnings                          | \$ .78                         | \$ .91        | \$ 1.59                      | \$ 1.82        |
| Special asbestos and environmental charge            | (.37)                          |               | (.37)                        |                |
| Realized gains                                       | .11                            | .06           | .09                          | .08            |
| <b>Net earnings attributable to shareholders</b>     | <b>\$ .52</b>                  | <b>\$ .97</b> | <b>\$ 1.31</b>               | <b>\$ 1.90</b> |

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

|                    |       |     |       |     |
|--------------------|-------|-----|-------|-----|
| Special A&E charge | \$ 21 | \$  | \$ 21 | \$  |
| Realized gains     | (7)   | (4) | (7)   | (5) |

In addition, realized gains(losses) are shown net of noncontrolling interests of \$1 million for both the second quarter and first six months of 2010.

Net earnings attributable to shareholders and core net operating earnings decreased in the second quarter and first six months of 2011 compared to the same periods in 2010 as improved results in the annuity and supplemental insurance operations were more than offset by a decline in Specialty property and casualty underwriting results and lower property and casualty investment income. Net earnings attributable to shareholders in 2011 was also impacted by the second quarter special A&E charge.

**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.

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 the 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<br>June 30, |        | Six months ended<br>June 30, |          |
|---|--------------------------------|--------|------------------------------|----------|
|   | 2011                           | 2010   | 2011                         | 2010     |
| Gross Written Premiums                                  |                                |        |                              |          |
| Property and transportation                             | \$ 496                         | \$ 364 | \$ 814                       | \$ 641   |
| Specialty casualty                                      | 323                            | 316    | 642                          | 663      |
| Specialty financial                                     | 129                            | 128    | 245                          | 250      |
| Other   | 1                              | 3      | 1                            | 1        |
|   | \$ 949                         | \$ 811 | \$ 1,702                     | \$ 1,555 |
| Net Written Premiums                                    |                                |        |                              |          |
| Property and transportation                             | \$ 346                         | \$ 246 | \$ 600                       | \$ 462   |
| Specialty casualty                                      | 211                            | 211    | 425                          | 449      |
| Specialty financial                                     | 96                             | 104    | 194                          | 202      |
| Other   | 16                             | 14     | 34                           | 28       |
|   | \$ 669                         | \$ 575 | \$ 1,253                     | \$ 1,141 |
| Combined Ratios   |                                |        |                              |          |
| Property and transportation                             | 99.8%                          | 96.0%  | 93.6%                        | 90.5%    |
| Specialty casualty                                      | 90.2                           | 89.5   | 94.7                         | 90.5     |
| Specialty financial                                     | 86.6                           | 74.0   | 89.1                         | 78.8     |
| Total Specialty   | 93.6                           | 88.1   | 93.0                         | 87.5     |
| Aggregate (including discontinued lines)                | 101.8%                         | 89.1%  | 97.1%                        | 88.4%    |
| Favorable (Unfavorable) Prior Year<br>Development       |                                |        |                              |          |
| Property and transportation                             | \$ 4                           | \$ 15  | \$ 26                        | \$ 24    |
| Specialty casualty                                      | 27                             | 31     | 27                           | 50       |
| Specialty financial                                     | 4                              | 13     |                              | 23       |
| Other specialty   | 2                              | 3      | 5                            | 10       |
|   | 37                             | 62     | 58                           | 107      |
| Other (primarily asbestos and environmental<br>charges) | (50)                           | (5)    | (50)                         | (11)     |
|   | \$ (13)                        | \$ 57  | \$ 8                         | \$ 96    |

The overall increases in gross and net written premiums in the second quarter and first six months of 2011 compared to the 2010 periods resulted from increased premiums in the property and transportation segment,

reflecting the impact of higher spring commodity prices on the crop business and National Interstate's third quarter 2010 acquisition of Vanliner. Overall average renewal rates for the second quarter and first six months of 2011 were flat when compared to the same 2010 periods.

The Specialty insurance operations generated an underwriting profit of \$39 million in the 2011 second quarter compared to \$68 million in the second quarter of 2010. The reduced profit in 2011 is primarily the result of a \$25 million decrease in favorable reserve development, which was partially offset by lower catastrophe losses. Catastrophe losses were \$23 million compared to \$34 million in the 2010 second quarter. Underwriting profit for the Specialty insurance operations for the first six months of 2011 was \$85 million compared to \$145 million in the comparable 2010 period. This difference was primarily the result of lower favorable reserve development.

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***Property and transportation*** gross and net written premiums for the second quarter and first six months of 2011 were higher than the 2010 periods as a result of additional premiums from the Vanliner acquisition as well as the impact of higher spring commodity prices on crop premiums. This group reported a small underwriting profit in the second quarter of 2011 compared to an underwriting profit of \$8 million in the second quarter of 2010. This decrease is attributable to lower favorable reserve development, particularly in the inland marine and crop insurance operations, and slightly lower earnings in the agricultural businesses, which was partially offset by lower catastrophe losses. The \$18 million in catastrophe losses recorded by this group in the second quarter of 2011 as a result of the April and May tornados was \$12 million lower than losses in the comparable 2010 period. Underwriting profit in the first six months of 2011 decreased approximately \$7 million from the comparable 2010 period. The largest businesses in this group produced solid underwriting profit margins through the first six months of 2011.

***Specialty casualty*** gross written premiums were up slightly and net written premiums were flat for the 2011 second quarter when compared to the second quarter of 2010. Gross and net written premiums decreased for the first six months of 2011 when compared to the 2010 period. The non-renewal of two major programs that did not meet management's return thresholds and a decision to exit the excess workers' compensation business resulted in lower premiums in both periods. This group reported an underwriting profit of \$21 million in the second quarter of 2011, slightly lower than the second quarter of 2010. Increased underwriting profit in the excess and surplus businesses and higher favorable development in the run-off legal professional liability business were more than offset by lower underwriting profits in the Marketform, executive liability and general liability operations. Underwriting profit in the first six months of 2011 decreased approximately \$18 million from the comparable 2010 period. Lower underwriting profit in a block of program business and lower favorable reserve development were partially offset by improved results in the excess and surplus lines. Most businesses in this group produced strong underwriting profit margins through the first six months of 2011.

***Specialty financial*** gross written premiums for the second quarter and first six months of 2011 were impacted by lower premiums from the run-off of automotive-related business and lower premiums in the financial institutions business, partially offset by higher premiums in the trade credit and international operations. Net written premiums decreased for the second quarter and first six months of 2011 when compared to 2010 periods as higher premiums in the trade credit operations were more than offset by lower premiums in the fidelity and crime and financial institutions businesses. This group reported underwriting profits of \$13 million in the second quarter and \$23 million in the first six months of 2011 compared to \$33 million and \$54 million in the same 2010 periods. The absence of favorable development related to the run-off automobile residual value insurance operations and higher catastrophe losses in the financial institutions business contributed to these lower results. Almost all lines of business in this group produced strong underwriting profit margins through the first six months of 2011.

***Special Asbestos and Environmental Reserve Charge*** AFG recently completed the previously announced comprehensive study of its asbestos and environmental exposures relating to the run-off operations of its property and casualty group and its exposures related to former railroad and manufacturing operations and sites.

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As a result of the study, AFG recorded a \$50 million special charge (net of reinsurance) to increase the property and casualty group's asbestos reserves by \$28 million and its environmental reserves by \$22 million. At June 30, 2011, the property and casualty group's A&E reserves were \$382 million, net of reinsurance recoverables. At that date, AFG's three year survival ratio was 18.0 times paid losses for the asbestos reserves and 12.3 times paid losses for the total A&E reserves. Excluding amounts associated with the settlements of asbestos related coverage litigation for A.P. Green Industries (see *Legal Proceedings in AFG's 2010 Form 10-K*) and another large claim, AFG's three year survival ratio was 11.5 and 8.8 times paid losses for the asbestos reserves and total A&E reserves, respectively. These ratios compare favorably with A.M. Best's most recent report on A&E survival ratios (February 2011) which were 8.3 for asbestos and 7.7 for total industry A&E reserves.

The property and casualty group's asbestos reserve increase related primarily to exposures on business assumed from other insurers resulting from an increase in anticipated aggregate exposures in several large settlements involving several insurers in which AFG has a small proportionate share. Some insurers have settled long-standing asbestos exposures with their insureds and are seeking payment from reinsurers. Asbestos reserves related to the property and casualty group's direct asbestos exposures were increased to reflect higher frequency and severity of mesothelioma and other cancer claims as well as increased defense costs on many of these claims. These trends were partially offset by a decline in the number of claims without serious injury and fewer new claims that required payment being reported to AFG. The increase in the property and casualty group's environmental reserves was attributed primarily to a small number of increases on specific environmental claims at several sites.

In addition to the property and casualty group, the study encompassed reserves for asbestos and environmental exposures of AFG's former railroad and manufacturing operations. As a result of the study, AFG recorded a \$9 million special charge (included in other expenses) to increase its (i) asbestos reserves by \$3 million in recognition of a higher number of expected mesothelioma and lung cancer cases than had previously been estimated, partially offset by a decrease in the number of claims without serious injury and (ii) environmental reserves by \$6 million due primarily to higher estimated costs with respect to several existing sites. At June 30, 2011, AFG had liabilities totaling \$101 million for environmental and personal injury claims associated with its former railroad and manufacturing operations.

The study relied on a ground-up exposure analysis. With respect to asbestos, it considered products and non-products exposures, paid claims history, the pattern of new claims, settlements and projected development. The asbestos legal climate remains very difficult to predict. While some progress has been made in state asbestos tort reform and judicial rulings, that progress has been somewhat offset by increased claims costs, increased defense costs, the assertion of non-products theories and an expanding pool of plaintiffs and defendants.

**Annuity and Supplemental Insurance Operations** Operating earnings before income taxes of the annuity and supplemental insurance segment increased \$10 million (22%) in the second quarter and \$18 million (20%) for the first six months of 2011 compared to the 2010 periods, due primarily to higher earnings in the fixed annuity operations, especially the bank distribution channels, as well as higher earnings in the supplemental health insurance operations.

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|                                     | Three months ended<br>June 30, |        | Six months ended<br>June 30, |        |
|-------------------------------------|--------------------------------|--------|------------------------------|--------|
|                                     | 2011                           | 2010   | 2011                         | 2010   |
| 403(b) Fixed and Indexed Annuities: |                                |        |                              |        |
| First Year                          | \$ 5                           | \$ 9   | \$ 11                        | \$ 20  |
| Renewal                             | 46                             | 45     | 88                           | 87     |
| Single Sum                          | 18                             | 26     | 35                           | 51     |
| Subtotal                            | 69                             | 80     | 134                          | 158    |
| Non-403(b) Indexed Annuities        | 454                            | 151    | 711                          | 283    |
| Non-403(b) Fixed Annuities          | 62                             | 157    | 122                          | 259    |
| Bank Annuities Direct               | 115                            | 142    | 215                          | 196    |
| Bank Annuities Indirect             | 190                            | 10     | 361                          | 10     |
| Variable Annuities                  | 16                             | 19     | 35                           | 39     |
| Total Annuity Premiums              | \$ 906                         | \$ 559 | \$ 1,578                     | \$ 945 |

Bank Annuities Direct represent premiums generated by financial institutions appointed and serviced directly by AFG. Bank Annuities Indirect represent premiums generated through banks by independent agents or brokers.

The increase in annuity premiums for the second quarter and first six months of 2011 compared to the same periods in 2010 is attributable to higher sales through the bank distribution channels and increased sales of indexed annuities in the non-403(b) single premium market. Higher sales in the bank channels reflect primarily indirect bank sales by one agent through Regions Bank; this relationship did not exist until late in the second quarter of 2010. Increased sales of indexed annuities reflects the industry trend towards indexed annuities and away from traditional fixed annuities, as well as AFG's introduction of new indexed products and features.

**Life, Accident and Health Premiums and Benefits** The following table summarizes AFG's life, accident and health premiums and benefits as shown in the Consolidated Statement of Earnings (in millions):

|                                   | Three months ended<br>June 30, |        | Six months ended<br>June 30, |        |
|-----------------------------------|--------------------------------|--------|------------------------------|--------|
|                                   | 2011                           | 2010   | 2011                         | 2010   |
| Premiums                          |                                |        |                              |        |
| Supplemental insurance operations |                                |        |                              |        |
| First year                        | \$ 10                          | \$ 17  | \$ 21                        | \$ 38  |
| Renewal                           | 92                             | 90     | 184                          | 177    |
| Life operations (in run-off)      | 5                              | 6      | 12                           | 13     |
|                                   | \$ 107                         | \$ 113 | \$ 217                       | \$ 228 |
| Benefits                          |                                |        |                              |        |
| Supplemental insurance operations | \$ 78                          | \$ 83  | \$ 164                       | \$ 169 |



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|                              |       |       |        |        |
|------------------------------|-------|-------|--------|--------|
| Life operations (in run-off) | 11    | 10    | 21     | 20     |
|                              | \$ 89 | \$ 93 | \$ 185 | \$ 189 |

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**Management's Discussion and Analysis**  
**of Financial Condition and Results of Operations Continued**

**Investment Income** The \$12 million and \$17 million increases in investment income for the second quarter and first six months of 2011, respectively, compared to the same periods in 2010 reflects higher average invested assets, primarily related to growth in the annuity business, partially offset by lower yields on fixed maturity investments. Investment income includes \$7 million and \$15 million in the second quarter and first six months of 2011 and \$18 million and \$44 million in the second quarter and first six months of 2010 of interest income earned on interest-only and similar MBS, primarily non-agency interest-only securities with interest rates that float inversely with short-term rates.

Over the past couple of years, yields available in the financial markets on fixed maturity securities have generally declined, placing downward pressure on AFG's investment portfolio yield.

**Realized Gains (Losses) on Securities** Net realized gains (losses) on securities consisted of the following (in millions):

|  | Three months ended<br>June 30, |       | Six months ended<br>June 30, |       |
|--|--------------------------------|-------|------------------------------|-------|
|  | 2011                           | 2010  | 2011                         | 2010  |
| Realized gains (losses) before impairments:                                |                                |       |                              |       |
| Disposals  | \$ 46                          | \$ 26 | \$ 63                        | \$ 45 |
| Change in the fair value of derivatives                                    | (6)                            | 3     | (11)                         | 12    |
| Adjustments to annuity deferred policy acquisition costs and related items |                                | (2)   | (2)                          | (5)   |
|  | 40                             | 27    | 50                           | 52    |
| Impairment charges:  |                                |       |                              |       |
| Securities   | (27)                           | (23)  | (41)                         | (53)  |
| Adjustments to annuity deferred policy acquisition costs and related items | 6                              | 7     | 10                           | 16    |
|  | (21)                           | (16)  | (31)                         | (37)  |
|  | \$ 19                          | \$ 11 | \$ 19                        | \$ 15 |

The change in fair value of derivatives includes net losses of less than \$1 million in the second quarter and \$3 million in the first six months of 2011 and net gains of \$9 million and \$26 million in the second quarter and first six months of 2010 from the mark-to-market of MBS, primarily interest-only securities with interest rates that float inversely with short-term rates. See *Note F Derivatives*.

**Annuity Benefits** Annuity benefits reflect amounts accrued on annuity policyholders' funds accumulated. On deferred annuities (annuities in the accumulation phase), interest is generally credited to policyholders' accounts at their current stated interest rates. Furthermore, for two-tier deferred annuities (annuities under which a higher interest amount can be earned if a policy is annuitized rather than surrendered), additional reserves are accrued for (i) persistency and premium bonuses and (ii) excess benefits expected to be paid for future deaths and

annuitizations. Changes in investment yields, crediting rates, actual surrender, death and annuitization experience or modifications in actuarial assumptions can affect these additional reserves and could result in charges (or credits) to earnings in the period the projections are modified.

The \$7 million and \$15 million increases in annuity benefits in the second quarter and first six months of 2011 compared to the 2010 periods reflect growth in the annuity business, partially offset by the impact of lower average crediting rates.

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**Annuity and Supplemental Insurance Acquisition Expenses** Annuity and supplemental insurance acquisition expenses include amortization of annuity, supplemental insurance and life business deferred policy acquisition costs ( DPAC ) as well as a portion of commissions on sales of insurance products. Annuity and supplemental insurance acquisition expenses also include amortization of the present value of future profits of businesses acquired ( PVFP ). The \$2 million decrease in annuity and supplemental insurance acquisition expenses for the second quarter of 2011 compared to the 2010 quarter reflects the unfavorable impact of poor stock market performance on variable annuities in the 2010 quarter and lower acquisition expenses in the supplemental business in the 2011 quarter, partially offset by the impact of growth in the fixed annuity business.

The vast majority of the annuity and supplemental insurance group's DPAC asset relates to its annuity and life insurance lines of business. Unanticipated spread compression, decreases in the stock market, adverse mortality experience, and higher than expected lapse rates could lead to write-offs of DPAC or PVFP in the future. If the current interest rate environment persists through the end of the year, AFG may be required to write-off DPAC related to its fixed annuity business. Any such write-off is not expected to have a material impact on AFG's net earnings for the year.

**Interest Charges on Borrowed Money** Interest expense increased \$3 million (17%) for the second quarter and \$6 million (17%) during the first six months of 2011 compared to the same periods of 2010 reflecting AFG's issuance of \$132 million of 7% Senior Notes in September 2010.

**Other Operating and General Expenses** Other operating and general expenses for 2011 include a \$9 million second quarter special charge to increase liabilities related to asbestos and environmental exposures of AFG's former railroad and manufacturing operations. For a discussion of the study that resulted in the A&E charge, see *Special Asbestos and Environmental Reserve Charge* under *Results of Operations* - *Property and Casualty Insurance - Underwriting*. For the six month period, the A&E charge was offset by the impact of a \$10 million recovery in the first quarter of 2011 on a prior property and casualty extracontractual obligation claim.

**RECENT ACCOUNTING STANDARDS**

In October 2010, the FASB issued Accounting Standards Update 2010-26 to address diversity in practice regarding 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 guidance is effective January 1, 2012, with retrospective application permitted, but not required. Management continues assessing the impact of adoption and expects that adoption will be reported retrospectively.

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In June 2011, the FASB issued Accounting Standards Update 2011-05, which eliminates the option to report other comprehensive income in the statement of changes in equity. Instead, the guidance requires that all other comprehensive income (non-owner changes in shareholders' equity) be presented either in a single continuous statement of comprehensive income, which would contain net income and other comprehensive income sections and replace the statement of earnings, or in a separate statement of other comprehensive income immediately following the statement of earnings. The guidance is effective January 1, 2012, with retrospective application required. The guidance relates solely to the presentation of other comprehensive income and therefore does not change the measurement of net income, other comprehensive income or earnings per share. Accordingly, the adoption of this guidance will have no impact on AFG's results of operations or financial position.

**ITEM 3**

**Quantitative and Qualitative Disclosure of Market Risk**

As of June 30, 2011, there were no material changes to the information provided in Item 7A - Quantitative and Qualitative Disclosure of Market Risk of AFG's 2010 Form 10-K.

**ITEM 4**

**Controls and Procedures**

AFG's management, with participation of its Co-Chief Executive Officers and its principal financial officer, has evaluated AFG's disclosure controls and procedures (as defined in Exchange Act Rule 13a-15) as of the end of the period covered by this report. Based on that evaluation, AFG's Co-CEOs and principal financial officer concluded that the controls and procedures are effective. There have been no changes in AFG's internal control over financial reporting during the second fiscal quarter of 2011 that materially affected, or are reasonably likely to materially affect, AFG's internal control over financial reporting.

In the ordinary course of business, AFG and its subsidiaries routinely enhance their information systems by either upgrading current systems or implementing new systems. There has been no change in AFG's business processes and procedures during the second fiscal quarter of 2011 that has materially affected, or is reasonably likely to materially affect, AFG's internal controls over financial reporting.

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**Issuer Purchases of Equity Securities** AFG repurchased shares of its Common Stock during the first six months of 2011 as follows:

|               | Total<br>Number<br>of Shares<br>Purchased | Average<br>Price Paid<br>Per Share | Total Number<br>of Shares<br>Purchased as<br>Part of Publicly<br>Announced<br>Plans<br>or Programs | Maximum<br>Number<br>of Shares<br>that May<br>Yet be Purchased<br>Under the Plans<br>or Programs (a) |
|---------------|---|------------------------------------|--|--|
| First Quarter | 2,457,721                                 | \$ 34.04                           | 2,457,721  | 10,250,706   |
| April         | 50,386                                    | \$ 34.37                           | 50,386   | 10,200,320   |
| May           | 1,095,735                                 | \$ 35.15                           | 1,095,735  | 9,104,585  |
| June          | 1,564,000                                 | \$ 34.55                           | 1,564,000  | 7,540,585  |

(a) Represents the remaining shares that may be repurchased under the Plans authorized by AFG's Board of Directors in August 2010 and February 2011.

**ITEM 6****Exhibits**

| Number | Exhibit Description  |
|--------|--|
| 12     | Computation of ratios of earnings to fixed charges.  |
| 31(a)  | Certification of the Co-Chief Executive Officer pursuant to section 302(a) of the Sarbanes-Oxley Act of 2002.  |
| 31(b)  | Certification of the Co-Chief Executive Officer pursuant to section 302(a) of the Sarbanes-Oxley Act of 2002.  |
| 31(c)  | Certification of the Chief Financial Officer pursuant to section 302(a) of the Sarbanes-Oxley Act of 2002.   |
| 32     | Certification of the Co-Chief Executive Officers and Chief Financial Officer pursuant to section 906 of the Sarbanes- Oxley Act of 2002.   |
| 101    | The following financial information from American Financial Group's Form 10-Q for the quarter ended June 30, 2011 formatted in XBRL (Extensible Business Reporting Language):<br>(i) Consolidated Balance Sheet<br>(ii) Consolidated Statement of Earnings |

- (iii) Consolidated Statement of Changes in Equity
- (iv) Consolidated Statement of Changes in Cash Flows
- (v) Notes to Consolidated Financial Statements

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**Signature**

Pursuant to the requirements of the Securities Exchange Act of 1934, American Financial Group, Inc. has duly caused this Report to be signed on its behalf by the undersigned duly authorized.

American Financial Group, Inc.

August 8, 2011

BY: /s/ Keith A. Jensen  
Keith A. Jensen  
Senior Vice President  
(principal financial and accounting  
officer)