

AMERICAN FINANCIAL GROUP INC

Form 10-Q

November 08, 2010

**Table of Contents**

**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 September 30, 2010**  
**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 November 1, 2010, there were 107,755,778 shares of the Registrant's Common Stock outstanding, excluding 14.9 million shares owned by subsidiaries.

---

**AMERICAN FINANCIAL GROUP, INC.  
TABLE OF CONTENTS**

	Page
<b><u>Part I Financial Information</u></b>	
<u>Item 1 Financial Statements:</u>	
<u>Consolidated Balance Sheet</u>	2
<u>Consolidated Statement of Earnings</u>	3
<u>Consolidated Statement of Changes in Equity</u>	4
<u>Consolidated Statement of Cash Flows</u>	5
<u>Notes to Consolidated Financial Statements</u>	6
<u>Item 2 Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	32
<u>Item 3 Quantitative and Qualitative Disclosure of Market Risk</u>	49
<u>Item 4 Controls and Procedures</u>	49
<b><u>Part II Other Information</u></b>	
<u>Item 2 Unregistered Sales of Equity Securities and Use of Proceeds</u>	50
<u>Item 6 Exhibits</u>	50
<u>Signatures</u>	51
<u>Exhibit 12</u>	
<u>Exhibit 31 (a)</u>	
<u>Exhibit 31 (b)</u>	
<u>Exhibit 31 (c)</u>	
<u>Exhibit 32</u>	
<u>EX-101 INSTANCE DOCUMENT</u>	
<u>EX-101 SCHEMA DOCUMENT</u>	
<u>EX-101 CALCULATION LINKBASE DOCUMENT</u>	
<u>EX-101 LABELS LINKBASE DOCUMENT</u>	
<u>EX-101 PRESENTATION LINKBASE DOCUMENT</u>	
<u>EX-101 DEFINITION LINKBASE DOCUMENT</u>	

---

**Table of Contents**

**AMERICAN FINANCIAL GROUP, INC. 10-Q**  
**PART I**  
**ITEM I FINANCIAL STATEMENTS**  
**AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEET (UNAUDITED)**  
**(Dollars In Millions)**

	September 30, 2010	December 31, 2009
<b>Assets:</b>		
Cash and cash equivalents	\$ 1,140	\$ 1,120
Investments:		
Fixed maturities, available for sale at fair value (amortized cost \$18,237 and \$16,730)	19,454	16,823
Fixed maturities, trading at fair value	385	372
Equity securities, at fair value (cost \$409 and \$228)	581	411
Mortgage loans	492	376
Policy loans	267	276
Real estate and other investments	404	413
 Total cash and investments	 22,723	 19,791
 Recoverables from reinsurers	 2,949	 3,279
Prepaid reinsurance premiums	536	381
Agents' balances and premiums receivable	773	554
Deferred policy acquisition costs	1,154	1,570
Assets of managed investment entities	2,491	
Other receivables	655	774
Variable annuity assets (separate accounts)	573	549
Other assets	599	577
Goodwill	186	208
 Total assets	 \$ 32,639	 \$ 27,683
 <b>Liabilities and Equity:</b>		
Unpaid losses and loss adjustment expenses	\$ 6,434	\$ 6,412
Unearned premiums	1,743	1,568
Annuity benefits accumulated	12,476	11,335
Life, accident and health reserves	1,643	1,603
Payable to reinsurers	446	462
Liabilities of managed investment entities	2,271	
Long-term debt	954	828
Variable annuity liabilities (separate accounts)	573	549
Other liabilities	1,370	1,007
 Total liabilities	 27,910	 23,764

Shareholders' Equity:			
Common Stock, no par value			
- 200,000,000 shares authorized			
- 107,739,128 and 113,386,343 shares outstanding	108		113
Capital surplus	1,190		1,231
Retained Earnings:			
Appropriated - managed investment entities	208		
Unappropriated	2,464		2,274
Accumulated other comprehensive income, net of tax	607		163
Total shareholders' equity	4,577		3,781
Noncontrolling interests	152		138
Total equity	4,729		3,919
Total liabilities and equity	\$ 32,639	\$	27,683

**Table of Contents**

**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 September 30,		Nine months ended September 30,	
	2010	2009	2010	2009
<b>Revenues:</b>				
Property and casualty insurance premiums	\$ 736	\$ 622	\$ 1,887	\$ 1,809
Life, accident and health premiums	112	112	340	331
Investment income	296	301	885	900
Realized gains (losses) on:				
Securities (*)	57	9	72	(17)
Subsidiaries	(22)	(5)	(22)	(5)
Income (loss) of managed investment entities:				
Investment income	23		68	
Loss on change in fair value of assets/liabilities	(4)		(44)	
Other income	57	54	155	177
<b>Total revenues</b>	<b>1,255</b>	<b>1,093</b>	<b>3,341</b>	<b>3,195</b>
<b>Costs and Expenses:</b>				
Property and casualty insurance:				
Losses and loss adjustment expenses	446	296	1,052	846
Commissions and other underwriting expenses	222	218	633	643
Annuity benefits	114	112	340	323
Life, accident and health benefits	90	86	279	268
Annuity and supplemental insurance acquisition expenses	47	38	150	136
Interest charges on borrowed money	21	19	57	48
Expenses of managed investment entities	15		38	
Other operating and general expenses	92	121	279	354
<b>Total costs and expenses</b>	<b>1,047</b>	<b>890</b>	<b>2,828</b>	<b>2,618</b>
Operating earnings before income taxes	208	203	513	577
Provision for income taxes	82	72	199	204
Net earnings, including noncontrolling interests	126	131	314	373
Less: Net earnings (loss) attributable to noncontrolling interests	(6)	4	(32)	15
<b>Net Earnings Attributable to Shareholders</b>	<b>\$ 132</b>	<b>\$ 127</b>	<b>\$ 346</b>	<b>\$ 358</b>

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

Basic	\$	1.22	\$	1.10	\$	3.14	\$	3.09
Diluted	\$	1.21	\$	1.09	\$	3.11	\$	3.07
Average number of Common Shares:								
Basic		108.2		116.1		110.1		115.8
Diluted		109.5		117.2		111.4		116.9
Cash dividends per Common Share	\$	.1375	\$	.13	\$	.4125	\$	.39
(*) Consists of the following:								
Realized gains before impairments	\$	68	\$	35	\$	120	\$	136
Losses on securities with impairment Non-credit portion recognized in other comprehensive income (loss)		(8)		(47)		(42)		(301)
		(3)		21		(6)		148
Impairment charges recognized in earnings		(11)		(26)		(48)		(153)
Total realized gains (losses) on securities	\$	57	\$	9	\$	72	\$	(17)

Table of Contents

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

	Shareholders		Equity		Total	Noncon- trolling Interests	Total Equity	
	Common Shares	Common Stock and Capital Surplus	Retained Earnings Appro.	Unappro.				Accum. Other Comp Inc.(Loss)
<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			245	4	(4)	245		245
Net earnings				346		346	(32)	314
Other comprehensive income (loss), net of tax:								
Change in unrealized gain (loss) on securities					440	440	6	446
Change in foreign currency translation					7	7	2	9
Change in unrealized pension and other postretirement benefits					1	1		1
Total comprehensive income						794	(24)	770
Allocation of losses of managed investment entities			(37)			(37)	37	
Dividends on Common Stock				(46)		(46)		(46)
Shares issued:								
Exercise of stock options	1,312,149	27				27		27
Other benefit plans	388,094	6				6		6
Dividend reinvestment plan	12,652							
Stock-based compensation expense		9				9		9
Shares acquired and retired	(7,360,110)	(87)		(114)		(201)		(201)
Other		(1)				(1)	1	
	107,739,128	\$ 1,298	\$ 208	\$ 2,464	\$ 607	\$ 4,577	\$ 152	\$ 4,729



**Balance at  
September 30, 2010**

<b>Balance at December 31, 2008</b>	115,599,169	\$ 1,351	\$	\$ 1,842	\$	(703)	\$ 2,490	\$	112	\$ 2,602
Cumulative effect of accounting change				17		(17)				
Net earnings				358			358		15	373
Other comprehensive income (loss), net of tax:										
Change in unrealized gain (loss) on securities						827	827		7	834
Change in foreign currency translation						14	14		1	15
Change in unrealized pension and other postretirement benefits						1	1			1
Total comprehensive income							1,200		23	1,223
Dividends on Common Stock				(45)			(45)			(45)
Shares issued:										
Exercise of stock options	903,133	16					16			16
Other benefit plans	190,629	2					2			2
Dividend reinvestment plan	16,589									
Stock-based compensation expense		8					8			8
Shares exchanged in option exercises	(175,530)	(2)		(2)			(4)			(4)
Other		3					3		(3)	
<b>Balance at September 30, 2009</b>	116,533,990	\$ 1,378	\$	\$ 2,170	\$	122	\$ 3,670	\$	132	\$ 3,802

**Table of Contents**

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

	Nine months ended September 30,	
	2010	2009
<b>Operating Activities:</b>		
Net earnings, including noncontrolling interests	\$ 314	\$ 373
Adjustments:		
Depreciation and amortization	141	155
Annuity benefits	340	323
Realized (gains) losses on investing activities	(57)	26
Net purchases of trading securities	(2)	(25)
Deferred annuity and life policy acquisition costs	(157)	(128)
Change in:		
Reinsurance and other receivables	256	188
Other assets	13	85
Insurance claims and reserves	(195)	(335)
Payable to reinsurers	(24)	142
Other liabilities	101	(44)
Other operating activities, net	51	1
Net cash provided by operating activities	781	761
<b>Investing Activities:</b>		
Purchases of:		
Fixed maturities	(3,737)	(3,245)
Equity securities	(183)	(20)
Mortgage loans	(143)	(9)
Real estate, property and equipment	(62)	(49)
Subsidiaries	(128)	(5)
Proceeds from:		
Maturities and redemptions of fixed maturities	1,474	1,388
Repayments of mortgage loans	35	6
Sales of fixed maturities	1,215	1,504
Sales of equity securities	10	41
Sales of real estate, property and equipment	3	1
Change in securities lending collateral		48
Managed investment entities:		
Purchases of investments	(617)	
Proceeds from sales and redemptions of investments	658	
Cash and cash equivalents of businesses acquired	95	
Other investing activities, net	6	(65)
Net cash used in investing activities	(1,374)	(405)

**Financing Activities:**

Annuity receipts	1,661	1,092
Annuity surrenders, benefits and withdrawals	(914)	(986)
Additional long-term borrowings	158	526
Reductions of long-term debt	(36)	(682)
Managed investment entities retirement of liabilities	(42)	
Change in securities lending obligation		(95)
Issuances of Common Stock	27	13
Repurchases of Common Stock	(201)	
Cash dividends paid on Common Stock	(46)	(45)
Other financing activities, net	6	(8)
Net cash provided by (used in) financing activities	613	(185)
<b>Net Change in Cash and Cash Equivalents</b>	20	171
Cash and cash equivalents at beginning of period	1,120	1,264
Cash and cash equivalents at end of period	\$ 1,140	\$ 1,435

**Table of Contents**

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

**A. Accounting Policies**

**B. Acquisition of Subsidiary**

**C. Segments of Operations**

**D. Fair Value Measurements**

**E. Investments**

**F. Derivatives**

**G. Deferred Policy Acquisition Costs**

**H. Managed Investment Entities**

**I. Goodwill and Intangible Assets**

**J. Long Term Debt**

**K. Shareholders' Equity**

**L. Income Taxes**

**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 September 30, 2010, 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. Except for the impairment of goodwill discussed in Note I, AFG did not have any significant nonrecurring fair value measurements of nonfinancial assets and liabilities in the first nine months of 2010.

New accounting guidance adopted by AFG on January 1, 2010, requires additional disclosures about transfers between levels in the hierarchy of fair value measurements. The guidance also clarifies existing disclosure requirements related to the level of disaggregation presented and inputs used in determining fair values. Additional detail relating to the roll-forward of Level 3 fair values will be required beginning in 2011.

**Investments** Fixed maturity and equity securities classified as available for sale are reported at fair value with unrealized gains and losses included in a separate component of shareholders' equity. 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.

**Table of Contents**

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

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.

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.

In 2009, AFG adopted new accounting guidance relating to the recognition and presentation of other-than-temporary impairments. Under the guidance, 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 an entity may separate other-than-temporary impairments 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 required to be 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 required to reduce the amortized cost of that security to fair value. AFG adopted this guidance effective January 1, 2009, and recorded a cumulative effect adjustment of \$17 million to reclassify the non-credit component of previously recognized impairments from retained earnings to accumulated other comprehensive income (loss). Additional disclosures required by this guidance are contained in *Note E Investments*.

**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.

**Table of Contents**

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

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.

**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 and universal life insurance products 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 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, net of tax in the Shareholders Equity section of the Balance Sheet.

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.

**Table of Contents**

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

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

**Managed Investment Entities** In 2009, the Financial Accounting Standards Board issued a new standard changing how a company determines if it is the primary beneficiary of, and therefore must consolidate, a variable interest entity ( VIE ). This determination is based primarily on a company's ability to direct the activities of the entity that most significantly impact the 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. As further described in Note H, these entities issued securities in various tranches and invested the proceeds primarily in secured bank loans, which serve as collateral for the debt securities issued by each particular CLO. 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. Based on the new accounting guidance, 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. Accordingly, AFG began consolidating these entities on January 1, 2010.

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 Consolidated Balance Sheet. As permitted under the new standard, the assets and liabilities of the CLOs have been recorded at fair value upon adoption of the new standard on January 1, 2010. At that date, the excess of fair value of the assets (\$2.382 billion) over the fair value of the liabilities (\$2.137 billion) of \$245 million was included in AFG's Balance Sheet as appropriated retained earnings managed investment entities, representing the cumulative effect of adopting the new standard that ultimately will inure to the benefit of the CLO debt holders.

At December 31, 2009, AFG's investments in the CLOs were included in fixed maturity securities and had a cost of approximately \$700,000 and a fair value of \$6.4 million. Beginning January 1, 2010, these investments are eliminated in consolidation.

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. As further detailed in *Note H - Managed Investment Entities*, 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.



**Table of Contents**

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

**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. Reserves 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.

Table of Contents

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

**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 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 on stock options.

**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 the following adjustments to weighted average common shares related to stock-based compensation plans: third quarter 2010 and 2009 1.3 million and 1.1 million; first nine months of 2010 and 2009 1.3 million and 1.1 million, respectively.

**Table of Contents**

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

AFG's weighted average diluted shares outstanding excludes the following anti-dilutive potential common shares related to stock compensation plans: third quarter 2010 and 2009 3.1 million and 4.6 million; first nine months of 2010 and 2009 4.0 million and 6.0 million, respectively. Adjustments to net earnings attributable to shareholders in the calculation of diluted earnings per share were nominal in the 2010 and 2009 periods.

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

**B. Acquisition of Subsidiary** In July 2010, National Interstate ( NATL ), a 52.5%-owned subsidiary of AFG, completed the acquisition of Vanliner Group, Inc., a subsidiary of UniGroup, Inc. for \$128 million in cash, which was based on Vanliner's estimated tangible book value at the date of closing and is subject to certain adjustments. The purchase price is subject to a four and one-half-year balance sheet guarantee whereby both favorable and unfavorable balance sheet developments inure to UniGroup. The preliminary allocation of the purchase price based on the estimated fair value of the assets and liabilities is subject to change upon finalizing valuations. NATL funded the acquisition primarily with cash on hand. Vanliner wrote approximately \$104 million of gross premiums in 2009 in the moving and storage industry.

**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 and 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, indexed and variable annuities and a variety of supplemental insurance products. AFG's reportable segments and their components were determined based primarily upon similar economic characteristics, products and services.

**Table of Contents**

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

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 September 30,		Nine months ended September 30,	
	2010	2009	2010	2009
<b>Revenues</b>				
Property and casualty insurance:				
Premiums earned:				
Specialty				
Property and transportation	\$ 407	\$ 239	\$ 832	\$ 676
Specialty casualty	224	237	661	692
Specialty financial	92	127	347	388
Other	13	19	47	53
	736	622	1,887	1,809
Investment income	80	102	257	313
Realized gains	46	17	69	41
Other	13	26	49	87
	875	767	2,262	2,250
Annuity and supplemental insurance:				
Investment income	215	195	625	585
Life, accident and health premiums	112	112	340	331
Realized losses	(11)	(13)	(19)	(63)
Other	23	26	81	88
	339	320	1,027	941
Other	41	6	52	4
	\$ 1,255	\$ 1,093	\$ 3,341	\$ 3,195

**Operating Earnings Before Income Taxes**

Property and casualty insurance:

Underwriting:

Specialty

Property and transportation	\$ 41	\$ 47	\$ 81	\$ 121
Specialty casualty	(13)	27	29	106
Specialty financial	36	29	91	96
Other	4	6	13	3
Other lines		(1)	(12)	(6)

	68	108	202	320
Investment and other operating income	67	80	229	253
Realized gains	46	17	69	41

Edgar Filing: AMERICAN FINANCIAL GROUP INC - Form 10-Q

	181	205	500	614
Annuity and supplemental insurance:				
Operations	58	46	148	127
Realized losses	(11)	(13)	(19)	(63)
	47	33	129	64
Other (*)	(20)	(35)	(116)	(101)
	\$ 208	\$ 203	\$ 513	\$ 577

(\*) The third quarter and first nine months of 2010 include \$8 million and \$23 million, respectively, in earnings from managed investment entities attributable to AFG shareholders and \$4 million and \$37 million, respectively, in losses of managed investment entities attributable to noncontrolling interests.

**Table of Contents**

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

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

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

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

Level 3 Valuations derived from market valuation techniques generally consistent with those used to estimate the fair values of Level 2 financial instruments in which one or more significant inputs are unobservable. 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), changes in interest rates, general economic conditions and the credit quality of the specific issuers.

**Table of Contents**

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

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

	Level 1	Level 2	Level 3	Total
<b>September 30, 2010</b>				
Assets:				
Available for sale ( AFS ) fixed maturities:				
U.S. Government and government agencies	\$ 264	\$ 259	\$	\$ 523
States, municipalities and political subdivisions		2,532	21	2,553
Foreign government		308		308
Residential MBS		3,646	292	3,938
Commercial MBS		2,092	5	2,097
All other corporate	10	9,573	452	10,035
<b>Total AFS fixed maturities</b>	<b>274</b>	<b>18,410</b>	<b>770</b>	<b>19,454</b>
Trading fixed maturities		384	1	385
Equity securities	402	158	21	581
Assets of managed investment entities ( MIE )	122	2,327	42	2,491
Variable annuity assets (separate accounts) (a)		573		573
Other investments		65		65
<b>Total assets accounted for at fair value</b>	<b>\$ 798</b>	<b>\$ 21,917</b>	<b>\$ 834</b>	<b>\$ 23,549</b>
Liabilities:				
Liabilities of managed investment entities	\$ 72	\$	\$ 2,199	\$ 2,271
Derivatives embedded in annuity benefits accumulated			170	170
<b>Total liabilities accounted for at fair value</b>	<b>\$ 72</b>	<b>\$</b>	<b>\$ 2,369</b>	<b>\$ 2,441</b>
<b>December 31, 2009</b>				
Assets:				
Fixed maturities:				
Available for sale	\$ 371	\$ 15,683	\$ 769	\$ 16,823
Trading		371	1	372
Equity securities	197	189	25	411
Variable annuity assets (separate accounts) (a)		549		549
Other investments		85		85
<b>Total assets accounted for at fair value</b>	<b>\$ 568</b>	<b>\$ 16,877</b>	<b>\$ 795</b>	<b>\$ 18,240</b>
Liabilities:				
Derivatives embedded in annuity benefits accumulated	\$	\$	\$ 113	\$ 113

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

During the third quarter of 2010, there were no significant transfers between Level 1 and Level 2. Approximately 4% of the total assets measured at fair value on September 30, 2010, were Level 3 assets. Approximately 36% 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 internal investment professionals.



**Table of Contents**

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

Changes in balances of Level 3 financial assets and liabilities during the third quarter and first nine months of 2010 and 2009 are presented below (in millions). The transfers into and out of Level 3 were due to changes in the availability of market observable inputs. All transfers are reflected in the table at fair value as of the end of the reporting period.

	Balance at June 30, 2010	Total realized/unrealized Gains (losses) included in Net income	Other comp. income (loss)	Purchases, sales, issuances and settlements	Transfer into Level 3	Transfer out of Level 3	Balance at September 30, 2010
AFS fixed maturities:							
State and municipal	\$ 21	\$	\$	\$	\$	\$	\$ 21
Residential MBS	326	4	11	5	7	(61)	292
Commercial MBS	6	(1)					5
All other corporate	426		7	14	27	(22)	452
Trading fixed maturities	1						1
Equity securities	24					(3)	21
Assets of MIE	46			(4)			42
Liabilities of MIE	(2,152)	(51)		4			(2,199)
Embedded derivatives	(128)	(26)		(16)			(170)

	Balance at June 30, 2009	Total realized/unrealized gains (losses) included in Net income	Other comp. income (loss)	Purchases, sales, issuances and settlements	Transfer out of Level 3	Balance at September 30, 2009
AFS fixed maturities	\$ 712	\$ 5	\$ 68	\$ 185	\$ (313)	\$ 657
Trading fixed maturities	5				(4)	1
Equity securities	26	(2)				24
Other assets						
Embedded derivatives	(93)	(23)			5	(111)

Total  
realized/unrealized  
gains (losses)  
included in

Consolidate      Other      Purchases,

Edgar Filing: AMERICAN FINANCIAL GROUP INC - Form 10-Q

	Balance at Dec. 31, 2009	Managed Inv. Entities	Net income	comp. income (loss)	sales, issuances and settlements	Transfer into Level 3	Transfer out of Level 3	Balance at September 30, 2010
AFS fixed maturities:								
State and municipal	\$ 23	\$	\$	\$ 1	\$ (3)	\$ 17	\$ (17)	\$ 21
Residential MBS	435		6	22	11	9	(191)	292
Commercial MBS			(1)		6			5
All other corporate	311	(6)	(12)	15	101	96	(53)	452
Trading fixed maturities	1				4		(4)	1
Equity securities	25			(1)			(3)	21
Assets of MIE		90	5		(8)	7	(52)	42
Liabilities of MIE		(2,100)	(141)		42			(2,199)
Embedded derivatives	(113)		(25)		(32)			(170)

Total  
realized/unrealized  
gains (losses)

	Balance at Dec. 31, 2008	Net income	included in Other comp. income (loss)	Purchases, sales, issuances and settlements	Transfer out of Level 3	Balance at September 30, 2009
AFS fixed maturities	\$ 706	\$ 12	\$ 71	\$ 144	\$ (276)	\$ 657
Trading fixed maturities	1					1
Equity securities	44	(11)	1	(4)	(6)	24
Other assets	5				(5)	
Embedded derivatives	(96)	(23)		8		(111)

**Table of Contents**

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

**Fair Value of Financial Instruments** The following table presents (in millions) the carrying value and estimated fair value of AFG's financial instruments at September 30, 2010 and December 31, 2009.

	September 30, 2010		December 31, 2009	
	Carrying Value	Fair Value	Carrying Value	Fair Value
<b>Assets:</b>				
Cash and cash equivalents	\$ 1,140	\$ 1,140	\$ 1,120	\$ 1,120
Fixed maturities	19,839	19,839	17,195	17,195
Equity securities	581	581	411	411
Mortgage loans	492	494	376	373
Policy loans	267	267	276	276
Assets of managed investment entities	2,491	2,491		
Variable annuity assets (separate accounts)	573	573	549	549
<b>Liabilities:</b>				
Annuity benefits accumulated (*)	\$ 12,266	\$ 12,131	\$ 11,123	\$ 10,365
Long-term debt	954	1,037	828	839
Liabilities of managed investment entities	2,271	2,271		
Variable annuity liabilities (separate accounts)	573	573	549	549

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

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

**E. Investments** Available for sale fixed maturities and equity securities at September 30, 2010, and December 31, 2009, consisted of the following (in millions):

	September 30, 2010				December 31, 2009			
	Amortized Cost	Fair Value	Gross Gains	Unrealized Losses	Amortized Cost	Fair Value	Gross Gains	Unrealized Losses
<b>Fixed maturities:</b>								
U.S. Government and government agencies States, municipalities and political subdivisions	\$ 502	\$ 523	\$ 21	\$	\$ 599	\$ 612	\$ 14	\$ (1)
	2,443	2,553	114	(4)	1,764	1,789	40	(15)

Edgar Filing: AMERICAN FINANCIAL GROUP INC - Form 10-Q

Foreign government	292	308	16		261	264	4	(1)
Residential MBS	3,873	3,938	223	(158)	4,142	3,956	126	(312)
Commercial MBS	1,916	2,097	185	(4)	1,434	1,431	22	(25)
All other corporate	9,211	10,035	849	(25)	8,530	8,771	375	(134)
	\$ 18,237	\$ 19,454	\$ 1,408	\$ (191)	\$ 16,730	\$ 16,823	\$ 581	\$ (488)
Common stocks	\$ 270	\$ 441	\$ 173	\$ (2)	\$ 112	\$ 298	\$ 187	\$ (1)
Perpetual preferred stocks	\$ 139	\$ 140	\$ 6	\$ (5)	\$ 116	\$ 113	\$ 6	\$ (9)

The non-credit related portion of other-than-temporary impairment charges are included in other comprehensive income (loss). Such charges taken for securities still owned at September 30, 2010 and December 31, 2009, respectively, were: residential MBS \$266 million and \$284 million; commercial MBS \$3 million in both periods; corporate bonds \$1 million and \$4 million.

**Table of Contents**

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

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 September 30, 2010 and December 31, 2009.

	Less Than Twelve Months			Twelve Months or More		
	Unrealized Loss	Fair Value	Fair Value as % of Cost	Unrealized Loss	Fair Value	Fair Value as % of Cost
<b>September 30, 2010</b>						
Fixed maturities:						
U.S. Government and government agencies	\$	\$ 53	100%	\$	\$	%
States, municipalities and political subdivisions	(1)	164	99%	(3)	54	95%
Foreign government		5	100%			%
Residential MBS	(13)	274	96%	(145)	664	82%
Commercial MBS		36	99%	(4)	20	85%
All other corporate	(4)	191	98%	(21)	365	95%
	\$ (18)	\$ 723	98%	\$ (173)	\$ 1,103	87%
Common Stocks	\$ (2)	\$ 35	95%	\$	\$ 2	91%
Perpetual Preferred Stocks	\$	\$ 4	99%	\$ (5)	\$ 37	87%
<b>December 31, 2009</b>						
Fixed maturities:						
U.S. Government and government agencies	\$ (1)	\$ 232	99%	\$	\$	%
States, municipalities and political subdivisions	(8)	470	98%	(7)	69	90%
Foreign government	(1)	81	99%			%
Residential MBS	(37)	458	93%	(275)	1,392	84%
Commercial MBS	(1)	209	99%	(24)	395	94%
All other corporate	(19)	895	98%	(115)	1,336	92%
	\$ (67)	\$ 2,345	97%	\$ (421)	\$ 3,192	88%
Common Stocks	\$ (1)	\$ 3	79%	\$	\$ 2	99%

Perpetual Preferred Stocks	\$	\$	%	\$	(9)	\$	47	84%
----------------------------	----	----	---	----	-----	----	----	-----

At September 30, 2010 the gross unrealized losses on fixed maturities of \$191 million relate to approximately 630 securities. Investment grade securities (as determined by nationally recognized rating agencies) represented approximately 37% of the gross unrealized loss and 64% of the fair value. Residential MBS comprised approximately 83% of the gross unrealized losses on the available for sale fixed maturity portfolio at September 30, 2010.

**Gross Unrealized Losses on MBS** Over 97% of AFG's commercial MBS are AAA-rated. Of the residential MBS that have been in an unrealized loss position (impaired) for 12 months or more (286 securities), approximately 37% of the unrealized losses and 50% 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 nine months of 2010, AFG recorded in earnings \$42 million in other-than-temporary impairment charges related to its residential MBS.

Table of Contents

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

**Gross Unrealized Losses on All Other Corporates** For the first nine months of 2010, AFG recorded in earnings \$18 million in other-than-temporary impairment charges on all other corporate securities. Management concluded that no additional impairment charges 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.

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).

	2010	2009
Balance at June 30	\$ 121	\$ 67
Additional credit impairments on:		
Previously impaired securities	11	4
Securities without prior impairments	1	9
Reductions disposals		(4)
 Balance at September 30	 \$ 133	 \$ 76
 Balance at January 1	 \$ 99	 \$ 14
Additional credit impairments on:		
Previously impaired securities	34	14
Securities without prior impairments	8	59
Reductions disposals	(8)	(11)
 Balance at September 30	 \$ 133	 \$ 76

The table below sets forth the scheduled maturities of available for sale fixed maturities as of September 30, 2010 (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 September 30, 2010.

Maturity	Amortized	Fair Value	
	Cost	Amount	%
One year or less	\$ 516	\$ 526	3%
After one year through five years	4,998	5,323	27
After five years through ten years	5,525	6,066	31
After ten years	1,409	1,504	8
	12,448	13,419	69
MBS	5,789	6,035	31

Total	\$	18,237	\$	19,454	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 (other than U.S. Treasury Notes) that exceeded 10% of Shareholders Equity at September 30, 2010 or December 31, 2009.



Table of Contents

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

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

	Pre-tax	Deferred Tax and Amounts Attributable to Noncontrolling Interests	Net
<b>September 30, 2010</b>			
Unrealized gain on:			
Fixed maturity securities	\$ 1,217	\$ (432)	\$ 785
Equity securities	172	(61)	111
Deferred policy acquisition costs	(460)	161	(299)
Annuity benefits and other liabilities	9	(3)	6
	\$ 938	\$ (335)	\$ 603
<b>December 31, 2009</b>			
Unrealized gain on:			
Fixed maturity securities	\$ 93	\$ (33)	\$ 60
Equity securities	183	(65)	118
Deferred policy acquisition costs	(18)	6	(12)
	\$ 258	\$ (92)	\$ 166

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

	Fixed Maturities	Equity Securities	Other (* )	Tax Effects	Noncon- trolling Interests	Total
<b>Quarter ended September 30, 2010</b>						
Realized before impairments	\$ 44	\$ 29	\$ (5)	\$ (24)	\$	\$ 44
Realized impairments	(14)	(1)	4	4		(7)
Change in Unrealized	498	(7)	(177)	(110)	(4)	200
<b>Quarter ended September 30, 2009</b>						
Realized before impairments	\$ 37	\$ 2	\$ (4)	\$ (11)	\$ (2)	\$ 22
Realized impairments	(28)	(8)	10	9	1	(16)
Change in Unrealized	1,039	98	(407)	(256)	(3)	471

**Nine months ended September 30, 2010**

Realized before impairments	\$ 99	\$ 31	\$ (10)	\$ (42)	\$ (1)	\$ 77
Realized impairments	(64)	(4)	20	17		(31)
Change in Unrealized	1,131	(11)	(434)	(240)	(6)	440

**Nine months ended September 30, 2009**

Realized before impairments	\$ 168	\$ (12)	\$ (20)	\$ (47)	\$ (2)	\$ 87
Realized impairments	(182)	(27)	56	54	1	(98)
Change in Unrealized	1,834	161	(712)	(449)	(7)	827

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

**Table of Contents**

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

Realized gains include net gains of \$25 million and \$51 million in the third quarter and first nine 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. In the 2009 periods, realized gains included \$32 million in the third quarter and \$129 million for the first nine months from the mark-to-market of these securities. 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):

	Nine months ended September 30,	
	2010	2009
Fixed maturities:		
Gross gains	\$ 74	\$ 68
Gross losses	(10)	(24)
Equity securities:		
Gross gains	29	6
Gross losses		(21)

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

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

Derivative	Balance Sheet Line	September 30, 2010		December 31, 2009	
		Asset	Liability	Asset	Liability
MBS with embedded derivatives	Fixed maturities	\$ 97	\$	\$ 226	\$
Interest rate swaptions	Other investments	13		24	
Indexed annuities (embedded derivative)	Annuity benefits accumulated		170		113
Equity index call options	Other investments	52		61	
Reinsurance contracts (embedded derivative)	Other liabilities		21		5
		\$ 162	\$ 191	\$ 311	\$ 118

The MBS with embedded derivatives consist primarily of interest-only MBS with interest rates that float inversely with short-term rates. AFG has elected to measure these securities (in their entirety) at fair value in its financial statements. 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 \$800 million 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 \$21 million to purchase these swaptions, which represents its maximum potential economic loss over the life of the contracts.

AFG's indexed annuities, which represented 26% of annuity benefits accumulated at September 30, 2010, 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.

**Table of Contents**

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

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 third quarter and first nine months of 2010 and 2009 (in millions):

Derivative	Statement of Earnings Line	Three months ended		Nine months ended	
		September 30, 2010	2009	September 30, 2010	2009
MBS with embedded derivatives	Realized gains	\$ 25	\$ 32	\$ 51	\$ 129
Interest rate swaptions	Realized gains	(2)		(16)	5
Indexed annuities (embedded derivative)	Annuity benefits	(26)	(23)	(25)	(23)
Equity index call options	Annuity benefits	23	19	11	17
Reinsurance contracts (embedded derivative)	Investment income	(6)	(14)	(16)	(24)
		\$ 14	\$ 14	\$ 5	\$ 104

**G. Deferred Policy Acquisition Costs** Deferred policy acquisition costs consisted of the following (in millions):

	September 30, 2010	December 31, 2009
Property and casualty insurance	\$ 321	\$ 338
Annuity and supplemental insurance:		
Policy acquisition costs	911	853
Policyholder sales inducements	214	207
Present value of future profits ( PVFP )	168	190
Impact of unrealized gains and losses on securities	(460)	(18)
Total annuity and supplemental	833	1,232
	\$ 1,154	\$ 1,570

The PVFP amounts in the table above are net of \$170 million and \$148 million of accumulated amortization at September 30, 2010 and December 31, 2009, respectively. Amortization of the PVFP was \$6 million in the third quarter and \$22 million during the first nine months of 2010 and \$7 million in the third quarter and \$22 million in the first nine months of 2009, 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.

**Table of Contents**

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

In analyzing expected cash flows related to these entities, AFG determined that it will not receive a majority of the residual returns nor absorb a majority of the entities' expected losses. Accordingly, AFG was not required to consolidate these variable interest entities prior to 2010. Beginning in 2010, accounting standards for determining the primary beneficiary of a variable interest entity changed from the above quantitative assessment to a qualitative assessment as outlined in *Note A - Accounting Policies, Managed Investment Entities*. Under the new guidance, AFG determined that it is the primary beneficiary of the CLOs it manages and began consolidating the CLOs on January 1, 2010.

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 \$12 million at September 30, 2010.

The revenues and expenses of the CLOs are separately identified in AFG's Statement of Earnings, after elimination of \$5 million and \$13 million in management fees and \$3 million and \$10 million in income attributable to shareholders of AFG for the third quarter and nine months of 2010, respectively, as measured by the change in the fair value of AFG's investments in the CLOs. AFG's Operating earnings before income taxes for the third quarter and first nine months of 2010 includes \$4 million and \$37 million, respectively, in CLO losses attributable to noncontrolling interests.

The net loss from changes in the fair value of assets and liabilities of managed investment entities included in the Statement of Earnings for 2010 includes gains of \$47 million in the third quarter and gains of \$97 million for the first nine months from changes in the fair value of CLO assets and losses of \$51 million in the third quarter and losses of \$141 million for the first nine months from changes in the fair value of CLO liabilities. The aggregate unpaid principal balance of the CLOs' fixed maturity investments exceeded the fair value of the investments by \$132 million at September 30, 2010. The aggregate unpaid principal balance of the CLOs' debt exceeded its fair value by \$390 million at that date. The CLO assets include \$17 million in loans (aggregate unpaid principal balance of \$37 million) for which the CLOs are not accruing interest because the loans are in default.

**I. Goodwill and Intangible Assets** Changes in the carrying value of goodwill during the first nine months of 2010, by reporting segment, are presented in the following table (in millions):

	Property and Casualty	Annuity and Supplemental	Total
Balance January 1, 2010	\$ 152	\$ 56	\$ 208
Impairment charge		(22)	(22)
Balance September 30, 2010	\$ 152	\$ 34	\$ 186

In the third quarter of 2010, management reached a decision to de-emphasize the sale of supplemental health insurance products through career agents, including the sale of a marketing subsidiary. As a result of this decision, AFG performed an interim impairment test of the goodwill associated with the reporting unit using an income valuation method based on discounted cash flows. Based on the results of this test, AFG recorded a goodwill impairment charge of \$22 million (included in realized gains (losses) on subsidiaries) to write off all of the goodwill related to this reporting unit.

**Table of Contents**

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

Included in other assets in AFG's Balance Sheet is \$52 million at September 30, 2010 and \$60 million at December 31, 2009, in amortizable intangible assets related to property and casualty insurance acquisitions, primarily the 2008 acquisitions of Marketform and Strategic Comp. These amounts are net of accumulated amortization of \$32 million and \$23 million, respectively. Amortization of these intangibles was \$3 million in the third quarter and \$9 million during the first nine months of 2010 compared to \$7 million in the third quarter and \$19 million during the first nine months of 2009. Other assets also include \$8 million in non-amortizable intangible assets related to insurance licenses acquired in the acquisition of Vanliner in 2010.

**J. Long-Term Debt** The carrying value of long-term debt consisted of the following (in millions):

	September 30, 2010	December 31, 2009
<b>Direct obligations of AFG:</b>		
9-7/8% Senior Notes due June 2019	\$ 350	\$ 350
7% Senior Notes due September 2050	132	
7-1/8% Senior Debentures due February 2034	115	115
Other	3	3
	600	468
<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 2010 through 2016	65	66
Secured borrowings (\$18 and \$19 guaranteed by AFG)	43	52
National Interstate bank credit facility	19	15
American Premier Underwriters 10-7/8% Subordinated Notes due May 2011	8	8
Other	1	1
	334	340
<b>Payable to Subsidiary Trusts:</b>		
AAG Holding Variable Rate Subordinated Debentures due May 2033	20	20
	\$ 954	\$ 828

Scheduled principal payments on debt for the balance of 2010 and the subsequent five years were as follows: 2010 \$3 million; 2011 \$20 million; 2012 \$31 million; 2013 \$20 million; 2014 \$2 million and 2015 \$14 million. As shown below (in millions), the majority of AFG's long-term debt is unsecured obligations of the holding company and its subsidiaries:

September 30, 2010	December 31, 2009
--------------------------	-------------------------



Edgar Filing: AMERICAN FINANCIAL GROUP INC - Form 10-Q

Unsecured obligations	\$	846	\$	710
Obligations secured by real estate		65		66
Other secured borrowings		43		52
	\$	954	\$	828

In August 2010, AFG replaced its credit facility with a three-year, \$500 million revolving credit line. 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 September 30, 2010.

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

In September 2010, AFG issued \$132 million of 7% Senior Notes due 2050. In April 2009, AFG paid \$136 million to redeem its outstanding 7-1/8% Senior Debentures at maturity. In June 2009, AFG issued \$350 million of 9-7/8% Senior Notes due 2019 and used the proceeds to repay borrowings under the credit facility.

In 2009, AFG subsidiaries borrowed a total of \$59 million at interest rates ranging from 3.8% to 4.25% over LIBOR (weighted average interest rate of 4.4% at September 30, 2010). The loans require principal payments over the next four years.

**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 Net Unrealized Gains (Losses) on Securities	Foreign Currency Translation Adjustment	Other (a)	Tax Effects	Noncon- trolling Interests	Accumulated Other Comprehensive Income (Loss)
<b>Balance at December 31, 2009</b>	\$ 258(b)	\$ 1	\$ (13)	\$ (86)	\$ 3	\$ 163(b)
Unrealized holding gains on securities arising during the period	758			(265)	(7)	486
Realized gains included in net income	(72)			25	1	(46)
Foreign currency translation gains		9			(2)	7
Other	(6)		1	2		(3)
<b>Balance at September 30, 2010</b>	\$ 938(b)	\$ 10	\$ (12)	\$ (324)	\$ (5)	\$ 607(b)
<b>Balance at December 31, 2008</b>	\$ (1,058)	\$ (18)	\$ (11)	\$ 374	\$ 10	\$ (703)
Cumulative effect of accounting change	(27)			10		(17)
Unrealized holding losses on securities arising during the period	1,266			(442)	(8)	816
Realized losses included in net income	17			(7)	1	11
		15			(1)	14

Foreign currency translation  
gains  
Other

1

1

**Balance at September 30,  
2009**

\$ 198 \$ (3) \$ (10) \$ (65) \$ 2 \$ 122

- (a) Net unrealized pension and other postretirement plan benefits.
- (b) Includes \$35 million at September 30, 2010, and \$98 million at December 31, 2009 in net pretax unrealized losses (\$24 million and \$63 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 nine months of 2010, AFG issued 175,282 shares of restricted Common Stock (fair value of \$24.83 per share) and granted stock options for 1.1 million shares of Common Stock (at an average exercise price of \$24.83) under the Stock Incentive Plan. In addition, AFG issued 141,264 shares of Common Stock (fair value of \$24.83 per share) in the first quarter of 2010 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 fair value of options granted during 2010 was \$8.90 per share based on the following assumptions: expected dividend yield 2.2%; expected volatility 39%; expected term 7.5 years; risk-free rate 3.2%.

**Table of Contents**

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

Total compensation expense related to stock incentive plans of AFG and its subsidiaries was as follows: third quarter of 2010 and 2009 \$5 million and \$4 million, respectively; nine months of 2010 and 2009 \$15 million and \$14 million, respectively.

**L. Income Taxes** Operating income before income taxes includes \$4 million in the third quarter of 2010 and \$37 million for the first nine months of 2010 in non-deductible losses of managed investment entities attributable to noncontrolling interests, thereby increasing AFG's effective tax rate.

As discussed in *Note K - Income Taxes*, to AFG's 2009 Form 10-K, AFG has several tax years for which there are ongoing disputes with the Internal Revenue Service ( IRS ). AFG filed a suit for refund in the U.S. District Court in Southern Ohio as a result of its dispute with the IRS regarding the calculation of tax reserves for certain annuity reserves pursuant to Actuarial Guideline 33. Oral arguments on joint motions for summary judgment were presented in June 2009. On March 15, 2010, the Court issued an Order denying both motions. On June 18, 2010, the Court issued a final judgment in favor of AFG. The IRS has appealed the decision. AFG's liabilities for uncertain tax positions will not be adjusted until the case is effectively settled. Resolution of the case could result in a decrease in the liability for unrecognized tax benefits by up to \$36 million and a decrease in related accrued interest of \$12 million. These amounts do not include tax and interest paid to the IRS in 2005 and 2006, for which the suit was filed, totaling \$17 million.

In the third quarter of 2010, AFG increased its liability for uncertain tax positions by \$19 million, exclusive of interest, to reflect uncertainty as to the timing of tax return inclusion of income related to certain securities. Because the ultimate recognition of income with respect to these securities is highly certain, the recording of this liability resulted in an offsetting reduction in AFG's deferred tax liability. Accordingly, the ultimate resolution of this item will not impact AFG's annual effective tax rate but could accelerate the payment of taxes.

**M. Contingencies** There have been no significant changes to the matters discussed and referred to in *Note M Contingencies* of AFG's 2009 Annual Report on 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.

**Table of Contents**

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

**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>September 30, 2010</b>						
<b>Assets:</b>						
Cash and investments	\$ 379	\$ 34	\$	\$ 22,312	\$ (2)	\$ 22,723
Recoverables from reinsurers and prepaid reinsurance premiums				3,485		3,485
Agents' balances and premiums receivable				773		773
Deferred policy acquisition costs				1,154		1,154
Assets of managed investment entities				2,491		2,491
Other assets	29	6	5	1,984	(11)	2,013
Investment in subsidiaries and affiliates	5,007	1,952	2,050	677	(9,686)	
<b>Total assets</b>	<b>\$ 5,415</b>	<b>\$ 1,992</b>	<b>\$ 2,055</b>	<b>\$ 32,876</b>	<b>\$ (9,699)</b>	<b>\$ 32,639</b>
<b>Liabilities and Equity:</b>						
Unpaid losses, loss adjustment expenses and unearned premiums	\$	\$	\$	\$ 8,177	\$	\$ 8,177
Annuity, life, accident and health benefits and reserves				14,120	(1)	14,119
Liabilities of managed investment entities				2,271		2,271
Long-term debt	600	1	219	134		954
Other liabilities	238	18	111	2,277	(255)	2,389
	838	19	330	26,979	(256)	27,910
Total shareholders' equity	4,577	1,973	1,725	5,745	(9,443)	4,577
Noncontrolling interests				152		152
<b>Total liabilities and equity</b>	<b>\$ 5,415</b>	<b>\$ 1,992</b>	<b>\$ 2,055</b>	<b>\$ 32,876</b>	<b>\$ (9,699)</b>	<b>\$ 32,639</b>
<b>December 31, 2009</b>						
<b>Assets:</b>						
Cash and investments	\$ 225	\$ 33	\$	\$ 19,535	\$ (2)	\$ 19,791
				3,660		3,660

Edgar Filing: AMERICAN FINANCIAL GROUP INC - Form 10-Q

Recoverables from reinsurers and prepaid reinsurance premiums							
Agents' balances and premiums receivable				554			554
Deferred policy acquisition costs				1,570			1,570
Other assets	14	5	6	2,063	20		2,108
Investment in subsidiaries and affiliates	4,189	1,539	1,624	687	(8,039)		
<b>Total assets</b>	<b>\$ 4,428</b>	<b>\$ 1,577</b>	<b>\$ 1,630</b>	<b>\$ 28,069</b>	<b>\$ (8,021)</b>	<b>\$</b>	<b>27,683</b>
<b>Liabilities and Equity:</b>							
Unpaid losses, loss adjustment expenses and unearned premiums	\$	\$	\$	\$ 7,980	\$	\$	7,980
Annuity, life, accident and health benefits and reserves				12,939	(1)		12,938
Long-term debt	468	1	219	140			828
Other liabilities	179	21	110	1,876	(168)		2,018
	647	22	329	22,935	(169)		23,764
Total shareholders' equity	3,781	1,555	1,301	4,996	(7,852)		3,781
Noncontrolling interests				138			138
<b>Total liabilities and equity</b>	<b>\$ 4,428</b>	<b>\$ 1,577</b>	<b>\$ 1,630</b>	<b>\$ 28,069</b>	<b>\$ (8,021)</b>	<b>\$</b>	<b>27,683</b>

**Table of Contents**

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

FOR THE THREE MONTHS ENDED SEPTEMBER 30, 2010	AFG	GAFRI	AAG Holding	All Other Subs	Consol. Entries	Consolidated
<b>Revenues:</b>						
Property and casualty insurance premiums	\$	\$	\$	\$ 736	\$	\$ 736
Life, accident and health premiums				112		112
Realized gains (losses)		(2)		37		35
Income of managed investment entities				19		19
Investment and other income	3	3		352	(5)	353
Equity in earnings of subsidiaries	242	48	76		(366)	
	245	49	76	1,256	(371)	1,255
<b>Costs and Expenses:</b>						
Insurance benefits and expenses				919		919
Interest charges on borrowed money	15		6	6	(6)	21
Expenses of managed investment entities				15		15
Other expenses	16	6	2	68		92
	31	6	8	1,008	(6)	1,047
Operating earnings before income taxes	214	43	68	248	(365)	208
Provision (credit) for income taxes	82	21	22	97	(140)	82
Net earnings, including noncontrolling interests	132	22	46	151	(225)	126
Less: Net earnings (loss) attributable to noncontrolling interests				(6)		(6)
<b>Net Earnings Attributable to Shareholders</b>	\$ 132	\$ 22	\$ 46	\$ 157	\$ (225)	\$ 132

FOR THE THREE MONTHS ENDED SEPTEMBER 30, 2009	AFG	GAFRI	AAG Holding	All Other Subs	Consol. Entries	Consolidated
<b>Revenues:</b>						
Property and casualty insurance premiums	\$	\$	\$	\$ 622	\$	\$ 622
Life, accident and health premiums				112		112
Realized gains (losses)		(6)		10		4

Edgar Filing: AMERICAN FINANCIAL GROUP INC - Form 10-Q

Investment and other income	4	8		349	(6)	355
Equity in earnings of subsidiaries	226	31	41		(298)	
	230	33	41	1,093	(304)	1,093
<b>Costs and Expenses:</b>						
Insurance benefits and expenses				750		750
Interest charges on borrowed money	15		6	4	(6)	19
Other expenses	16	4	2	99		121
	31	4	8	853	(6)	890
Operating earnings before income taxes	199	29	33	240	(298)	203
Provision (credit) for income taxes	72	9	10	80	(99)	72
Net earnings, including noncontrolling interests	127	20	23	160	(199)	131
Less: Net earnings (loss) attributable to noncontrolling interests				4		4
<b>Net Earnings Attributable to Shareholders</b>	<b>\$ 127</b>	<b>\$ 20</b>	<b>\$ 23</b>	<b>\$ 156</b>	<b>\$ (199)</b>	<b>\$ 127</b>



**Table of Contents**

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

FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2010	AFG	GAFRI	AAG Holding	All Other Subs	Consol. Entries	Consolidated
<b>Revenues:</b>						
Property and casualty insurance premiums	\$	\$	\$	\$ 1,887	\$	\$ 1,887
Life, accident and health premiums				340		340
Realized gains (losses)		(2)		52		50
Income of managed investment entities				24		24
Investment and other income	3	8		1,045	(16)	1,040
Equity in earnings of subsidiaries	621	129	172		(922)	
	624	135	172	3,348	(938)	3,341
<b>Costs and Expenses:</b>						
Insurance benefits and expenses				2,454		2,454
Interest charges on borrowed money	42		19	13	(17)	57
Expenses of managed investment entities				38		38
Other expenses	37	13	5	224		279
	79	13	24	2,729	(17)	2,828
Operating earnings before income taxes	545	122	148	619	(921)	513
Provision (credit) for income taxes	199	49	50	236	(335)	199
Net earnings, including noncontrolling interests	346	73	98	383	(586)	314
Less: Net earnings (loss) attributable to noncontrolling interests				(32)		(32)
<b>Net Earnings Attributable to Shareholders</b>	\$ 346	\$ 73	\$ 98	\$ 415	\$ (586)	\$ 346

FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2009	AFG	GAFRI	AAG Holding	All Other Subs	Consol. Entries	Consolidated
<b>Revenues:</b>						
Property and casualty insurance premiums	\$	\$	\$	\$ 1,809	\$	\$ 1,809
Life, accident and health premiums				331		331
Realized gains (losses)		(6)		(16)		(22)

Edgar Filing: AMERICAN FINANCIAL GROUP INC - Form 10-Q

Investment and other income	3	7		1,084	(17)	1,077
Equity in earnings of subsidiaries	629	61	94		(784)	
	632	62	94	3,208	(801)	3,195
<b>Costs and Expenses:</b>						
Insurance benefits and expenses				2,216		2,216
Interest charges on borrowed money	36		19	10	(17)	48
Other expenses	34	13	4	304	(1)	354
	70	13	23	2,530	(18)	2,618
Operating earnings before income taxes	562	49	71	678	(783)	577
Provision (credit) for income taxes	204	14	21	233	(268)	204
Net earnings, including noncontrolling interests	358	35	50	445	(515)	373
Less: Net earnings (loss) attributable to noncontrolling interests				15		15
<b>Net Earnings Attributable to Shareholders</b>	<b>\$ 358</b>	<b>\$ 35</b>	<b>\$ 50</b>	<b>\$ 430</b>	<b>\$ (515)</b>	<b>\$ 358</b>

**Table of Contents**

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

FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2010	AFG	GAFRI	AAG Holding	All Other Subs	Consol. Entries	Consolidated
<b>Operating Activities:</b>						
Net earnings, including noncontrolling interests	\$ 346	\$ 73	\$ 98	\$ 383	\$ (586)	\$ 314
Adjustments:						
Equity in net earnings of subsidiaries	(395)	(78)	(114)		587	
Dividends from subsidiaries	359		16		(375)	
Other operating activities, net	(52)	(2)	4	518	(1)	467
Net cash provided by (used in) operating activities	258	(7)	4	901	(375)	781
<b>Investing Activities:</b>						
Purchases of investments, property and equipment	(6)			(4,119)		(4,125)
Purchase of subsidiaries				(128)		(128)
Capital contributions to subsidiaries	(12)	(2)	(5)		19	
Proceeds from maturities and redemptions of investments		6		1,503		1,509
Proceeds from sales of investments, property and equipment				1,228		1,228
Managed investment entities:						
Purchases of investments				(617)		(617)
Proceeds from sales and redemptions of investments				658		658
Other investing activities, net				101		101
Net cash provided by (used in) investing activities	(18)	4	(5)	(1,374)	19	(1,374)
<b>Financing Activities:</b>						
Annuity receipts				1,661		1,661
Annuity surrenders, benefits and withdrawals				(914)		(914)
Additional long-term borrowings	128			30		158
Reductions of long-term debt				(36)		(36)
Managed investment entities retirement of liabilities				(42)		(42)
Issuances of Common Stock	26			1		27
Capital contributions from parent		12	1	6	(19)	
Repurchases of Common Stock	(201)					(201)

Edgar Filing: AMERICAN FINANCIAL GROUP INC - Form 10-Q

Cash dividends paid	(46)			(375)	375	(46)
Other financing activities, net	(1)			7		6
Net cash provided by (used in) financing activities	(94)	12	1	338	356	613
<b>Net change in cash and cash equivalents</b>	146	9		(135)		20
Cash and cash equivalents at beginning of period	197	12		911		1,120
Cash and cash equivalents at end of period	\$ 343	\$ 21	\$	\$ 776	\$	\$ 1,140

**Table of Contents**

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

FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2009	AFG	GAFRI	AAG Holding	All Other Subs	Consol. Entries	Consolidated
<b>Operating Activities:</b>						
Net earnings including noncontrolling interests	\$ 358	\$ 35	\$ 50	\$ 445	\$ (515)	\$ 373
Adjustments:						
Equity in net earnings of subsidiaries	(407)	(43)	(66)		516	
Dividends from subsidiaries	284	3			(287)	
Other operating activities, net	16	2	(3)	374	(1)	388
Net cash provided by (used in) operating activities	251	(3)	(19)	819	(287)	761
<b>Investing Activities:</b>						
Purchases of investments, property and equipment	(9)			(3,314)		(3,323)
Capital contributions to subsidiaries	(129)	(119)	(98)		346	
Proceeds from maturities and redemptions of investments				1,394		1,394
Proceeds from sales of investments, property and equipment	8	1		1,537		1,546
Other investing activities, net		1		(23)		(22)
Net cash provided by (used in) investing activities	(130)	(117)	(98)	(406)	346	(405)
<b>Financing Activities:</b>						
Annuity receipts				1,092		1,092
Annuity surrenders, benefits and withdrawals				(986)		(986)
Additional long-term borrowings	467			59		526
Reductions of long-term debt	(676)			(6)		(682)
Issuances of Common Stock	12			1		13
Capital contributions from parent		128	118	100	(346)	
Cash dividends paid	(45)			(287)	287	(45)
Other financing activities, net				(103)		(103)
Net cash provided by (used in) financing activities	(242)	128	118	(130)	(59)	(185)
<b>Net change in cash and cash equivalents</b>	<b>(121)</b>	<b>8</b>	<b>1</b>	<b>283</b>		<b>171</b>

Edgar Filing: AMERICAN FINANCIAL GROUP INC - Form 10-Q

Cash and cash equivalents at beginning of period	160	2	1,102	1,264
Cash and cash equivalents at end of period	\$ 39	\$ 10	\$ 1,385	\$ 1,435

**Table of Contents**

**AMERICAN FINANCIAL GROUP, INC. 10-Q**  
**ITEM 2**  
**Management's Discussion and Analysis**  
**of Financial Condition and Results of Operations**  
**INDEX TO MD&A**

	<b>Page</b>
<b><u>Forward-Looking Statements</u></b>	32
<b><u>Overview</u></b>	33
<b><u>Critical Accounting Policies</u></b>	33
<b><u>Liquidity and Capital Resources</u></b>	34
<b><u>Ratios</u></b>	34
<b><u>Parent and Subsidiary Liquidity</u></b>	34
<b><u>Investments</u></b>	35
<b><u>Uncertainties</u></b>	40
<b><u>Managed Investment Entities</u></b>	41
<b><u>Results of Operations</u></b>	43
<b><u>General</u></b>	43
<b>Income Items</b>	43
<b>Expense Items</b>	48
<b><u>Recent Accounting Standards</u></b>	49

**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 those words or other 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 rates 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, including mortgage-backed securities;

the availability of capital;

regulatory actions (including changes in statutory accounting rules);

changes in legal environment affecting AFG or its customers;

tax law and accounting changes;

levels of natural catastrophes, terrorist activities (including any nuclear, biological, chemical or radiological events), incidents of war 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

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.



**Table of Contents**

**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, indexed and variable annuities and a variety of supplemental insurance products.

Net earnings attributable to AFG's shareholders for the third quarter of 2010 were \$132 million (\$1.21 per share, diluted) compared to \$127 million (\$1.09 per share, diluted) in the comparable 2009 period. Net earnings attributable to AFG's shareholders for the nine months ended September 30, 2010 were \$346 million (\$3.11 per share, diluted) compared to \$358 million (\$3.07 per share, diluted) in the comparable 2009 period. The 2010 results reflect improved operating results in the annuity and supplemental insurance group and higher realized gains offset by a decline in underwriting profit in the property and casualty 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 2009 Form 10-K.

Table of Contents

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

**LIQUIDITY AND CAPITAL RESOURCES**

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

	September 30, 2010	December 31, 2009	December 31, 2008
Long-term debt	\$ 954	\$ 828	\$ 1,030
Total capital	4,984	4,698	4,351
Ratio of debt to total capital:			
Including debt secured by real estate	19.1%	17.6%	23.7%
Excluding debt secured by real estate	18.1%	16.4%	22.5%

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

AFG's ratio of earnings to fixed charges, including annuity benefits as a fixed charge, was 2.35 for the nine months ended September 30, 2010 and 2.58 for the entire year of 2009. Excluding annuity benefits, this ratio was 9.12 and 11.06, 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. In September 2010, AFG issued \$132 million of 7% Senior Notes due 2050. In August 2010, AFG replaced its credit facility with a three-year, \$500 million revolving credit line. No amounts were borrowed under this facility at September 30, 2010.

During the first nine months of 2010, AFG repurchased 7.4 million shares of its Common Stock for \$201 million. AFG retired the \$136 million of 7-1/8% Senior Debentures at maturity in April 2009, using cash on hand. In June 2009, AFG issued \$350 million of 9-7/8% Senior Notes due 2019.

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

**Subsidiary Liquidity** Great American Life Insurance Company ( GALIC ), a wholly-owned annuity and supplemental insurance subsidiary, became a member of the Federal Home Loan Bank of Cincinnati ( FHLB ) in the third quarter of 2009.

**Table of Contents**

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

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 \$15 million investment in FHLB capital stock at September 30, 2010 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 52.5%-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 \$19 million outstanding under this agreement at September 30, 2010.

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 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 September 30, 2010, contained \$19.5 billion in Fixed maturities classified as available for sale and \$581 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, \$385 million in fixed maturities were classified as trading with changes in unrealized holding gains or losses included in investment income.

**Table of Contents**

**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 one-third of AFG's fixed maturities, prices for each security are generally obtained from both pricing services and broker quotes. For the other two-thirds 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.

Data obtained from external sources is reviewed by AFG's internal investment professionals who ensure the fair value is representative of an exit price and consistent with accounting standards. 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 September 30, 2010 (dollars in millions). Increases or decreases from the 100 basis points illustrated would be approximately proportional.

Fair value of fixed maturity portfolio	\$ 19,839
Pretax impact on fair value of 100 bps increase in interest rates	\$ (932)
Pretax impact as % of total fixed maturity portfolio	(4.7)%

Approximately 91% of the fixed maturities held by AFG at September 30, 2010, 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.

AFG's \$6.1 billion investment in MBS represented approximately one-third of its fixed maturities at September 30, 2010. 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.

**Table of Contents**

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

Summarized information for AFG's MBS (including those classified as trading) at September 30, 2010, 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.

Collateral type	Amortized		Fair Value	Unrealized Gain (Loss)	% Rated
	Cost	Fair Value	as % of Cost		Investment Grade
Residential:					
Agency-backed	\$ 474	\$ 497	105%	\$ 23	100%
Non-agency prime	2,271	2,356	104	85	80
Alt-A	758	720	95	(38)	54
Subprime	386	378	98	(8)	56
Other	27	30	111	3	53
Commercial	1,951	2,132	109	181	100
	\$ 5,867	\$ 6,113	104%	\$ 246	84%

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. Beginning with year-end 2009 reporting of MBS by insurance companies, the NAIC retained a third-party investment management firm to assist in the determination of appropriate NAIC designations for all non-agency residential 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 September 30, 2010, 98% (based on statutory carrying value of \$5.8 billion) of AFG's MBS securities had an NAIC designation of 1 or 2.

**Table of Contents**

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

Summarized information for the unrealized gains and losses recorded in AFG's Balance Sheet at September 30, 2010, is shown in the following table (dollars in millions). Approximately \$433 million of available for sale Fixed maturities and \$51 million of Equity securities had no unrealized gains or losses at September 30, 2010.

	Securities With Unrealized Gains	Securities With Unrealized Losses
<b>Available for Sale Fixed Maturities</b>		
Fair value of securities	\$ 17,195	\$ 1,826
Amortized cost of securities	\$ 15,787	\$ 2,017
Gross unrealized gain (loss)	\$ 1,408	\$ (191)
Fair value as % of amortized cost	109%	91%
Number of security positions	3,433	631
Number individually exceeding \$2 million gain or loss	125	3
Concentration of gains (losses) by type or industry (exceeding 5% of unrealized):		
Mortgage-backed securities	\$ 408	\$ (162)
Banks, savings and credit institutions	114	(8)
States and municipalities	114	(4)
Gas and electric services	177	(2)
Percentage rated investment grade	94%	63%
<b>Equity Securities</b>		
Fair value of securities	\$ 452	\$ 78
Cost of securities	\$ 273	\$ 85
Gross unrealized gain (loss)	\$ 179(*)	\$ (7)
Fair value as % of cost	166%	92%
Number of security positions	77	29
Number individually exceeding \$2 million gain or loss	3	

(\*) Includes  
\$126 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 September 30, 2010, based on their fair values. Asset-backed securities and other securities with sinking funds are reported at average maturity. Actual maturities may differ from contractual maturities because certain securities may be called or prepaid by the issuers.

	Securities With Unrealized Gains	Securities With Unrealized Losses
<b>Maturity</b>		

Edgar Filing: AMERICAN FINANCIAL GROUP INC - Form 10-Q

One year or less	2%	1%
After one year through five years	29	19
After five years through ten years	34	15
After ten years	7	10
	72	45
Mortgage-backed securities (average life of approximately four years)	28	55
	100%	100%

**Table of Contents**

**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.

Fixed Maturities at September 30, 2010	Aggregate Fair Value	Aggregate Unrealized Gain (Loss)	Fair Value as % of Cost Basis
<b>Securities with unrealized gains:</b>			
Exceeding \$500,000 (831 issues)	\$ 10,103	\$ 1,078	112%
\$500,000 or less (2,602 issues)	7,092	330	105
	\$ 17,195	\$ 1,408	109%
<b>Securities with unrealized losses:</b>			
Exceeding \$500,000 (125 issues)	\$ 449	\$ (132)	77%
\$500,000 or less (506 issues)	1,377	(59)	96
	\$ 1,826	\$ (191)	91%

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.

Securities with Unrealized Losses at September 30, 2010	Aggregate Fair Value	Aggregate Unrealized Loss	Fair Value as % of Cost Basis
<b>Investment grade fixed maturities with losses for:</b>			
Less than one year (172 issues)	\$ 599	\$ (10)	98%
One year or longer (192 issues)	560	(61)	90
	\$ 1,159	\$ (71)	94%
<b>Non-investment grade fixed maturities with losses for:</b>			
Less than one year (56 issues)	\$ 124	\$ (8)	94%
One year or longer (211 issues)	543	(112)	83
	\$ 667	\$ (120)	85%
<b>Common equity securities with losses for:</b>			
Less than one year (12 issues)	\$ 35	\$ (2)	95%
One year or longer (5 issues)	2		91



	\$	37	\$	(2)	95%
--	----	----	----	-----	-----

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

Less than one year (1 issues)	\$	4	\$		99%
One year or longer (11 issues)		37		(5)	88
	\$	41	\$	(5)	89%

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 2009 Form 10-K under *Management's Discussion and Analysis - Investments*.

**Table of Contents**

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

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 September 30, 2010, 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 related to potential asbestos and environmental liabilities arising out of its former railroad and manufacturing operations. See *Management's Discussion and Analysis - Uncertainties* in AFG's 2009 Form 10-K.

***Asbestos and Environmental Reserve Review*** During the second quarter of 2010, AFG completed the previously announced in-depth internal review of its asbestos and environmental (A&E) 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. Previous studies have been completed with the assistance of outside actuarial and engineering firms and specialty outside counsel every two years with an in-depth internal review during the intervening years. This year's internal review resulted in an increase of \$8 million to A&E reserves. During the course of this review, there were no newly identified emerging trends or issues that management believes significantly impact the overall adequacy of AFG's A&E reserves.

At September 30, 2010, the property and casualty group's A&E reserves were \$350 million, net of reinsurance recoverables. At that date, AFG's three year survival ratio for property and casualty exposures was 9.6 times paid losses for the asbestos reserves and 8.3 times paid losses for the total A&E reserves. These ratios compare favorably with industry data published by Conning Research and Consulting, Inc. in May 2010, which indicate that industry survival ratios were 8.2 for asbestos and 7.7 for total industry A&E reserves at December 31, 2009. The survival ratio, which is often used by industry analysts to compare A&E reserves strength across companies, is a measure of the number of years that it would take to pay the amount of the current reserves based on the average paid losses over the preceding three years.

**Table of Contents**

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

**MANAGED INVESTMENT ENTITIES**

Beginning January 1, 2010, new 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, which would be comparable to periods prior to adopting the new standards.

**CONDENSED CONSOLIDATING BALANCE SHEET**

September 30, 2010	Before CLO Consolidation	Managed Investment Entities	Consol. Entries	Consolidated As Reported
<b>Assets:</b>				
Cash and other investments	\$ 22,735	\$	\$ (12)(a)	\$ 22,723
Assets of managed investment entities		2,491		2,491
Other assets	7,425			7,425
	\$ 30,160	\$ 2,491	\$ (12)	\$ 32,639
<b>Liabilities:</b>				
Unpaid losses, loss adjustment expenses and unearned premiums	\$ 8,177	\$	\$	\$ 8,177
Annuity, life, accident and health benefits and reserves	14,119			14,119
Liabilities of managed investment entities		2,283	(12)(a)	2,271
Long-term debt and other liabilities	3,343			3,343
	25,639	2,283	\$ (12)	27,910
<b>Shareholders' Equity:</b>				
Common Stock and Capital surplus	1,298			1,298
<b>Retained earnings:</b>				
Appropriated - managed investment entities		208		208
Unappropriated	2,464			2,464
Accumulated other comprehensive income	607			607
	4,369	208		4,577
Noncontrolling interests	152			152
	4,521	208		4,729
	\$ 30,160	\$ 2,491	\$ (12)	\$ 32,639

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

**Table of Contents**

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

	Before CLO Consolidation(a)	Managed Investment Entities	Consol. Entries	Consol. As Reported
<b>Three months ended September 30, 2010</b>				
Revenues:				
Insurance premiums	\$ 848	\$	\$	\$ 848
Investment income	296			296
Realized gains (losses) on securities	60		(3)(b)(c)	57
Realized gains(losses) on subsidiaries	(22)			(22)
Income (loss) of managed investment entities:				
Investment income		23		23
Loss on change in fair value of assets/liabilities		(4)	(b)	(4)
Other income	62		(5)(c)	57
	1,244	19	(8)	1,255
Costs and Expenses:				
Insurance benefits and expenses	919			919
Expenses of managed investment entities		23	(8)(c)	15
Interest on borrowed money and other expenses	113			113
	1,032	23	(8)	1,047
Operating earnings before income taxes	212	(4)		208
Provision for income taxes	82			82
Net earnings, including noncontrolling interests	130	(4)		126
Less: Net earnings (loss) attributable to noncontrolling interests	(2)		(4)(d)	(6)
Net Earnings Attributable to Shareholders	\$ 132	\$ (4)	\$ 4	\$ 132
<b>Nine months ended September 30, 2010</b>				
Revenues:				
Insurance premiums	\$ 2,227	\$	\$	\$ 2,227
Investment income	885			885
Realized gains (losses) on securities	82		(10)(b)(c)	72
Realized gains(losses) on subsidiaries	(22)			(22)
Income (loss) of managed investment entities:				
Investment income		68		68
		(49)	5(b)	(44)

Loss on change in fair value of assets/liabilities				
Other income	168		(13)(c)	155
	3,340	19	(18)	3,341
Costs and Expenses:				
Insurance benefits and expenses	2,454			2,454
Expenses of managed investment entities		56	(18)(c)	38
Interest on borrowed money and other expenses	336			336
	2,790	56	(18)	2,828
Operating earnings before income taxes	550	(37)		513
Provision for income taxes	199			199
Net earnings, including noncontrolling interests	351	(37)		314
Less: Net earnings (loss) attributable to noncontrolling interests	5		(37)(d)	(32)
Net Earnings Attributable to Shareholders	\$ 346	\$ (37)	\$ 37	\$ 346

(a) Includes \$3 million and \$10 million for the third quarter and nine months of 2010 in realized gains representing the change in fair value of AFG's CLO investments plus \$5 million and \$13 million for the same 2010 periods in CLO management fees earned.

(b) Elimination of the change in fair value of AFG's investments in the CLOs.

(c)

Elimination of management fees earned by AFG and distributions received on AFG's CLO investments.

- (d) Allocate losses of CLOs attributable to other debt holders to noncontrolling interests.

**Table of Contents**

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

**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 reported operating earnings before income taxes of \$208 million for the third quarter of 2010 compared to \$203 million for the 2009 third quarter. Results for the third quarter of 2010 include (i) a \$12 million improvement in the annuity and supplemental insurance operating results, (ii) \$35 million in realized gains, compared to \$4 million in the third quarter of 2009, (iii) a \$40 million decline in Specialty property and casualty underwriting results, (iv) a \$22 million decline in property and casualty investment income, (v) \$16 million in income from the sale of real estate and termination of leases by a tenant in 2010, (vi) \$8 million in income from managed investment entities, (vii) \$3 million of amortization of intangible assets compared to \$7 million in the third quarter of 2009 and (viii) \$4 million in losses of managed investment entities attributable to noncontrolling interests.

Nine month pretax operating earnings decreased \$64 million in 2010 compared to the comparable 2009 period reflecting (i) a \$21 million improvement in the annuity and supplemental insurance operating results, (ii) \$50 million in realized gains, compared to realized losses of \$22 million in the first nine months of 2009, (iii) a \$112 million decline in Specialty property and casualty underwriting results, (iv) a \$56 million decline in property and casualty investment income, (v) \$16 million in income from the sale of real estate and lease termination in the third quarter of 2010, (vi) \$23 million in income from managed investment entities, (vii) \$9 million in amortization of intangible assets compared to \$19 million in the first nine months of 2009 and (viii) \$37 million in losses of managed investment entities attributable to noncontrolling interests.

**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. Due to the decreasing size of the California workers' compensation business, this former sub-segment is included in Specialty casualty.

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.



**Table of Contents**

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

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

	Three months ended September 30,		Nine months ended September 30,	
	2010	2009	2010	2009
<b>Gross Written Premiums</b>				
Property and transportation	\$ 809	\$ 864	\$ 1,450	\$ 1,541
Specialty casualty	335	368	998	1,089
Specialty financial	129	137	379	409
Other			1	(2)
	\$ 1,273	\$ 1,369	\$ 2,828	\$ 3,037
<b>Net Written Premiums</b>				
Property and transportation	\$ 450	\$ 236	\$ 912	\$ 662
Specialty casualty	227	250	676	731
Specialty financial	10	116	212	349
Other	16	18	44	52
	\$ 703	\$ 620	\$ 1,844	\$ 1,794
<b>Combined Ratios</b>				
Property and transportation	89.9%	80.6%	90.3%	82.1%
Specialty casualty	105.6	88.6	95.7	84.7
Specialty financial	60.4	77.3	73.8	75.2
Total Specialty	90.7	82.7	88.8	81.9
Aggregate (including discontinued lines)	90.7%	82.7%	89.4%	82.2%
<b>Favorable (Unfavorable) Prior Year Development</b>				
Property and transportation	\$ (2)	\$ 8	\$ 22	\$ 47
Specialty casualty	(3)	25	47	91
Specialty financial	16	37	39	78
Other specialty	4	8	14	6
	15	78	122	222
Other (primarily asbestos and environmental charges)	(1)	(2)	(12)	(6)
	\$ 14	\$ 76	\$ 110	\$ 216

The overall decreases in gross written premiums in the third quarter and first nine months of 2010 were the result of soft market conditions and competitive pressures, depressed economic conditions and lower agricultural

commodity prices. The increase in net written premiums for the third quarter and first nine months of 2010 compared to the 2009 periods is a result of decreased cessions under the crop reinsurance agreement, partially offset by the decline in premiums resulting from a reinsurance transaction in the Specialty financial group. Excluding crop operations and the reinsurance transaction, gross and net written premiums decreased 3% and 1% in the first nine months of 2010 compared to the same period of 2009. Overall average renewal rates for the first nine months of 2010 were flat when compared with the same period of last year.

The Specialty insurance operations generated underwriting profits of \$68 million and \$214 million in the third quarter and first nine months of 2010, respectively, compared to \$108 million and \$326 million for the same periods of 2009. The reduced profit in the third quarter of 2010 compared to 2009 is primarily the result of lower favorable reserve development. Favorable reserve development was \$15 million (2 points on the combined ratio) in the third quarter of 2010 compared to \$78 million (12 points) in the 2009 third quarter.

**Table of Contents**

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

Catastrophe losses were \$6 million in the 2010 third quarter compared to \$3 million in the 2009 third quarter. The reduced profit in the first nine months of 2010 compared to 2009 reflects a \$34 million increase in catastrophe losses and a \$100 million decrease in favorable prior year reserve development.

**Property and transportation** gross written premiums for the third quarter and first nine months of 2010 declined from the 2009 periods primarily as a result of lower spring commodity prices that have the effect of lowering AFG's crop premium volume. These declines were partially offset by additional premiums from the Vanliner acquisition in July 2010. In 2010, AFG returned to historical levels of cessions under its crop reinsurance agreement, contributing to a substantial increase in this group's net written premiums for the third quarter and first nine months of 2010 when compared to the 2009 periods. Excluding crop, this group's net written premiums for the 2010 third quarter increased 27% from the comparable 2009 period, primarily as a result of additional premiums resulting from the Vanliner acquisition. This group reported an underwriting profit of \$41 million in the 2010 third quarter, \$6 million lower than the 2009 third quarter. Approximately three fourths of this underwriting profit comes from the crop business, which had an underwriting profit consistent with 2009 third quarter results. Continued competitive market conditions and lower favorable reserve development contributed to the decline in underwriting profits. This group's underwriting profit for the first nine months of 2010 decreased \$40 million from the comparable 2009 period due primarily to higher catastrophe losses and lower favorable reserve development. Catastrophe losses totaled \$42 million in the first nine months of 2010 compared to \$8 million for the comparable 2009 period.

**Specialty casualty** gross and net written premiums declined for the third quarter and first nine months of 2010 when compared to the 2009 periods due primarily to a soft pricing environment and competitive market conditions in the excess and surplus markets and California workers' compensation business, as well as volume reductions resulting from decreased demand for general liability coverages in the homebuilders' market. Growth in gross written premiums in the Marketform and environmental operations partially offset these declines. This group reported an underwriting loss of \$13 million in the 2010 third quarter, compared to an underwriting profit of \$27 million in the third quarter of 2009. The decrease in underwriting profit reflects \$39 million in adverse reserve development related to Marketform, primarily its run-off Italian public hospital business. Included in AFG's liability for unpaid losses and loss adjustment expenses at September 30, 2010, are reserves of \$131 million related to this business. Specialty casualty underwriting profit in the first nine months of 2010 was \$29 million, approximately \$77 million lower than the comparable 2009 period. Lower underwriting profits in Marketform, the general liability operations (primarily those that serve the homebuilders' industry), excess and surplus lines and the California workers' compensation businesses were offset somewhat by improvements in the targeted markets operations. Other businesses in this group produced strong underwriting profit margins, but at lower levels than in 2009.

**Specialty financial** gross written premiums decreased for the third quarter and first nine months of 2010 when compared to the 2009 periods, reflecting the decision to exit certain automotive lines of business in 2009. During the third quarter of 2010, AFG ceded the unearned premium related to these businesses in a reinsurance transaction, which was the primary cause of the

**Table of Contents**

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

decrease of \$106 million in net written premiums during the quarter. The Specialty financial group reported underwriting income of \$36 million for the third quarter of 2010, compared to \$29 million for the same period a year ago. The 2010 results reflect income of approximately \$8 million in connection with the reinsurance transaction. Additionally, higher underwriting income in the financial institutions business and run-off lease and loan operations more than offset lower favorable reserve development. Specialty financial underwriting profit was \$91 million for the nine month period, compared to \$96 million in the same 2009 period.

**Annuity and Supplemental Insurance Operations** Operating earnings before income taxes of the annuity and supplemental insurance segment increased \$12 million (26%) and \$21 million (17%) from the comparable 2009 third quarter and nine months, respectively, due primarily to higher earnings in the fixed annuity and supplemental insurance operations. For the nine month period, these higher earnings were partially offset by lower earnings in the variable annuity operations.

**Statutory Annuity Premiums** The following table summarizes AFG's annuity sales (in millions):

	Three months ended September 30,		Nine months ended September 30,	
	2010	2009	2010	2009
403(b) Fixed and Indexed Annuities:				
First Year	\$ 6	\$ 14	\$ 26	\$ 49
Renewal	35	29	122	104
Single Sum	35	31	86	103
Subtotal	76	74	234	256
Non-403(b) Indexed Annuities	221	108	504	282
Non-403(b) Fixed Annuities	232	87	501	198
Bank Fixed Annuities	170	137	366	288
Variable Annuities	17	17	56	68
Total Annuity Premiums	\$ 716	\$ 423	\$ 1,661	\$ 1,092

The increase in annuity premiums for the third quarter and first nine months of 2010 compared to the same periods in 2009 reflects increased sales of indexed and traditional fixed annuities in the non-403(b) single premium market and increased sales of traditional fixed annuities through the bank distribution channel.

**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 September 30,		Nine months ended September 30,	
	2010	2009	2010	2009
<b>Premiums</b>				
Supplemental insurance operations				
First year	\$ 14	\$ 23	\$ 52	\$ 63
Renewal	91	82	268	247
Life operations (in run-off)	7	7	20	21
	\$ 112	\$ 112	\$ 340	\$ 331

**Benefits**

Supplemental insurance operations	\$	81	\$	77	\$	250	\$	236
Life operations (in run-off)		9		9		29		32
	\$	90	\$	86	\$	279	\$	268

**Table of Contents**

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

**Investment Income** The \$5 million and \$15 million decreases in investment income for the third quarter and first nine months of 2010, respectively, compared to the same periods in 2009 reflects lower yields on fixed maturity investments partially offset by higher average invested assets. Investment income includes \$14 million and \$58 million in the third quarter and first nine months of 2010 and \$32 million and \$100 million in the third quarter and first nine months of 2009 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.

Since January 1, 2009, the amortized cost of AFG's portfolio of non-agency residential MBS decreased \$680 million due primarily to paydowns. As these securities paid down, proceeds were reinvested principally in high quality corporate bonds, highly rated commercial mortgage-backed securities, municipal bonds and dividend-paying stocks, placing downward pressure on AFG's investment portfolio yield. Management estimates that 2011 investment income in AFG's property and casualty segment will be approximately 10% to 15% lower than in 2010. The anticipated impact of the reduction in AFG's non-agency residential MBS portfolio is much less for the annuity and supplemental insurance business. In addition, lower reinvestment rates can be partially offset by the ability to reduce crediting rates. Given the growth expected in 2011 in the annuity and supplemental insurance business, this segment's investment income is expected to exceed that of the current year.

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

	Three months ended September 30,		Nine months ended September 30,	
	2010	2009	2010	2009
Realized gains (losses) before impairments:				
Disposals	\$ 50	\$ 10	\$ 95	\$ 32
Change in the fair value of derivatives	22	29	34	124
Adjustments to annuity deferred policy acquisition costs and related items	(4)	(4)	(9)	(20)
	68	35	120	136
Impairment charges:				
Securities	(15)	(36)	(68)	(209)
Adjustments to annuity deferred policy acquisition costs and related items	4	10	20	56
	(11)	(26)	(48)	(153)
	\$ 57	\$ 9	\$ 72	\$ (17)

The change in fair value of derivatives includes net gains of \$25 million and \$51 million in the third quarter and first nine months of 2010 and \$32 million and \$129 million in the third quarter and first nine months of 2009 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*.



**Table of Contents**

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

**Realized Losses on Subsidiaries** In the third quarter of 2010, AFG recorded an impairment charge of \$22 million resulting from management's decision to de-emphasize the sale of supplemental health insurance products through career agents, including the sale of a marketing subsidiary. See *Note I - Goodwill and Intangible Assets*. The \$5 million loss in the third quarter of 2009 includes a \$3 million impairment charge to write off the goodwill associated with an annuity and supplemental insurance agency subsidiary and an estimated pretax loss of \$2 million related to the October 2009 sale of a property and casualty subsidiary that represented less than 1% of AFG's assets and revenues.

**Other Income** The \$22 million decrease in other income for the first nine months of 2010 compared to the 2009 period reflects a decline in income from AFG's warranty business and lower fee income in certain other businesses, partially offset by \$16 million in income recorded during the third quarter of 2010 from the sale of real estate and the termination of leases by a tenant.

**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. The \$17 million increase in annuity benefits in the first nine months of 2010 compared to the 2009 period reflects growth in the fixed annuity business from increased premium production and strong persistency. 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.

**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 \$9 million and \$14 million increases in annuity and supplemental insurance acquisition expenses for the third quarter and first nine months of 2010, respectively, compared to the 2009 periods reflect primarily growth in the fixed annuity business. For the nine month period, the impact of this growth was partially offset by the impact of changes in the fair value of derivatives related to the indexed annuity business. The vast majority of the annuity and supplemental insurance group's DPAC asset relates to its fixed annuity, variable 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.

**Interest Charges on Borrowed Money** Interest expense increased \$9 million (19%) for the first nine months of 2010 compared to the same periods of 2009 reflecting AFG's issuance of \$350 million of 9-7/8% Senior Notes in June 2009.

**Other Operating and General Expenses** The \$29 million and \$75 million decreases in the third quarter and first nine months of 2010 compared to the 2009 periods reflect the 2009 sale of a small subsidiary, lower expenses in AFG's warranty business due to the run-off of certain products and lower amortization of intangible assets.



**Table of Contents**

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

**RECENT ACCOUNTING STANDARDS**

New accounting standards implemented in 2010, are discussed in *Note A Accounting Policies* under the following subheadings.

Accounting Standard	Note A Reference
---------------------	------------------

Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities	Managed Investment Entities
---	-----------------------------

Fair Value Measurements and Disclosures	Fair Value Measurements
---	-------------------------

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 for periods ending after December 31, 2011, with retrospective application permitted, but not required. AFG expects that this guidance will result in fewer acquisition costs being capitalized and is currently assessing the impact of adoption.

**ITEM 3**

**Quantitative and Qualitative Disclosure of Market Risk**

As of September 30, 2010, there were no material changes to the information provided in Item 7A Quantitative and Qualitative Disclosure of Market Risk of AFG's 2009 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 third fiscal quarter of 2010 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 third fiscal quarter of 2010 that has materially affected, or is reasonably likely to materially affect, AFG's internal controls over financial reporting.

**Table of Contents**

**AMERICAN FINANCIAL GROUP, INC. 10-Q**  
**PART II**  
**OTHER INFORMATION**  
**ITEM 2**

**Unregistered Sales of Equity Securities and Use of Proceeds**

**Issuer Purchases of Equity Securities** AFG repurchased shares of its common stock during the first nine months of 2010 as follows:

	Total Number  Of Shares Purchased	Average  Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares That May Yet be Purchased  Under the Plans Or Programs (a)
First Quarter	2,911,834	\$ 25.76	2,911,834	5,055,431
Second Quarter	2,730,521	\$ 27.82	2,730,521	2,324,910
July	319,700	\$ 27.75	319,700	2,005,210
August	801,398	\$ 28.93	801,398	6,203,812
September	596,657	\$ 30.07	596,657	5,607,155

(a) Represents the remaining shares that may be repurchased under the Plans authorized by AFG's Board of Directors in November 2009, February 2010 and August 2010. In August 2010, AFG's Board of Directors authorized the repurchase of five million additional shares.

**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 September 30, 2010, formatted in XBRL (Extensible Business Reporting Language): <ul style="list-style-type: none"><li>(i) Consolidated Balance Sheet</li><li>(ii) Consolidated Statement of Earnings</li><li>(iii) Consolidated Statement of Changes in Equity</li><li>(iv) Consolidated Statement of Changes in Cash Flows</li><li>(v) Notes to Consolidated Financial Statements, tagged as blocks of text</li></ul>

**Table of Contents**

**AMERICAN FINANCIAL GROUP, INC. 10-Q  
PART II  
OTHER INFORMATION**

**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.

November 8, 2010

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