AMERICAN FINANCIAL GROUP INC
Form 10-Q
November 08, 2010

**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 þ No o

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 þ No o

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 þ | Accelerated Filer o | Non-Accelerated Filer o | Smaller Reporting Company o |

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

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**

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 |
|---|---|---|
| **Assets:** | | |
| 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 |
| **Liabilities and Equity:** | | |
| 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, 2010 | Three months ended September 30, 2009 | Nine months ended September 30, 2010 | Nine months ended September 30, 2009 |
|---|---|---|---|---|
| **Revenues:** | | | | |
| 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 |
| Total revenues | 1,255 | 1,093 | 3,341 | 3,195 |
| **Costs and Expenses:** | | | | |
| 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 |
| Total costs and expenses | 1,047 | 890 | 2,828 | 2,618 |
| 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 |
| **Net Earnings Attributable to Shareholders** | $ 132 | $ 127 | $ 346 | $ 358 |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| **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 | | (8) | | (47) | | (42) | | (301) |
| Non-credit portion recognized in other comprehensive income (loss) | | (3) | | 21 | | (6) | | 148 |
| Impairment charges recognized in earnings | | (11) | | (26) | | (48) | | (153) |
| Total realized gains (losses) on securities | $ | 57 | $ | 9 | $ | 72 | $ | (17) |

3

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 | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | Common Shares | Common Stock and Capital Surplus | Retained Earnings Appro. | Retained Earnings Unappro. | Accum. Other Comp Inc.(Loss) | Total | Noncon-trolling Interests | Total Equity |
| **Balance at December 31, 2009** | 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** | | | | | | | | |
| **Balance at December 31, 2008** | 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) | |
| **Balance at September 30, 2009** | 116,533,990 | $ 1,378 | $ | $ 2,170 | $ 122 | $ 3,670 | $ 132 | $ 3,802 |

4

**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 |
|---|---|---|
| **Operating Activities:** | | |
| 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 |
| **Investing Activities:** | | |
| 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) |
| **Net Change in Cash and Cash Equivalents** | 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**

**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.

**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.

**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.

**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 |
| **Revenues** | | | | |
| 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 |

| | | | | |
|---|---|---|---|---|
| | 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 |
|---|---|---|---|---|
| **September 30, 2010** | | | | |
| 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 |
| Total AFS fixed maturities | 274 | 18,410 | 770 | 19,454 |
| 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 |
| Total assets accounted for at fair value | $ 798 | $ 21,917 | $ 834 | $ 23,549 |
| Liabilities: | | | | |
| Liabilities of managed investment entities | $ 72 | $ | $ 2,199 | $ 2,271 |
| Derivatives embedded in annuity benefits accumulated | | | 170 | 170 |
| Total liabilities accounted for at fair value | $ 72 | $ | $ 2,369 | $ 2,441 |
| **December 31, 2009** | | | | |
| 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 |
| Total assets accounted for at fair value | $ 568 | $ 16,877 | $ 795 | $ 18,240 |
| 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 | Total realized/unrealized Gains (losses) included in 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 | Total realized/unrealized gains (losses) included in 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) |

| | Consolidate | Total realized/unrealized gains (losses) included in | Other | Purchases, |
|---|---|---|---|---|

| | 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) |

| | Balance at Dec. 31, 2008 | 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 | $ 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) |

**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 |
| **Assets:** | | | | |
| 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 |
| **Liabilities:** | | | | |
| 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 Unrealized Gains | Gross Unrealized Losses | Amortized Cost | Fair Value | Gross Unrealized Gains | Gross Unrealized Losses |
| Fixed maturities: | | | | | | | | |
| U.S. Government and government agencies | $ 502 | $ 523 | $ 21 | $ | $ 599 | $ 612 | $ 14 | $ (1) |
| States, municipalities and political subdivisions | 2,443 | 2,553 | 114 | (4) | 1,764 | 1,789 | 40 | (15) |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| 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.

**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 |
| **September 30, 2010** | | | | | | |
| 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% |
| **December 31, 2009** | | | | | | |
| 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.

| | Amortized | Fair Value | |
|---|---|---|---|
| | Cost | Amount | % |
| **Maturity** | | | |
| 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 |
|---|---|---|---|
| **September 30, 2010** | | | |
| 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 |
| **December 31, 2009** | | | |
| 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 |
|---|---|---|---|---|---|---|
| **Quarter ended September 30, 2010** | | | | | | |
| Realized before impairments | $ 44 | $ 29 | $ (5) | $ (24) | $ | $ 44 |
| Realized  impairments | (14) | (1) | 4 | 4 | | (7) |
| Change in Unrealized | 498 | (7) | (177) | (110) | (4) | 200 |
| **Quarter ended September 30, 2009** | | | | | | |
| 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 |