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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION**  
**Washington, D.C. 20549**

**FORM 10-Q**

**Quarterly Report Pursuant to Section 13 or 15(d) of the  
Securities Exchange Act of 1934**

**For the Quarterly Period Ended  
June 30, 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 X 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 X 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 X Accelerated Filer    Non-Accelerated Filer    Smaller Reporting Company   

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

As of August 1, 2010, there were 108,395,325 shares of the Registrant's Common Stock outstanding, excluding 14.9 million shares owned by subsidiaries.

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**AMERICAN FINANCIAL GROUP, INC.**

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**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)**

	June 30, 2010	December 31, 2009
<b>Assets:</b>		
Cash and cash equivalents	\$ 1,011	\$ 1,120
Investments:		
Fixed maturities, available for sale at fair value (amortized cost - \$17,230 and \$16,730)	17,950	16,823
Fixed maturities, trading at fair value	384	372
Equity securities, at fair value (cost - \$259 and \$228)	438	411
Mortgage loans	489	376
Policy loans	269	276
Real estate and other investments	386	413
Total cash and investments	<u>20,927</u>	<u>19,791</u>
Recoverables from reinsurers	3,071	3,511
Prepaid reinsurance premiums	398	381
Agents' balances and premiums receivable	639	554
Deferred policy acquisition costs	1,323	1,570
Assets of managed investment entities	2,432	-
Other receivables	309	542
Variable annuity assets (separate accounts)	526	549
Other assets	693	577
Goodwill	<u>208</u>	<u>208</u>
Total assets	<u>\$30,526</u>	<u>\$27,683</u>
<b>Liabilities and Equity:</b>		
Unpaid losses and loss adjustment expenses	\$ 6,070	\$ 6,412
Unearned premiums	1,555	1,568
Annuity benefits accumulated	11,897	11,335
Life, accident and health reserves	1,629	1,603
Payable to reinsurers	277	462
Liabilities of managed investment entities	2,209	-
Long-term debt	851	828
Variable annuity liabilities (separate accounts)	526	549
Other liabilities	<u>1,081</u>	<u>1,007</u>
Total liabilities	26,095	23,764
Shareholders' Equity:		
Common Stock, no par value		
- 200,000,000 shares authorized		
- 108,647,517 and 113,386,343 shares outstanding	109	113
Capital surplus	1,190	1,231
Retained Earnings:		
Appropriated - managed investment entities	212	-
Unappropriated	2,376	2,274
Accumulated other comprehensive income, net of tax	<u>398</u>	<u>163</u>
Total shareholders' equity	4,285	3,781
Noncontrolling interests	<u>146</u>	<u>138</u>
Total equity	<u>4,431</u>	<u>3,919</u>
Total liabilities and equity	<u>\$30,526</u>	<u>\$27,683</u>

**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 June 30,		Six months ended June 30,	
	<u>2010</u>	<u>2009</u>	<u>2010</u>	<u>2009</u>
<b>Revenues:</b>				
Property and casualty insurance premiums	\$ 572	\$ 612	\$1,151	\$1,187
Life, accident and health premiums	113	110	228	219
Investment income	294	299	589	599
Realized gains (losses) on securities (*)	11	15	15	(26)
Income (loss) of managed investment entities:				
Investment income	23	-	45	-
Loss on change in fair value of assets/liabilities	(15)	-	(40)	-
Other income	<u>54</u>	<u>60</u>	<u>98</u>	<u>123</u>
Total revenues	<u>1,052</u>	<u>1,096</u>	<u>2,086</u>	<u>2,102</u>
<b>Costs and Expenses:</b>				
Property and casualty insurance:				
Losses and loss adjustment expenses	302	278	606	550
Commissions and other underwriting expenses	207	226	411	425
Annuity benefits	118	103	226	211
Life, accident and health benefits	93	91	189	182
Annuity and supplemental insurance acquisition expenses	54	46	103	98
Interest charges on borrowed money	18	13	36	29
Expenses of managed investment entities	14	-	23	-
Other operating and general expenses	<u>88</u>	<u>133</u>	<u>187</u>	<u>233</u>
Total costs and expenses	<u>894</u>	<u>890</u>	<u>1,781</u>	<u>1,728</u>
Operating earnings before income taxes	158	206	305	374
Provision for income taxes	<u>58</u>	<u>74</u>	<u>117</u>	<u>132</u>
Net earnings, including noncontrolling interests	100	132	188	242
Less: Net earnings (loss) attributable to noncontrolling interests	<u>(8)</u>	<u>5</u>	<u>(26)</u>	<u>11</u>
<b>Net Earnings Attributable to Shareholders</b>	<u>\$ 108</u>	<u>\$ 127</u>	<u>\$ 214</u>	<u>\$ 231</u>
<b>Earnings Attributable to Shareholders per Common Share:</b>				
Basic	<u>\$ .98</u>	<u>\$1.10</u>	<u>\$1.92</u>	<u>\$2.00</u>
Diluted	<u>\$ .97</u>	<u>\$1.09</u>	<u>\$1.90</u>	<u>\$1.98</u>
Average number of Common Shares:				
Basic	110.2	115.8	111.1	115.7
Diluted	111.8	116.5	112.5	116.5
Cash dividends per Common Share	\$.1375	\$.13	\$.275	\$.26
<hr/>				
(*) Consists of the following:				
Realized gains before impairments	\$ 27	\$ 66	\$ 52	\$101
Losses on securities with impairment	(20)	(70)	(34)	(254)
Non-credit portion recognized in other comprehensive income (loss)	4	19	(3)	127
Impairment charges recognized in earnings	<u>(16)</u>	<u>(51)</u>	<u>(37)</u>	<u>(127)</u>
Total realized gains (losses) on securities	<u>\$ 11</u>	<u>\$ 15</u>	<u>\$ 15</u>	<u>(\$ 26)</u>

**AMERICAN FINANCIAL GROUP, INC. 10-Q**

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

	Common Shares	Shareholders' Equity					Noncon- trolling Interests	Total Equity
		Common Stock and Capital Surplus	Retained Earnings Appro.	Retained Earnings Unappro.	Accum. Other Comp Inc. (Loss)	Total		
<b>Balance at December 31, 2009</b>	<u>113,386,343</u>	<u>\$1,344</u>	<u>\$ -</u>	<u>\$2,274</u>	<u>\$163</u>	<u>\$3,781</u>	<u>\$138</u>	<u>\$3,919</u>
Cumulative effect of accounting change	-	-	245	4	(4)	245	-	245
Net earnings	-	-	-	214	-	214	(26)	188
Other comprehensive income (loss), net of tax:								
Change in unrealized gain (loss) on securities	-	-	-	-	240	240	2	242
Change in foreign currency translation	-	-	-	-	(1)	(1)	-	(1)
Total comprehensive income						453	(24)	429
Allocation of losses of managed investment entities	-	-	(33)	-	-	(33)	33	-
Dividends on Common Stock	-	-	-	(31)	-	(31)	-	(31)
Shares issued:								
Exercise of stock options	523,671	11	-	-	-	11	-	11
Other benefit plans	371,186	5	-	-	-	5	-	5
Dividend reinvestment plan	8,672	-	-	-	-	-	-	-
Stock-based compensation expense	-	6	-	-	-	6	-	6
Shares acquired and retired	(5,642,355)	(66)	-	(85)	-	(151)	-	(151)
Other	-	(1)	-	-	-	(1)	(1)	(2)
<b>Balance at June 30, 2010</b>	<u>108,647,517</u>	<u>\$1,299</u>	<u>\$212</u>	<u>\$2,376</u>	<u>\$398</u>	<u>\$4,285</u>	<u>\$146</u>	<u>\$4,431</u>
<b>Balance at December 31, 2008</b>	<u>115,599,169</u>	<u>\$1,351</u>	<u>\$ -</u>	<u>\$1,842</u>	<u>(\$703)</u>	<u>\$2,490</u>	<u>\$112</u>	<u>\$2,602</u>
Cumulative effect of accounting change	-	-	-	17	(17)	-	-	-
Net earnings	-	-	-	231	-	231	11	242
Other comprehensive income (loss), net of tax:								
Change in unrealized gain (loss) on securities	-	-	-	-	356	356	2	358
Change in foreign currency translation	-	-	-	-	10	10	2	12
Total comprehensive income						597	15	612
Dividends on Common Stock	-	-	-	(30)	-	(30)	-	(30)
Shares issued:								
Exercise of stock options	54,350	1	-	-	-	1	-	1
Other benefit plans	169,076	2	-	-	-	2	-	2
Dividend reinvestment plan	12,065	-	-	-	-	-	-	-
Stock-based compensation expense	-	6	-	-	-	6	-	6
Other	-	1	-	-	-	1	(1)	-
<b>Balance at June 30, 2009</b>	<u>115,834,660</u>	<u>\$1,361</u>	<u>\$ -</u>	<u>\$2,060</u>	<u>(\$354)</u>	<u>\$3,067</u>	<u>\$126</u>	<u>\$3,193</u>

**AMERICAN FINANCIAL GROUP, INC. 10-Q**

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

	Six months ended June 30,	
	2010	2009
<b>Operating Activities:</b>		
Net earnings, including noncontrolling interests	\$ 188	\$ 242
Adjustments:		
Depreciation and amortization	97	115
Annuity benefits	226	211
Realized (gains) losses on investing activities	(15)	30
Net purchases of trading securities	(9)	(38)
Deferred annuity and life policy acquisition costs	(97)	(82)
Change in:		
Reinsurance and other receivables	571	734
Other assets	10	40
Insurance claims and reserves	(329)	(491)
Payable to reinsurers	(185)	(230)
Other liabilities	(28)	(48)
Other operating activities, net	32	9
Net cash provided by operating activities	<u>461</u>	<u>492</u>
<b>Investing Activities:</b>		
Purchases of:		
Fixed maturities	(2,353)	(1,733)
Equity securities	(24)	(5)
Mortgage loans	(137)	(9)
Real estate, property and equipment	(54)	(21)
Proceeds from:		
Maturities and redemptions of fixed maturities	970	901
Repayments of mortgage loans	27	2
Sales of fixed maturities	932	778
Sales of equity securities	8	26
Sales of real estate, property and equipment	1	1
Change in securities lending collateral	-	49
Managed investment entities:		
Purchases of investments	(394)	-
Proceeds from sales and redemptions of investments	441	-
Other investing activities, net	(124)	(32)
Net cash used in investing activities	<u>(707)</u>	<u>(43)</u>
<b>Financing Activities:</b>		
Annuity receipts	945	670
Annuity surrenders, benefits and withdrawals	(617)	(682)
Additional long-term borrowings	30	408
Reductions of long-term debt	(6)	(525)
Managed investment entities' retirement of liabilities	(39)	-
Change in securities lending obligation	-	(96)
Issuances of Common Stock	11	1
Repurchases of Common Stock	(151)	-
Cash dividends paid on Common Stock	(31)	(30)
Other financing activities, net	(5)	(8)
Net cash provided by (used in) financing activities	<u>137</u>	<u>(262)</u>
<b>Net Change in Cash and Cash Equivalents</b>	(109)	187
Cash and cash equivalents at beginning of period	<u>1,120</u>	<u>1,264</u>
Cash and cash equivalents at end of period	<u><u>\$1,011</u></u>	<u><u>\$1,451</u></u>

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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**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 years to conform to the current year's presentation. All significant intercompany balances and transactions have been eliminated. The results of operations of companies since their formation or acquisition are included in the consolidated financial statements. Events or transactions occurring subsequent to June 30, 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. In the first six months of 2010, AFG did not have any significant nonrecurring fair value measurements of nonfinancial assets and liabilities.

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

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

income. Mortgage and policy loans are carried primarily at the aggregate unpaid balance.

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

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



## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

assume reinsurance from other companies. Earnings on reinsurance assumed is recognized based on information received from ceding companies.

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

**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.

## 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

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

and in appropriated retained earnings - managed investment entities in the Balance Sheet. As the CLOs approach maturity (2016 to 2022), it is expected that losses attributable to noncontrolling interests will reduce appropriated retained earnings towards zero as the fair values of the assets and liabilities converge and the CLO assets are used to pay the CLO debt.

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

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

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

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

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

excess death benefits using assumptions together with a range of reasonably possible scenarios for investment fund performance that are consistent with DPAC capitalization and amortization assumptions.

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

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

**Income Taxes** Deferred income taxes are calculated using the liability method. Under this method, deferred income tax assets and liabilities are determined based on differences between financial reporting and tax bases and are measured using enacted tax rates. 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: second quarter 2010 and 2009 - 1.6 million and .7 million; first six months of 2010 and 2009 - 1.4 million and .8 million, respectively.

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: second quarter 2010 and 2009 - 3.8 million and 6.8 million; first six months of 2010 and 2009 - 4.3 million and 7.7 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** On July 1, 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. NATL funded the acquisition with cash on hand and borrowings under its bank credit facility. Assets and liabilities acquired and Vanliner's operations following the acquisition will be reflected in AFG's September 30, 2010 financial statements. 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.

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**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 June 30,		Six months ended June 30,	
	<u>2010</u>	<u>2009</u>	<u>2010</u>	<u>2009</u>
<b>Revenues</b>				
Property and casualty insurance:				
Premiums earned:				
Specialty				
Property and transportation	\$ 209	\$ 225	\$ 425	\$ 437
Specialty casualty	219	240	437	455
Specialty financial	127	131	255	261
Other	17	16	34	34
	<u>572</u>	<u>612</u>	<u>1,151</u>	<u>1,187</u>
Investment income	85	104	177	211
Realized gains	13	34	23	24
Other	21	32	36	61
	<u>691</u>	<u>782</u>	<u>1,387</u>	<u>1,483</u>
Annuity and supplemental insurance:				
Investment income	208	194	410	390
Life, accident and health premiums	113	110	228	219
Realized losses	(2)	(19)	(8)	(50)
Other	33	30	58	62
	<u>352</u>	<u>315</u>	<u>688</u>	<u>621</u>
Other	9	(1)	11	(2)
	<u>\$1,052</u>	<u>\$1,096</u>	<u>\$2,086</u>	<u>\$2,102</u>
<b>Operating Earnings Before Income Taxes</b>				
Property and casualty insurance:				
Underwriting:				
Specialty				
Property and transportation	\$ 8	\$ 26	\$ 40	\$ 74
Specialty casualty	23	38	41	79
Specialty financial	33	54	54	67
Other	4	(6)	10	(3)
Other lines	(5)	(4)	(11)	(5)
	<u>63</u>	<u>108</u>	<u>134</u>	<u>212</u>
Investment and other operating income	81	82	162	173
Realized gains	13	34	23	24
	<u>157</u>	<u>224</u>	<u>319</u>	<u>409</u>
Annuity and supplemental insurance:				
Operations	46	42	90	81
Realized losses	(2)	(19)	(8)	(50)
	<u>44</u>	<u>23</u>	<u>82</u>	<u>31</u>
Other (*)	(43)	(41)	(96)	(66)
	<u>\$ 158</u>	<u>\$ 206</u>	<u>\$ 305</u>	<u>\$ 374</u>

(\*) The second quarter and first six months of 2010 include \$7 million and \$15 million, respectively, in earnings from managed investment entities attributable to AFG shareholders and \$13 million and \$33 million, respectively, in losses of managed investment entities attributable to noncontrolling interests.

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.

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

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

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
<u>June 30, 2010</u>				
Assets:				
Available for sale ("AFS") fixed maturities:				
U.S. Government and government agencies	\$267	\$ 196	\$ -	\$ 463
States, municipalities and political subdivisions	-	2,297	21	2,318
Foreign government	-	280	-	280
Residential MBS	-	3,377	326	3,703
Commercial MBS	-	1,922	6	1,928
All other corporate	9	8,823	426	9,258
Total AFS fixed maturities	<u>276</u>	<u>16,895</u>	<u>779</u>	<u>17,950</u>
Trading fixed maturities	-	383	1	384
Equity securities	221	193	24	438
Assets of managed investment entities ("MIE")	131	2,255	46	2,432
Variable annuity assets (separate accounts) (a)	-	526	-	526
Other investments	-	46	-	46
Total assets accounted for at fair value	<u>\$628</u>	<u>\$20,298</u>	<u>\$ 850</u>	<u>\$21,776</u>
Liabilities:				
Liabilities of managed investment entities	\$ 57	\$ -	\$2,152	\$ 2,209
Derivatives embedded in annuity benefits accumulated	-	-	128	128
Total liabilities accounted for at fair value	<u>\$ 57</u>	<u>\$ -</u>	<u>\$2,280</u>	<u>\$ 2,337</u>
<u>December 31, 2009</u>				
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	<u>\$568</u>	<u>\$16,877</u>	<u>\$ 795</u>	<u>\$18,240</u>
Liabilities:				
Derivatives embedded in annuity benefits accumulated	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 113</u>	<u>\$ 113</u>

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

During the second 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 June 30, 2010, were Level 3 assets. Approximately 39% 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.



# AMERICAN FINANCIAL GROUP, INC. 10-Q

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

Changes in balances of Level 3 financial assets and liabilities during the second quarter and first six 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.

		Total realized/unrealized gains (losses) included in					
	Balance at March 31, 2010	Net income	Other comp. income (loss)	Purchases, sales, issuances and settlements	Transfer into Level 3	Transfer out of Level 3	Balance at June 30, 2010
AFS fixed maturities:							
State and municipal	\$ 6	\$ -	\$ 1	(\$ 3)	\$17	\$ -	\$ 21
Residential MBS	372	1	10	(12)	2	(47)	326
Commercial MBS	6	-	-	-	-	-	6
All other corporate	356	(11)	9	42	46	(16)	426
Trading fixed maturities	4	-	-	-	-	(3)	1
Equity securities	24	-	-	-	-	-	24
Assets of MIE	100	1	-	(10)	7	(52)	46
Liabilities of MIE	(2,178)	16	-	10	-	-	(2,152)
Embedded derivatives	(131)	13	-	(10)	-	-	(128)

		Total realized/unrealized gains (losses) included in					
	Balance at March 31, 2009	Net income	Other comp. income (loss)	Purchases, sales, issuances and settlements	Transfer into (out of) Level 3		Balance at June 30, 2009
AFS fixed maturities	\$689	\$ 4	\$15	(\$24)	\$28		\$712
Trading fixed maturities	1	-	-	-	4		5
Equity securities	28	(2)	5	(5)	-		26
Other assets	5	-	-	-	(5)		-
Embedded derivatives	(86)	(12)	-	5	-		(93)

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

		Total realized/unrealized gains (losses) included in						
	Balance at Dec. 31, 2008	Net income	Other comp. income (loss)	Purchases, sales, issuances and settlements	Transfer into (out of) Level 3			Balance at June 30, 2009
AFS fixed maturities	\$706	\$7	\$3	(\$41)	\$37			\$712
Trading fixed maturities	1	-	-	-	4			5
Equity securities	44	(9)	1	(4)	(6)			26
Other assets	5	-	-	-	(5)			-
Embedded derivatives	(96)	-	-	3	-			(93)

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**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 June 30, 2010 and December 31, 2009.

	June 30, 2010		December 31, 2009	
	Carrying Value	Fair Value	Carrying Value	Fair Value
<b>Assets:</b>				
Cash and cash equivalents	\$ 1,011	\$ 1,011	\$ 1,120	\$ 1,120
Fixed maturities	18,334	18,334	17,195	17,195
Equity securities	438	438	411	411
Mortgage loans	489	491	376	373
Policy loans	269	269	276	276
Assets of managed investment entities	2,432	2,432	-	-
Variable annuity assets (separate accounts)	526	526	549	549
<b>Liabilities:</b>				
Annuity benefits accumulated(*)	\$11,686	\$11,284	\$11,123	\$10,365
Long-term debt	851	901	828	839
Liabilities of managed investment entities	2,209	2,209	-	-
Variable annuity liabilities (separate accounts)	526	526	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 June 30, 2010, and December 31, 2009, consisted of the following (in millions):

	June 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	\$ 444	\$ 463	\$ 19	\$ -	\$ 599	\$ 612	\$ 14	(\$ 1)
States, municipalities and political subdivisions	2,255	2,318	69	(6)	1,764	1,789	40	(15)
Foreign government	271	280	9	-	261	264	4	(1)
Residential MBS	3,774	3,703	161	(232)	4,142	3,956	126	(312)
Commercial MBS	1,817	1,928	116	(5)	1,434	1,431	22	(25)
All other corporate	8,669	9,258	638	(49)	8,530	8,771	375	(134)
	<u>\$17,230</u>	<u>\$17,950</u>	<u>\$1,012</u>	<u>(\$292)</u>	<u>\$16,730</u>	<u>\$16,823</u>	<u>\$581</u>	<u>(\$488)</u>
Common stocks	\$ 134	\$ 317	\$ 185	(\$ 2)	\$ 112	\$ 298	\$187	(\$ 1)
Perpetual preferred stocks	\$ 125	\$ 121	\$ 5	(\$ 9)	\$ 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 June 30, 2010 and December 31, 2009, respectively,

# AMERICAN FINANCIAL GROUP, INC. 10-Q

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

were: residential MBS - \$272 million and \$284 million; commercial MBS - \$3 million in both periods; corporate bonds - \$1 million and \$4 million.

The following tables show gross unrealized losses (in millions) on fixed maturities and equity securities by investment category and length of time that individual securities have been in a continuous unrealized loss position at June 30, 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
<u>June 30, 2010</u>						
Fixed maturities:						
U.S. Government and government agencies	\$ -	\$ 16	99%	\$ -	\$ -	-%
States, municipalities and political subdivisions	(2)	247	99%	(4)	58	95%
Foreign government	-	-	-%	-	30	99%
Residential MBS	(27)	578	96%	(205)	900	81%
Commercial MBS	-	30	98%	(5)	83	95%
All other corporate	(12)	394	97%	(37)	498	93%
	<u>(\$41)</u>	<u>\$1,265</u>	97%	<u>(\$251)</u>	<u>\$1,569</u>	86%
Common Stocks	<u>(\$ 2)</u>	<u>\$ 29</u>	95%	<u>\$ -</u>	<u>\$ 2</u>	86%
Perpetual Preferred Stocks	<u>\$ -</u>	<u>\$ 5</u>	98%	<u>(\$ 9)</u>	<u>\$ 40</u>	82%
<u>December 31, 2009</u>						
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%
	<u>(\$67)</u>	<u>\$2,345</u>	97%	<u>(\$421)</u>	<u>\$3,192</u>	88%
Common Stocks	<u>(\$ 1)</u>	<u>\$ 3</u>	79%	<u>\$ -</u>	<u>\$ 2</u>	99%
Perpetual Preferred Stocks	<u>\$ -</u>	<u>\$ -</u>	-%	<u>(\$ 9)</u>	<u>\$ 47</u>	84%

At June 30, 2010 the gross unrealized losses on fixed maturities of \$292 million relate to approximately 850 securities. Investment grade securities (as determined by nationally recognized rating agencies) represented approximately 47% of the gross unrealized loss and 69% of the fair value. MBS comprised approximately 81% of the gross unrealized losses on the available for sale fixed maturity portfolio at June 30, 2010.

**Gross Unrealized Losses on MBS** Over 98% 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 (349 securities), approximately 44% of the unrealized losses and 62% of the fair value relate to investment grade rated securities. AFG analyzes its MBS securities for other-than-temporary impairment each quarter based upon expected future cash flows. Management estimates expected future cash flows based upon its knowledge of the MBS market, cash flow projections (which reflect loan to collateral values, subordination, vintage and geographic concentration) received from independent sources, implied cash flows inherent in security ratings and analysis of historical payment data. For the first six months of 2010, AFG recorded in earnings \$31 million in other-than-temporary impairment charges related to its residential MBS.

**Gross Unrealized Losses on All Other Corporates** For the first six months of 2010, AFG recorded in earnings \$17 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

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

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).

	<u>2010</u>	<u>2009</u>
Balance at March 31	\$122	\$61
Additional credit impairments on:		
Previously impaired securities	4	10
Securities without prior impairments	3	4
Reductions - disposals	<u>(8)</u>	<u>(8)</u>
Balance at June 30	<u>\$121</u>	<u>\$67</u>
 Balance at January 1	 \$ 99	 \$14
Additional credit impairments on:		
Previously impaired securities	23	10
Securities without prior impairments	7	51
Reductions - disposals	<u>(8)</u>	<u>(8)</u>
Balance at June 30	<u>\$121</u>	<u>\$67</u>

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

	<u>Amortized</u>	<u>Fair Value</u>	
<u>Maturity</u>	<u>Cost</u>	<u>Amount</u>	<u>%</u>
One year or less	\$ 576	\$ 584	3%
After one year through five years	4,829	5,085	28
After five years through ten years	5,069	5,426	30
After ten years	<u>1,165</u>	<u>1,224</u>	<u>7</u>
	11,639	12,319	68
MBS	<u>5,591</u>	<u>5,631</u>	<u>32</u>
Total	<u>\$17,230</u>	<u>\$17,950</u>	<u>100%</u>

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 June 30, 2010 or December 31, 2009.

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

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

	<u>Pre-tax</u>	<u>Deferred Tax and Amounts Attributable to Noncontrolling Interests</u>	<u>Net</u>
<u>June 30, 2010</u>			
Unrealized gain on:			
Fixed maturity securities	\$720	(\$255)	\$465
Equity securities	179	(63)	116
Deferred policy acquisition costs	(280)	98	(182)
Annuity benefits and other liabilities	6	(2)	4
	<u>\$625</u>	<u>(\$222)</u>	<u>\$403</u>
 <u>December 31, 2009</u>			
Unrealized gain on:			
Fixed maturity securities	\$ 93	(\$ 33)	\$ 60
Equity securities	183	(65)	118
Deferred policy acquisition costs	(18)	6	(12)
	<u>\$258</u>	<u>(\$ 92)</u>	<u>\$166</u>

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

	<u>Fixed Maturities</u>	<u>Equity Securities</u>	<u>Other(*)</u>	<u>Tax Effects</u>	<u>Noncon- trolling Interests</u>	<u>Total</u>
<u>Quarter ended June 30, 2010</u>						
Realized before impairments	\$ 28	\$ 1	(\$ 2)	(\$ 10)	(\$1)	\$ 16
Realized - impairments	(22)	(1)	7	6	-	(10)
Change in Unrealized	283	1	(110)	(61)	-	113
 <u>Quarter ended June 30, 2009</u>						
Realized before impairments	\$ 76	(\$ 2)	(\$ 8)	(\$ 23)	\$-	\$ 43
Realized - impairments	(59)	(11)	19	18	-	(33)
Change in Unrealized	848	81	(352)	(201)	(4)	372
 <u>Six months ended June 30, 2010</u>						
Realized before impairments	\$ 55	\$ 2	(\$ 5)	(\$ 18)	(\$1)	\$ 33
Realized - impairments	(50)	(3)	16	13	-	(24)
Change in Unrealized	633	(4)	(257)	(130)	(2)	240
 <u>Six months ended June 30, 2009</u>						
Realized before impairments	\$131	(\$14)	(\$ 16)	(\$ 36)	\$-	\$ 65
Realized - impairments	(154)	(19)	46	45	-	(82)
Change in Unrealized	795	63	(307)	(193)	(2)	356

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

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

Realized gains includes net gains of \$9 million and \$26 million in the second quarter and first six months of 2010 from the mark-to-market of certain MBS, primarily interest-only securities with interest rates that float inversely with short-term rates. In the 2009 periods, realized gains included \$61 million in the second quarter and \$97 million for the first six 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):

	Six months ended	
	June 30,	
	2010	2009
Fixed maturities:		
Gross gains	\$52	\$44
Gross losses	(9)	(9)
Equity securities:		
Gross gains	2	5
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.

Certain securities held in AFG's investment portfolio, primarily interest-only MBS with interest rates that float inversely with short-term rates, are considered to contain embedded derivatives. 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 \$700 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 \$19 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 June 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.

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

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

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

Derivative	Balance Sheet Line	June 30, 2010		December 31, 2009	
		Asset	Liability	Asset	Liability
MBS with embedded derivatives	Fixed maturities	\$156	\$ -	\$226	\$ -
Interest rate swaptions	Other investments	11	-	24	-
Indexed annuities					
(embedded derivative)	Annuity benefits accumulated	-	128	-	113
Equity index call options	Other investments	35	-	61	-
Reinsurance contracts					
(embedded derivative)	Other liabilities	-	15	-	5
		<u>\$202</u>	<u>\$143</u>	<u>\$311</u>	<u>\$118</u>

The following table summarizes the gain (loss) included in the Statement of Earnings for changes in the fair value of these derivatives for the first quarter and first six months of 2010 and 2009 (in millions):

Derivative	Statement of Earnings Line	Three months ended June 30,		Six months ended June 30,	
		2010	2009	2010	2009
MBS with embedded derivatives	Realized gains	\$ 9	\$61	\$26	\$97
Interest rate swaptions	Realized gains	(6)	4	(14)	5
Indexed annuities					
(embedded derivative)	Annuity benefits	13	(12)	1	-
Equity index call options	Annuity benefits	(23)	9	(12)	(2)
Reinsurance contracts					
(embedded derivative)	Investment income	(5)	(13)	(10)	(10)
		<u>(\$12)</u>	<u>\$49</u>	<u>(\$ 9)</u>	<u>\$90</u>

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

	June 30, 2010	December 31, 2009
Property and casualty insurance	\$ 332	\$ 338
Annuity and supplemental insurance:		
Policy acquisition costs	886	853
Policyholder sales inducements	211	207
Present value of future profits ("PVFP")	174	190
Impact of unrealized gains and losses on securities	(280)	(18)
Total annuity and supplemental	<u>991</u>	<u>1,232</u>
	<u>\$1,323</u>	<u>\$1,570</u>

The PVFP amounts in the table above are net of \$164 million and \$148 million of accumulated amortization at June 30, 2010 and December 31, 2009, respectively. Amortization of the PVFP was \$10 million in the second quarter and \$16 million during the first six months of 2010 and \$8 million in the second quarter and \$16 million in the first six 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.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

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.

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 \$11 million at June 30, 2010.

The revenues and expenses of the CLOs are separately identified in AFG's Statement of Earnings, after elimination of \$4 million and \$8 million in management fees and \$3 million and \$7 million in income attributable to shareholders of AFG for the second quarter and six 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 second quarter and first six months of 2010 includes \$13 million and \$33 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 losses of \$31 million in the second quarter and gains of \$50 million for the six months from changes in the fair value of CLO assets and gains of \$16 million in the second quarter and losses of \$90 million for the six 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 \$184 million at June 30, 2010. The aggregate unpaid principal balance of the CLOs' debt exceeded its fair value by \$441 million at that date. The CLO assets include \$30 million in loans (aggregate unpaid principal balance of \$67 million) for which the CLOs are not accruing interest because the loans are in default.

- I. **Amortizable Intangible Assets** Included in other assets in AFG's Balance Sheet is \$54 million at June 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 \$29 million and \$23 million, respectively. Amortization of these intangibles was \$3 million in the second quarter and \$6 million during the first six months of 2010 compared to \$6 million in the second quarter and \$12 million during the first six months of 2009.



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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

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

	June 30, 2010	December 31, 2009
<b>Direct obligations of AFG:</b>		
9-7/8% Senior Notes due June 2019	\$350	\$350
7-1/8% Senior Debentures due February 2034	115	115
Other	<u>3</u>	<u>3</u>
	<u>468</u>	<u>468</u>
<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)	46	52
National Interstate bank credit facility	45	15
American Premier Underwriters 10-7/8% Subordinated Notes due May 2011	8	8
Other	<u>1</u>	<u>1</u>
	<u>363</u>	<u>340</u>
<b>Payable to Subsidiary Trusts:</b>		
AAG Holding Variable Rate Subordinated Debentures due May 2033	<u>20</u>	<u>20</u>
	<u>\$851</u>	<u>\$828</u>

Scheduled principal payments on debt for the balance of 2010 and the subsequent five years were as follows: 2010 - \$6 million; 2011 - \$20 million; 2012 - \$57 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:

	June 30, 2010	December 31, 2009
Unsecured obligations	<u>\$740</u>	<u>\$710</u>
Obligations secured by real estate	65	66
Other secured borrowings	<u>46</u>	<u>52</u>
	<u>\$851</u>	<u>\$828</u>

At June 30, 2010, AFG had no amounts borrowed under its \$500 million revolving credit facility, which was scheduled to expire in March 2011. In August 2010, AFG replaced this facility with a three-year, \$500 million revolving credit line. Amounts borrowed under the new agreement bear interest at rates ranging from 1.75% to 3.00% (currently 2.25%) over LIBOR based on AFG's credit rating.

In June 2010, National Interstate borrowed \$30 million under its bank credit facility in connection with the July acquisition of Vanliner.

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 June 30, 2010). The loans require principal payments over the next four years.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

- K. Shareholders' Equity** AFG is authorized to issue 12.5 million shares of Voting Preferred Stock and 12.5 million shares of Nonvoting Preferred Stock, each without par value.

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

	Pretax 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	388	-	-	(136)	(3)	249
Realized gains included in net income	(15)	-	-	5	1	(9)
Foreign currency translation gains	-	(1)	-	-	-	(1)
Other	(6)	-	1	1	-	(4)
<b>Balance at June 30, 2010</b>	<u>\$ 625(b)</u>	<u>\$ -</u>	<u>(\$12)</u>	<u>(\$216)</u>	<u>\$ 1</u>	<u>\$398(b)</u>
<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	525	-	-	(184)	(2)	339
Realized losses included in net income	26	-	-	(9)	-	17
Foreign currency translation losses	-	12	-	-	(2)	10
Other	-	-	-	-	-	-
<b>Balance at June 30, 2009</b>	<u>(\$ 534)</u>	<u>(\$ 6)</u>	<u>(\$11)</u>	<u>\$191</u>	<u>\$ 6</u>	<u>(\$354)</u>

(a) Net unrealized pension and other postretirement plan benefits.

(b) Includes \$76 million at June 30, 2010, and \$98 million at December 31, 2009 in net pretax unrealized losses (\$50 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 six 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%.

Total compensation expense related to stock incentive plans of AFG and its subsidiaries was as follows: second quarter of 2010 and 2009 - \$5.3 million and \$4.5 million, respectively; six months of 2010 and 2009 - \$10.5 million and \$9.2 million, respectively.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

- L. Income Taxes** Operating income before income taxes includes \$13 million in the second quarter of 2010 and \$33 million for the first six 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 Government has 60 days to appeal the decision. AFG's liabilities for uncertain tax positions will not be adjusted until the case is "effectively settled." Resolution of the open years could result in a decrease in the liability for unrecognized tax benefits by up to \$36 million and a decrease in related accrued interest of \$11 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.

- 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.

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**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)

<u>June 30, 2010</u>	<u>AFG</u>	<u>GAFRI</u>	<u>AAG Holding</u>	<u>All Other Subs</u>	<u>Consol. Entries</u>	<u>Consolidated</u>
<b>Assets:</b>						
Cash and investments	\$ 155	\$ 43	\$ -	\$20,732	(\$ 3)	\$20,927
Recoverables from reinsurers and prepaid reinsurance premiums	-	-	-	3,469	-	3,469
Agents' balances and premiums receivable	-	-	-	639	-	639
Deferred policy acquisition costs	-	-	-	1,323	-	1,323
Assets of managed investment entities	-	-	-	2,432	-	2,432
Other assets	18	3	6	1,707	2	1,736
Investment in subsidiaries and affiliates	4,736	1,766	1,845	682	(9,029)	-
Total assets	<u>\$4,909</u>	<u>\$1,812</u>	<u>\$1,851</u>	<u>\$30,984</u>	<u>(\$9,030)</u>	<u>\$30,526</u>
<b>Liabilities and Equity:</b>						
Unpaid losses, loss adjustment expenses and unearned premiums	\$ -	\$ -	\$ -	\$ 7,625	\$ -	\$ 7,625
Annuity, life, accident and health benefits and reserves	-	-	-	13,528	(2)	13,526
Liabilities of managed investment entities	-	-	-	2,209	-	2,209
Long-term debt	468	1	219	164	(1)	851
Other liabilities	156	17	111	1,779	(179)	1,884
	624	18	330	25,305	(182)	26,095
Total shareholders' equity	4,285	1,794	1,521	5,533	(8,848)	4,285
Noncontrolling interests	-	-	-	146	-	146
Total liabilities and equity	<u>\$4,909</u>	<u>\$1,812</u>	<u>\$1,851</u>	<u>\$30,984</u>	<u>(\$9,030)</u>	<u>\$30,526</u>
<u>December 31, 2009</u>						
<b>Assets:</b>						
Cash and investments	\$ 225	\$ 33	\$ -	\$19,535	(\$ 2)	\$19,791
Recoverables from reinsurers and prepaid reinsurance premiums	-	-	-	3,892	-	3,892
Agents' balances and premiums receivable	-	-	-	554	-	554
Deferred policy acquisition costs	-	-	-	1,570	-	1,570
Other assets	14	5	6	1,831	20	1,876
Investment in subsidiaries and affiliates	4,189	1,539	1,624	687	(8,039)	-
Total assets	<u>\$4,428</u>	<u>\$1,577</u>	<u>\$1,630</u>	<u>\$28,069</u>	<u>(\$8,021)</u>	<u>\$27,683</u>
<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
Total liabilities and equity	<u>\$4,428</u>	<u>\$1,577</u>	<u>\$1,630</u>	<u>\$28,069</u>	<u>(\$8,021)</u>	<u>\$27,683</u>

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

**CONDENSED CONSOLIDATING STATEMENT OF EARNINGS**  
(In millions)

FOR THE THREE MONTHS ENDED JUNE 30, 2010	AFG	GAFRI	AAG Holding	All Other Subs	Consol. Entries	Consolidated
<b>Revenues:</b>						
Property and casualty insurance premiums	\$ -	\$ -	\$ -	\$ 572	\$ -	\$ 572
Life, accident and health premiums	-	-	-	113	-	113
Realized gains (losses)	-	-	-	11	-	11
Income of managed investment entities	-	-	-	8	-	8
Investment and other income	(1)	3	-	352	(6)	348
Equity in earnings of subsidiaries	187	41	47	-	(275)	-
	<u>186</u>	<u>44</u>	<u>47</u>	<u>1,056</u>	<u>(281)</u>	<u>1,052</u>
<b>Costs and Expenses:</b>						
Insurance benefits and expenses	-	-	-	774	-	774
Interest charges on borrowed money	13	-	7	4	(6)	18
Expenses of managed investment entities	-	-	-	14	-	14
Other expenses	7	3	1	74	3	88
	<u>20</u>	<u>3</u>	<u>8</u>	<u>866</u>	<u>(3)</u>	<u>894</u>
Operating earnings before income taxes	166	41	39	190	(278)	158
Provision (credit) for income taxes	<u>58</u>	<u>15</u>	<u>14</u>	<u>67</u>	<u>(96)</u>	<u>58</u>
Net earnings, including noncontrolling interests	108	26	25	123	(182)	100
Less: Net earnings (loss) attributable to noncontrolling interests	<u>-</u>	<u>-</u>	<u>-</u>	<u>(8)</u>	<u>-</u>	<u>(8)</u>
<b>Net Earnings Attributable to Shareholders</b>	<u>\$108</u>	<u>\$26</u>	<u>\$25</u>	<u>\$ 131</u>	<u>(\$182)</u>	<u>\$ 108</u>

FOR THE THREE MONTHS ENDED JUNE 30, 2009	AFG	GAFRI	AAG Holding	All Other Subs	Consol. Entries	Consolidated
<b>Revenues:</b>						
Property and casualty insurance premiums	\$ -	\$ -	\$ -	\$ 612	\$ -	\$ 612
Life, accident and health premiums	-	-	-	110	-	110
Realized gains (losses)	-	-	-	15	-	15
Investment and other income	1	2	-	361	(5)	359
Equity in earnings of subsidiaries	224	21	34	-	(279)	-
	<u>225</u>	<u>23</u>	<u>34</u>	<u>1,098</u>	<u>(284)</u>	<u>1,096</u>
<b>Costs and Expenses:</b>						
Insurance benefits and expenses	-	-	-	744	-	744
Interest charges on borrowed money	9	-	6	4	(6)	13
Other expenses	15	4	1	113	-	133
	<u>24</u>	<u>4</u>	<u>7</u>	<u>861</u>	<u>(6)</u>	<u>890</u>
Operating earnings before income taxes	201	19	27	237	(278)	206
Provision (credit) for income taxes	<u>74</u>	<u>7</u>	<u>9</u>	<u>85</u>	<u>(101)</u>	<u>74</u>
Net earnings, including noncontrolling interests	127	12	18	152	(177)	132
Less: Net earnings (loss) attributable to noncontrolling interests	<u>-</u>	<u>-</u>	<u>-</u>	<u>5</u>	<u>-</u>	<u>5</u>
<b>Net Earnings Attributable to Shareholders</b>	<u>\$127</u>	<u>\$12</u>	<u>\$18</u>	<u>\$ 147</u>	<u>(\$177)</u>	<u>\$ 127</u>

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

**CONDENSED CONSOLIDATING STATEMENT OF EARNINGS**  
(In millions)

FOR THE SIX MONTHS ENDED JUNE 30, 2010	AFG	GAFRI	AAG Holding	All Other Subs	Consol. Entries	Consolidated
<b>Revenues:</b>						
Property and casualty insurance premiums	\$ -	\$ -	\$ -	\$1,151	\$ -	\$1,151
Life, accident and health premiums	-	-	-	228	-	228
Realized gains (losses)	-	-	-	15	-	15
Income of managed investment entities	-	-	-	5	-	5
Investment and other income	-	5	-	693	(11)	687
Equity in earnings of subsidiaries	379	81	96	-	(556)	-
	<u>379</u>	<u>86</u>	<u>96</u>	<u>2,092</u>	<u>(567)</u>	<u>2,086</u>
<b>Costs and Expenses:</b>						
Insurance benefits and expenses	-	-	-	1,535	-	1,535
Interest charges on borrowed money	27	-	13	7	(11)	36
Expenses of managed investment entities	-	-	-	23	-	23
Other expenses	21	7	3	156	-	187
	<u>48</u>	<u>7</u>	<u>16</u>	<u>1,721</u>	<u>(11)</u>	<u>1,781</u>
Operating earnings before income taxes	331	79	80	371	(556)	305
Provision (credit) for income taxes	<u>117</u>	<u>28</u>	<u>28</u>	<u>139</u>	<u>(195)</u>	<u>117</u>
Net earnings, including noncontrolling interests	214	51	52	232	(361)	188
Less: Net earnings (loss) attributable to noncontrolling interests	-	-	-	(26)	-	(26)
<b>Net Earnings Attributable to Shareholders</b>	<u>\$214</u>	<u>\$51</u>	<u>\$ 52</u>	<u>\$ 258</u>	<u>(\$361)</u>	<u>\$ 214</u>

FOR THE SIX MONTHS ENDED JUNE 30, 2009	AFG	GAFRI	AAG Holding	All Other Subs	Consol. Entries	Consolidated
<b>Revenues:</b>						
Property and casualty insurance premiums	\$ -	\$ -	\$ -	\$1,187	\$ -	\$1,187
Life, accident and health premiums	-	-	-	219	-	219
Realized gains (losses)	-	-	-	(26)	-	(26)
Investment and other income	(2)	-	-	735	(11)	722
Equity in earnings of subsidiaries	404	30	53	-	(487)	-
	<u>402</u>	<u>30</u>	<u>53</u>	<u>2,115</u>	<u>(498)</u>	<u>2,102</u>
<b>Costs and Expenses:</b>						
Insurance benefits and expenses	-	-	-	1,466	-	1,466
Interest charges on borrowed money	21	-	13	7	(12)	29
Other expenses	18	8	2	205	-	233
	<u>39</u>	<u>8</u>	<u>15</u>	<u>1,678</u>	<u>(12)</u>	<u>1,728</u>
Operating earnings before income taxes	363	22	38	437	(486)	374
Provision (credit) for income taxes	<u>132</u>	<u>6</u>	<u>11</u>	<u>153</u>	<u>(170)</u>	<u>132</u>
Net earnings, including noncontrolling interests	231	16	27	284	(316)	242
Less: Net earnings (loss) attributable to noncontrolling interests	-	-	-	11	-	11
<b>Net Earnings Attributable to Shareholders</b>	<u>\$231</u>	<u>\$16</u>	<u>\$27</u>	<u>\$ 273</u>	<u>(\$316)</u>	<u>\$ 231</u>

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

**CONDENSED CONSOLIDATING STATEMENT OF CASH FLOWS**  
(In millions)

FOR THE SIX MONTHS ENDED JUNE 30, 2010	AFG	GAFRI	AAG Holding	All Other Subs	Consol. Entries	Consolidated
<b>Operating Activities:</b>						
Net earnings, including noncontrolling interests	\$214	\$ 51	\$ 52	\$ 232	(\$361)	\$ 188
Adjustments:						
Equity in net earnings of subsidiaries	(246)	(53)	(63)	-	362	-
Dividends from subsidiaries	204	-	16	-	(220)	-
Other operating activities, net	(61)	(2)	3	334	(1)	273
Net cash provided by (used in) operating activities	<u>111</u>	<u>(4)</u>	<u>8</u>	<u>566</u>	<u>(220)</u>	<u>461</u>
<b>Investing Activities:</b>						
Purchases of investments, property and equipment	(3)	-	-	(2,565)	-	(2,568)
Capital contributions to (returns of capital from) subsidiaries	(8)	8	-	-	-	-
Proceeds from maturities and redemptions of investments	-	4	-	993	-	997
Proceeds from sales of investments, property and equipment	-	-	-	941	-	941
Managed investment entities:						
Purchases of investments	-	-	-	(394)	-	(394)
Proceeds from sales and redemptions of investments	-	-	-	441	-	441
Other investing activities, net	-	-	-	(124)	-	(124)
Net cash provided by (used in) investing activities	<u>(11)</u>	<u>12</u>	<u>-</u>	<u>(708)</u>	<u>-</u>	<u>(707)</u>
<b>Financing Activities:</b>						
Annuity receipts	-	-	-	945	-	945
Annuity surrenders, benefits and withdrawals	-	-	-	(617)	-	(617)
Additional long-term borrowings	-	-	-	30	-	30
Reductions of long-term debt	-	-	-	(6)	-	(6)
Managed investment entities' retirement of liabilities	-	-	-	(39)	-	(39)
Issuances of Common Stock	11	-	-	-	-	11
Capital contributions from (returns of capital to) parent	-	8	(8)	-	-	-
Repurchases of Common Stock	(151)	-	-	-	-	(151)
Cash dividends paid	(31)	-	-	(220)	220	(31)
Other financing activities, net	(2)	-	-	(3)	-	(5)
Net cash provided by (used in) financing activities	<u>(173)</u>	<u>8</u>	<u>(8)</u>	<u>90</u>	<u>220</u>	<u>137</u>
<b>Net change in cash and cash equivalents</b>	<b>(73)</b>	<b>16</b>	<b>-</b>	<b>(52)</b>	<b>-</b>	<b>(109)</b>
Cash and cash equivalents at beginning of period	<u>197</u>	<u>12</u>	<u>-</u>	<u>911</u>	<u>-</u>	<u>1,120</u>
Cash and cash equivalents at end of period	<u>\$124</u>	<u>\$ 28</u>	<u>\$ -</u>	<u>\$ 859</u>	<u>\$ -</u>	<u>\$1,011</u>

**AMERICAN FINANCIAL GROUP, INC. 10-Q**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

**CONDENSED CONSOLIDATING STATEMENT OF CASH FLOWS**  
(In millions)

FOR THE SIX MONTHS ENDED JUNE 30, 2009	AFG	GAFRI	AAG Holding	All Other Subs	Consol. Entries	Consolidated
<b>Operating Activities:</b>						
Net earnings including noncontrolling interests	\$231	\$ 16	\$ 27	\$ 284	(\$316)	\$ 242
Adjustments:						
Equity in net earnings of subsidiaries	(258)	(22)	(37)	-	317	-
Dividends from subsidiaries	189	2	-	-	(191)	-
Other operating activities, net	(23)	2	(4)	276	(1)	250
Net cash provided by (used in) operating activities	<u>139</u>	<u>(2)</u>	<u>(14)</u>	<u>560</u>	<u>(191)</u>	<u>492</u>
<b>Investing Activities:</b>						
Purchases of investments, property and equipment	(3)	(1)	-	(1,764)	-	(1,768)
Capital contributions to subsidiaries	(89)	(81)	(65)	-	235	-
Proceeds from maturities and redemptions of investments	-	-	-	903	-	903
Proceeds from sales of investments, property and equipment	3	1	-	801	-	805
Other investing activities, net	-	-	-	17	-	17
Net cash provided by (used in) investing activities	<u>(89)</u>	<u>(81)</u>	<u>(65)</u>	<u>(43)</u>	<u>235</u>	<u>(43)</u>
<b>Financing Activities:</b>						
Annuity receipts	-	-	-	670	-	670
Annuity surrenders, benefits and withdrawals	-	-	-	(682)	-	(682)
Additional long-term borrowings	368	-	-	40	-	408
Reductions of long-term debt	(521)	-	-	(4)	-	(525)
Issuances of Common Stock	1	-	-	-	-	1
Capital contributions from parent	-	87	80	68	(235)	-
Cash dividends paid	(30)	-	-	(191)	191	(30)
Other financing activities, net	-	-	-	(104)	-	(104)
Net cash provided by (used in) financing activities	<u>(182)</u>	<u>87</u>	<u>80</u>	<u>(203)</u>	<u>(44)</u>	<u>(262)</u>
<b>Net change in cash and cash equivalents</b>	<b>(132)</b>	<b>4</b>	<b>1</b>	<b>314</b>	<b>-</b>	<b>187</b>
Cash and cash equivalents at beginning of period	<u>160</u>	<u>2</u>	<u>-</u>	<u>1,102</u>	<u>-</u>	<u>1,264</u>
Cash and cash equivalents at end of period	<u>\$ 28</u>	<u>\$ 6</u>	<u>\$ 1</u>	<u>\$1,416</u>	<u>\$ -</u>	<u>\$1,451</u>

**O. Subsequent Events** AFG is negotiating a reinsurance transaction in which it would cede its unearned premium in certain runoff automotive-related lines of business. If completed, the transaction would reduce AFG's third quarter property and casualty insurance net written premiums by approximately \$105 million. In addition, AFG expects to record third quarter gains in connection with the sale of certain real estate and the termination of a lease by a tenant. The completion of these transactions would result in pretax income aggregating approximately \$25 million.



## ITEM 2

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

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**FORWARD-LOOKING STATEMENTS**

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

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### **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 second quarter and first six months of 2010 were \$108 million (\$.97 per share, diluted) and \$214 million (\$1.90 per share, diluted), respectively, compared to \$127 million (\$1.09 per share, diluted) and \$231 million (\$1.98 per share, diluted) reported in the same periods of 2009. Improved results in the annuity and supplemental insurance group were more than offset by lower underwriting profit in the property and casualty insurance operations resulting from higher weather related losses and lower investment income.

#### **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.

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

#### LIQUIDITY AND CAPITAL RESOURCES

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

	June 30, 2010	December 31, 2009 2008	
Long-term debt	\$ 851	\$ 828	\$1,030
Total capital (*)	4,783	4,698	4,351
Ratio of debt to total capital:			
Including debt secured by real estate	17.8%	17.6%	23.7%
Excluding debt secured by real estate	16.7%	16.4%	22.5%

(\*) 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 2.26 for the six months ended June 30, 2010 and 2.58 for the entire year of 2009. Excluding annuity benefits, this ratio was 8.83 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.

At June 30, 2010, AFG had no amounts borrowed under its \$500 million revolving credit facility, which was scheduled to expire in March 2011. In August 2010, AFG replaced this facility with a three-year, \$500 million revolving credit line.

During the first six months of 2010, AFG repurchased 5.6 million shares of its Common Stock for \$151 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. 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 June 30, 2010 is included in other

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

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 \$45 million outstanding under this agreement at June 30, 2010, including \$30 million borrowed in June in connection with the Vanliner acquisition.

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 June 30, 2010, contained \$18.0 billion in "Fixed maturities" classified as available for sale and \$438 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, \$384 million in fixed maturities were classified as trading with changes in unrealized holding gains or losses included in investment income.

Fair values for AFG's portfolio are determined by AFG's internal investment professionals using data from nationally recognized pricing services as well as non-binding broker quotes. Fair values of equity securities are generally based on closing prices obtained from the pricing services. For mortgage-backed securities ("MBS"), which comprise approximately 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

## AMERICAN FINANCIAL GROUP, INC. 10-Q

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

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 June 30, 2010 (dollars in millions). Increases or decreases from the 100 basis points illustrated would be approximately proportional.

Fair value of fixed maturity portfolio	\$18,334
Pretax impact on fair value of 100 bps increase in interest rates	(\$ 843)
Pretax impact as % of total fixed maturity portfolio	(4.6%)

Approximately 91% of the fixed maturities held by AFG at June 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 \$5.7 billion investment in MBS represented approximately one-third of its fixed maturities at June 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.

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## 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 June 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 Cost	Fair Value	Fair Value as % of Cost	Unrealized Gain (Loss)	% Rated Investment Grade
Residential:					
Agency-backed	\$ 442	\$ 465	105%	\$23	100%
Non-agency prime	2,214	2,225	100	11	84
Alt-A	802	724	90	(78)	55
Subprime	331	302	91	(29)	54
Other	29	31	107	2	52
Commercial	1,852	1,963	106	111	100
	<u>\$5,670</u>	<u>\$5,710</u>	101%	<u>\$40</u>	85%

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 June 30, 2010, 98% (based on statutory carrying value of \$5.5 billion) of AFG's MBS securities had an NAIC designation of 1 or 2.

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**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 June 30, 2010, is shown in the following table (dollars in millions). Approximately \$375 million of available for sale "Fixed maturities" and \$49 million of "Equity securities" had no unrealized gains or losses at June 30, 2010.

	<u>Securities With Unrealized Gains</u>	<u>Securities With Unrealized Losses</u>
<u>Available for Sale Fixed Maturities</u>		
Fair value of securities	\$14,741	\$2,834
Amortized cost of securities	\$13,729	\$3,126
Gross unrealized gain (loss)	\$ 1,012	(\$ 292)
Fair value as % of amortized cost	107%	91%
Number of security positions	2,896	845
Number individually exceeding \$2 million gain or loss	72	12
Concentration of gains (losses) by type or industry (exceeding 5% of unrealized):		
Mortgage-backed securities	\$ 277	(\$ 237)
Banks, savings and credit institutions	78	(17)
States and municipalities	69	(6)
Gas and electric services	138	(2)
Percentage rated investment grade	96%	69%
<u>Equity Securities</u>		
Fair value of securities	\$ 313	\$ 76
Cost of securities	\$ 123	\$ 87
Gross unrealized gain (loss)	\$ 190 (*)	(\$ 11)
Fair value as % of cost	254%	87%
Number of security positions	51	48
Number individually exceeding \$2 million gain or loss	3	1

(\*) Includes \$161 million on AFG's investment in Verisk Analytics, Inc.

The table below sets forth the scheduled maturities of AFG's available for sale fixed maturity securities at June 30, 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.

<u>Maturity</u>	<u>Securities With Unrealized Gains</u>	<u>Securities With Unrealized Losses</u>
One year or less	3%	1%
After one year through five years	30	20
After five years through ten years	34	16
After ten years	<u>7</u>	<u>7</u>
	74	44
Mortgage-backed securities (average life of approximately four years)	<u>26</u>	<u>56</u>
	<u>100%</u>	<u>100%</u>

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

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

	Aggregate Fair Value	Aggregate Unrealized Gain (Loss)	Fair Value as % of Cost Basis
<u>Fixed Maturities at June 30, 2010</u>			
<b>Securities with unrealized gains:</b>			
Exceeding \$500,000 (614 issues)	\$ 7,725	\$ 725	110%
\$500,000 or less (2,282 issues)	7,016	287	104
	<u>\$14,741</u>	<u>\$1,012</u>	107%
<b>Securities with unrealized losses:</b>			
Exceeding \$500,000 (184 issues)	\$ 1,051	(\$ 204)	84%
\$500,000 or less (661 issues)	1,783	(88)	95
	<u>\$ 2,834</u>	<u>(\$ 292)</u>	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.

	Aggregate Fair Value	Aggregate Unrealized Loss	Fair Value as % of Cost Basis
<u>Securities with Unrealized Losses at June 30, 2010</u>			
<b>Investment grade fixed maturities with losses for:</b>			
Less than one year (204 issues)	\$1,000	(\$ 29)	97%
One year or longer (264 issues)	949	(109)	90
	<u>\$1,949</u>	<u>(\$138)</u>	93%
<b>Non-investment grade fixed maturities with losses for:</b>			
Less than one year (129 issues)	\$ 265	(\$ 12)	96%
One year or longer (248 issues)	620	(142)	81
	<u>\$ 885</u>	<u>(\$154)</u>	85%
<b>Common equity securities with losses for:</b>			
Less than one year (26 issues)	\$ 29	(\$ 2)	94%
One year or longer (2 issues)	2	-	86
	<u>\$ 31</u>	<u>(\$ 2)</u>	94%
<b>Perpetual preferred equity securities with losses for:</b>			
Less than one year (6 issues)	\$ 5	\$ -	98%
One year or longer (14 issues)	40	(9)	82
	<u>\$ 45</u>	<u>(\$ 9)</u>	83%

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."*

Based on its analysis, management believes (i) AFG will recover its cost basis in the securities with unrealized losses and (ii) that AFG has the ability and intent to hold the securities until they recover in value and, at June 30, 2010, had no intent to sell them. Although AFG has the ability to continue holding its



## AMERICAN FINANCIAL GROUP, INC. 10-Q

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

investments with unrealized losses, its intent to hold them may change due to deterioration in the issuers' creditworthiness, decisions to lessen exposure to a particular issuer or industry, asset/liability management decisions, market movements, changes in views about appropriate asset allocation or the desire to offset taxable realized gains. Should AFG's ability or intent change with regard to a particular security, a charge for impairment would likely be required. While it is not possible to accurately predict if or when a specific security will become impaired, charges for other-than-temporary impairment could be material to results of operations in future periods. Significant declines in the fair value of AFG's investment portfolio could have a significant adverse effect on AFG's liquidity.

**Uncertainties** Management believes that the areas posing the greatest risk of material loss are the adequacy of its insurance reserves and contingencies arising out of its former railroad and manufacturing operations. 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 June 30, 2010, the property and casualty group's A&E reserves were \$360 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 8.5 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.

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## 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

June 30, 2010	Before CLO Consolidation	Managed Investment Entities	Consol. Entries	Consolidated As Reported
<b>Assets:</b>				
Cash and other investments	\$20,938	\$ -	(\$11) (a)	\$20,927
Assets of managed investment entities	-	2,432	-	2,432
Other assets	7,167	-	-	7,167
	<u>\$28,105</u>	<u>\$2,432</u>	<u>(\$11)</u>	<u>\$30,526</u>
<b>Liabilities:</b>				
Unpaid losses, loss adjustment expenses and unearned premiums	\$ 7,625	\$ -	\$ -	\$ 7,625
Annuity, life, accident and health benefits and reserves	13,526	-	-	13,526
Liabilities of managed investment entities	-	2,220	(11) (a)	2,209
Long-term debt and other liabilities	2,735	-	-	2,735
	<u>23,886</u>	<u>2,220</u>	<u>(11)</u>	<u>26,095</u>
<b>Shareholders' Equity:</b>				
Common Stock and Capital surplus	1,299	-	-	1,299
Retained earnings:				
Appropriated - managed investment entities	-	212	-	212
Unappropriated	2,376	-	-	2,376
Accumulated other comprehensive income	398	-	-	398
	<u>4,073</u>	<u>212</u>	<u>-</u>	<u>4,285</u>
Noncontrolling interests	146	-	-	146
	<u>4,219</u>	<u>212</u>	<u>-</u>	<u>4,431</u>
	<u>\$28,105</u>	<u>\$2,432</u>	<u>(\$11)</u>	<u>\$30,526</u>

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

# AMERICAN FINANCIAL GROUP, INC. 10-Q

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

### CONDENSED CONSOLIDATING STATEMENT OF EARNINGS

Three months ended June 30, 2010	Before CLO Consolidation (a)	Managed Investment Entities	Consol. Entries	Consol. As Reported
Revenues:				
Insurance premiums	\$ 685	\$ -	\$ -	\$ 685
Investment income	294	-	-	294
Realized gains (losses) on securities	14	-	(3) (b) (c)	11
Income (loss) of managed investment entities:				
Investment income	-	23	-	23
Loss on change in fair value of assets/liabilities	-	(16)	1 (b)	(15)
Other income	58	-	(4) (c)	54
	<u>1,051</u>	<u>7</u>	<u>(6)</u>	<u>1,052</u>
Costs and Expenses:				
Insurance benefits and expenses	774	-	-	774
Expenses of managed investment entities	-	20	(6) (c)	14
Interest on borrowed money and other expenses	106	-	-	106
	<u>880</u>	<u>20</u>	<u>(6)</u>	<u>894</u>
Operating earnings before income taxes	171	(13)	-	158
Provision for income taxes	58	-	-	58
Net earnings, including noncontrolling interests	113	(13)	-	100
Less: Net earnings (loss) attributable to noncontrolling interests	5	-	(13) (d)	(8)
Net Earnings Attributable to Shareholders	<u>\$ 108</u>	<u>\$ (13)</u>	<u>\$ 13</u>	<u>\$ 108</u>
Six months ended June 30, 2010				
Revenues:				
Insurance premiums	\$1,379	\$ -	\$ -	\$1,379
Investment income	589	-	-	589
Realized gains (losses) on securities	22	-	(7) (b) (c)	15
Income (loss) of managed investment entities:				
Investment income	-	45	-	45
Loss on change in fair value of assets/liabilities	-	(45)	5 (b)	(40)
Other income	106	-	(8) (c)	98
	<u>2,096</u>	<u>-</u>	<u>(10)</u>	<u>2,086</u>
Costs and Expenses:				
Insurance benefits and expenses	1,535	-	-	1,535
Expenses of managed investment entities	-	33	(10) (c)	23
Interest on borrowed money and other expenses	223	-	-	223
	<u>1,758</u>	<u>33</u>	<u>(10)</u>	<u>1,781</u>
Operating earnings before income taxes	338	(33)	-	305
Provision for income taxes	117	-	-	117
Net earnings, including noncontrolling interests	221	(33)	-	188
Less: Net earnings (loss) attributable to noncontrolling interests	7	-	(33) (d)	(26)
Net Earnings Attributable to Shareholders	<u>\$ 214</u>	<u>(\$ 33)</u>	<u>\$ 33</u>	<u>\$ 214</u>

(a) Includes \$3 million and \$7 million for the second quarter and six months of 2010 in realized gains representing the change in fair value of AFG's CLO investments plus \$4 million and \$8 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.

**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 \$158 million for the second quarter of 2010 compared to \$206 million for the 2009 second quarter. Results for the second quarter of 2010 include (i) \$13 million in losses of managed investment entities attributable to noncontrolling interests, (ii) \$11 million in realized gains on securities, compared to \$15 million in the second quarter of 2009, (iii) a \$44 million decline in Specialty property and casualty underwriting results, and (iv) a \$4 million improvement in the annuity and supplemental insurance operating results.

Six month pretax operating earnings decreased \$69 million in 2010 compared to the 2009 period reflecting (i) a \$72 million decline in Specialty property and casualty underwriting results, (ii) \$33 million in losses of managed investment entities attributable to noncontrolling interest, (iii) \$15 million in realized gains on securities, compared to realized losses of \$26 million in the first six months of 2009 and (iv) a \$9 million improvement in the annuity and supplemental insurance operating results.

**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.

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## 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 June 30,		Six months ended June 30,	
	2010	2009	2010	2009
<u>Gross Written Premiums</u>				
Property and transportation	\$364	\$361	\$ 641	\$ 677
Specialty casualty	316	352	663	721
Specialty financial	128	137	250	272
Other	3	-	1	(2)
	<u>\$811</u>	<u>\$850</u>	<u>\$1,555</u>	<u>\$1,668</u>
<u>Net Written Premiums</u>				
Property and transportation	\$246	\$224	\$ 462	\$ 426
Specialty casualty	211	233	449	481
Specialty financial	104	114	202	233
Other	14	18	28	34
	<u>\$575</u>	<u>\$589</u>	<u>\$1,141</u>	<u>\$1,174</u>
<u>Combined Ratios</u>				
Property and transportation	96.0%	88.2%	90.5%	83.0%
Specialty casualty	89.5	84.2	90.5	82.7
Specialty financial	74.0	58.7	78.8	74.1
Total Specialty	88.1	81.6	87.5	81.7
Aggregate (including discontinued lines)	89.1%	82.3%	88.4%	82.0%
<u>Favorable (Unfavorable) Prior Year Development</u>				
Property and transportation	\$15	\$11	\$ 24	\$ 39
Specialty casualty	31	34	50	66
Specialty financial	13	40	23	41
Other specialty	3	(5)	10	(2)
	<u>62</u>	<u>80</u>	<u>107</u>	<u>144</u>
Other (primarily asbestos and environmental charges)	(5)	(3)	(11)	(4)
	<u>\$57</u>	<u>\$77</u>	<u>\$ 96</u>	<u>\$140</u>

The overall decreases in gross and net written premiums in the second quarter and first six months of 2010 were the result of soft market conditions and competitive pressures, depressed economic conditions and lower spring commodity prices. The decreases in net written premiums were partially offset by higher levels of retained crop premium as cessions under the crop quota share agreement returned to historical levels (approximately 50%). Excluding crop operations, gross and net written premiums decreased 6% in the first six months of 2010 compared to the same period of 2009. Overall average renewal rates for the first six 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 \$145 million in the second quarter and first six months of 2010, compared to \$112 million and \$217 million for the same periods of 2009. The reduced profit in the second quarter of 2010 is primarily the result of \$34 million (6 points on the combined ratio) in catastrophe losses compared to \$11 million (2 points) in the 2009 second quarter. Favorable reserve development was \$62 million (11 points) in the second quarter of 2010 compared to \$80 million (13 points) in the 2009 second quarter. The reduced profit in the first six months of 2010 compared to 2009 reflects a \$31 million increase in catastrophe losses and a \$37 million decrease in favorable prior year reserve development.

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

**Property and transportation** gross written premiums for the second quarter and first six months of 2010 were impacted by a competitive pricing environment as well as lower spring commodity prices that have the effect of lowering the crop premium volume. Net written premiums increased for the second quarter and first six months of 2010 due primarily to higher levels of retained crop premium as cessions under the crop reinsurance agreement returned to historical levels. Excluding crop, this group's net written premiums for the first six months of 2010 decreased by 1% from the comparable prior year period. This group reported an underwriting profit of \$8 million in the second quarter of 2010, compared to \$26 million in the second quarter of 2009. The decrease is largely attributable to a \$22 million increase in catastrophe losses due primarily to hail storms in Oklahoma during the month of May. Increased favorable reserve development partially offset the higher catastrophe losses. Underwriting profit in the first six months of 2010 decreased approximately \$34 million from the comparable 2009 period.

**Specialty casualty** gross and net written premiums decreased for the second quarter and first six months of 2010 due primarily to a soft pricing environment and competitive market conditions in the excess and surplus markets and California workers' compensation businesses. Volume reductions resulting from decreased demand for general liability coverages in the homebuilders market contributed to these declines. Growth in the Marketform, executive liability and environmental operations partially offset these declines. This group reported an underwriting profit of \$23 million in the second quarter of 2010, compared to \$38 million in the second quarter of 2009. Underwriting profit in the first six months of 2010 decreased approximately \$37 million from the comparable 2009 period. Both periods include the results of the California Workers' Compensation business, which was previously reported as a separate operating group. Lower underwriting results in 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 executive liability and targeted markets operations. Many businesses in this group produced strong underwriting profit margins, but at lower levels than in 2009.

**Specialty financial** gross and net written premiums decreased for the second quarter and first six months of 2010 compared to 2009 due to economic conditions affecting the automotive industry and a decision to exit certain automotive lines of business during 2009. This group reported an underwriting profit of \$33 million in the second quarter of 2010 compared to \$54 million in the same 2009 period. Improvements in used car sales prices resulted in \$13 million in favorable reserve development in this group's automobile residual value insurance "RVI" business, compared to \$39 million of favorable development in the second quarter of 2009. The remaining \$23 million of Canadian RVI reserves relate to leases that terminate through the end of 2010. Specialty Financial underwriting profits were \$54 million for the six month period, compared to \$67 million in the same 2009 period. All other lines of business in this group produced underwriting profits, but at lower levels than the prior year.

**Annuity and Supplemental Insurance Operations** Operating earnings before income taxes of the annuity and supplemental insurance segment increased \$4 million (10%) and \$9 million (11%) from the comparable 2009 second quarter and six months, respectively, due primarily to higher earnings in the fixed annuity and supplemental insurance operations, partially offset by lower earnings in the variable annuity operations.

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

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

	Three months ended June 30,		Six months ended June 30,	
	2010	2009	2010	2009
403(b) Fixed and Indexed Annuities:				
First Year	\$ 9	\$ 19	\$ 20	\$ 35
Renewal	45	39	87	75
Single Sum	26	35	51	72
Subtotal	80	93	158	182
Non-403(b) Indexed Annuities	151	82	283	174
Non-403(b) Fixed Annuities	167	70	269	111
Bank Fixed Annuities	142	133	196	151
Variable Annuities	19	25	39	51
Total Annuity Premiums	<u>\$559</u>	<u>\$403</u>	<u>\$945</u>	<u>\$669</u>

The increase in annuity premiums for the second quarter and first six 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, partially offset by lower overall sales of 403(b) annuities.

**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 June 30,		Six months ended June 30,	
	2010	2009	2010	2009
<u>Premiums</u>				
Supplemental insurance operations				
First year	\$ 17	\$ 21	\$ 38	\$ 40
Renewal	90	83	177	165
Life operations (in run-off)	6	6	13	14
	<u>\$113</u>	<u>\$110</u>	<u>\$228</u>	<u>\$219</u>
<u>Benefits</u>				
Supplemental insurance operations	\$ 83	\$ 81	\$169	\$159
Life operations (in run-off)	10	10	20	23
	<u>\$ 93</u>	<u>\$ 91</u>	<u>\$189</u>	<u>\$182</u>

**Investment Income** The \$5 million and \$10 million decreases in investment income for the second quarter and first six 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 \$18 million and \$44 million in the second quarter and first six months of 2010 and \$32 million and \$68 million in the second quarter and first six 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 \$748 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 and municipal bonds, placing downward pressure on AFG's investment portfolio yield.

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

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

	Three months ended June 30,		Six months ended June 30,	
	2010	2009	2010	2009
Realized gains (losses) before impairments:				
Disposals	\$26	\$ 17	\$45	\$ 22
Change in the fair value of derivatives	3	57	12	95
Adjustments to annuity deferred policy acquisition costs and related items	(2)	(8)	(5)	(16)
	<u>27</u>	<u>66</u>	<u>52</u>	<u>101</u>
Impairment charges:				
Securities	(23)	(70)	(53)	(173)
Adjustments to annuity deferred policy acquisition costs and related items	7	19	16	46
	<u>(16)</u>	<u>(51)</u>	<u>(37)</u>	<u>(127)</u>
	<u>\$11</u>	<u>\$ 15</u>	<u>\$15</u>	<u>(\$ 26)</u>

The change in fair value of derivatives includes net gains of \$9 million and \$26 million in the second quarter and first six months of 2010 and \$61 million and \$97 million in the second quarter and first six 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."

**Other Income** The \$6 million and \$25 million decreases in other income for the second quarter and first six months of 2010, respectively, compared to the 2009 periods reflect a decline in income from AFG's warranty business and lower fee income in certain other businesses.

**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 \$15 million increase in annuity benefits in the second quarter of 2010 compared to the 2009 quarter reflects the impact of lower interest rates and poor stock market performance on the fair value of the derivatives related to the indexed annuity business, as well as growth in the fixed annuity business.

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



## AMERICAN FINANCIAL GROUP, INC. 10-Q

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

supplemental insurance acquisition expenses also include amortization of the present value of future profits of businesses acquired ("PVFP"). The \$8 million increase in annuity and supplemental insurance acquisition expenses for the second quarter of 2010 compared to the 2009 quarter reflects the impact of poor stock market performance on variable annuities, as well as growth in the fixed annuity business, 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 \$5 million (38%) during the second quarter and \$7 million (24%) during the first six months of 2010 compared to the same periods of 2009 as the impact of the June 2009 issuance of \$350 million in 9-7/8% Senior Notes more than offset the effect of lower average indebtedness.

**Other Operating and General Expenses** The \$45 million decrease in the second quarter of 2010 compared to the 2009 quarter reflects the 2009 sale of a small subsidiary, lower expenses in AFG's warranty business due to the runoff of certain products, lower expenses related to extra-contractual obligations in the property and casualty business and reduced expense associated with the Company stock portion of certain employee retirement plans.

#### RECENT ACCOUNTING STANDARDS

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

<u>Accounting Standard</u>	<u>Note A Reference</u>
Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities	Managed Investment Entities
Fair Value Measurements and Disclosures	Fair Value Measurements

ITEM 3

**Quantitative and Qualitative Disclosure of Market Risk**

As of June 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 second 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 second fiscal quarter of 2010 that has materially affected, or is reasonably likely to materially affect, AFG's internal controls over financial reporting.

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## 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 six 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
April	43,300	\$28.78	43,300	5,012,131
May	1,763,094	\$27.70	1,763,094	3,249,037
June	924,127	\$28.00	924,127	2,324,910

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

### ITEM 6

#### Exhibits

<u>Number</u>	<u>Exhibit Description</u>
12	Computation of ratios of earnings to fixed charges.
31(a)	Certification of the Co-Chief Executive Officer pursuant to section 302(a) of the Sarbanes-Oxley Act of 2002.
31(b)	Certification of the Co-Chief Executive Officer pursuant to section 302(a) of the Sarbanes-Oxley Act of 2002.
31(c)	Certification of the Chief Financial Officer pursuant to section 302(a) of the Sarbanes-Oxley Act of 2002.
32	Certification of the Co-Chief Executive Officers and Chief Financial Officer pursuant to section 906 of the Sarbanes-Oxley Act of 2002.
101	The following financial information from American Financial Group's Form 10-Q for the quarter ended June 30, 2010, formatted in XBRL (Extensible Business Reporting Language): (i) Consolidated Balance Sheet (ii) Consolidated Statement of Earnings (iii) Consolidated Statement of Changes in Equity (iv) Consolidated Statement of Changes in Cash Flows (v) Notes to Consolidated Financial Statements, tagged as blocks of text

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**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.

August 9, 2010

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