AMERICAN FINANCIAL GROUP INC
Form 10-Q
August 08, 2011

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

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

For the Quarterly Period Ended June 30, 2011

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

Incorporated under the Laws of Ohio **IRS Employer I.D. No. 31-1544320**
One East Fourth Street, Cincinnati, Ohio 45202
(513) 579-2121

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

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

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

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

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

As of August 1, 2011, there were 100,516,338 shares of the Registrant s Common Stock outstanding, excluding 14.9 million shares owned by subsidiaries.

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

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

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

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

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

Earnings Attributable to Shareholders per Common Share:								
Basic	$	.53	$	.98	$	1.33	$	1.92
Diluted	$	.52	$	.97	$	1.31	$	1.90
Average number of Common Shares:								
Basic		102.7		110.2		103.7		111.1
Diluted		104.4		111.8		105.3		112.5
Cash dividends per Common Share	$	.1625	$	.1375	$	.325	$	.275

(*) Consists of the following:

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

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

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

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

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

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

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

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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 periods to conform to the current year s presentation. All significant intercompany balances and transactions have been eliminated. The results of operations of companies since their formation or acquisition are included in the consolidated financial statements. Events or transactions occurring subsequent to June 30, 2011, and prior to the filing date of this Form 10-Q, have been evaluated for potential recognition or disclosure herein.

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

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

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

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

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

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

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

Goodwill Goodwill represents the excess of cost of subsidiaries over AFG s equity in their underlying net assets. Goodwill is not amortized, but is subject to an impairment test at least annually.

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

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

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

Deferred Policy Acquisition Costs (DPAC) Policy acquisition costs (principally commissions, premium taxes and other marketing and underwriting expenses) related to the production of new business are deferred. DPAC also includes capitalized costs associated with sales inducements offered to fixed annuity policyholders such as enhanced interest rates and premium and persistency bonuses.

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

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

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

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

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

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

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED

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

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

Because AFG has no right to use the CLO assets and no obligation to pay the CLO liabilities, the assets and liabilities of the CLOs are shown separately in AFG s Balance Sheet. As permitted under accounting guidance adopted on January 1, 2010, the assets and liabilities of the CLOs are included in AFG s Balance Sheet at fair value. Prior to adoption of this guidance, the CLOs were not consolidated. Upon adoption of the guidance, the $261 million excess of fair value of the CLOs assets over the fair value of the liabilities was recorded in AFG s Balance Sheet as appropriated retained earnings managed investment entities, representing the cumulative effect of adopting the new guidance that ultimately will inure to the benefit of the CLO debt holders.

AFG has elected the fair value option for reporting on the CLO assets and liabilities to improve the transparency of financial reporting related to the CLOs. The net gain or loss from accounting for the CLO assets and liabilities at fair value subsequent to January 1, 2010, is separately presented in AFG s Statement of Earnings. CLO earnings attributable to AFG s shareholders represent the change in fair value of AFG s investments in the CLOs and management fees earned. All other CLO earnings (losses) are not attributable to AFG s shareholders and will ultimately inure to the benefit of the other CLO debt holders. As a result, such CLO earnings (losses) are included in net earnings (loss) attributable to noncontrolling interests in AFG s Statement of Earnings and in appropriated retained earnings managed investment entities in the Balance Sheet. As the CLOs approach maturity (2016 to 2022), it is expected that losses attributable to noncontrolling interests will reduce appropriated retained earnings towards zero as the fair values of the assets and liabilities converge and the CLO assets are used to pay the CLO debt.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED

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

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

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

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

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

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

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

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

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

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

Income Taxes Deferred income taxes are calculated using the liability method. Under this method, deferred income tax assets and liabilities are determined based on differences between financial reporting and tax bases and are measured using enacted tax rates. Deferred tax assets are recognized if it is more likely than not that a benefit will be realized.

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

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

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

Earnings Per Share Basic earnings per share is calculated using the weighted average number of shares of common stock outstanding during the period. The calculation of diluted earnings per share includes adjustments to weighted average common shares related to stock-based compensation plans: second quarter 2011 and 2010 1.7 million and 1.6 million; first six months of 2011 and 2010 1.6 million and 1.4 million, respectively.

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

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

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

B. Acquisition

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

C. Segments of Operations

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

AFG reports its property and casualty insurance business in the following Specialty sub-segments: (i) Property and transportation, which includes physical damage and liability coverage for buses, trucks and recreational vehicles, inland and ocean marine, agricultural-related products and other property coverages, (ii) Specialty casualty, which includes primarily excess and surplus, general liability, executive liability, umbrella and excess liability, customized programs for small to mid-sized businesses and California workers compensation, and (iii) Specialty financial, which includes risk management insurance programs for lending and leasing institutions (including collateral and mortgage protection insurance), surety and fidelity products and trade credit insurance. AFG s annuity and supplemental insurance business markets traditional fixed and indexed annuities and a variety of supplemental insurance products such as Medicare supplement. AFG s reportable segments and their components were determined based primarily upon similar economic characteristics, products and services.

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

	Three months ended June 30, 2011	Three months ended June 30, 2010	Six months ended June 30, 2011	Six months ended June 30, 2010
Revenues				
Property and casualty insurance:				
Premiums earned:				
Specialty				
Property and transportation	$ 274	$ 209	$ 529	$ 425
Specialty casualty	219	219	435	437
Specialty financial	100	127	212	255
Other	16	17	32	34
Total premiums earned	609	572	1,208	1,151
Investment income	75	85	148	177
Realized gains (losses)	32	13	32	23
Other income	20	21	35	36
Total property and casualty insurance	736	691	1,423	1,387
Annuity and supplemental insurance:				
Investment income	230	208	456	410
Life, accident and health premiums	107	113	217	228
Realized gains (losses)	(13)	(2)	(16)	(8)
Other income	27	33	50	58
Total annuity and supplemental insurance	351	352	707	688
Other	6	9	2	11
Total revenues	$ 1,093	$ 1,052	$ 2,132	$ 2,086
Operating Earnings Before Income Taxes				
Property and casualty insurance:				
Underwriting income (loss):				
Specialty				
Property and transportation	$	$ 8	$ 33	$ 40
Specialty casualty	21	23	23	41
Specialty financial	13	33	23	54
Other	5	4	6	10
Other lines (a)	(50)	(5)	(50)	(11)
Total underwriting	(11)	63	35	134
Investment and other income, net	70	81	138	162
Realized gains (losses)	32	13	32	23

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

(a) Includes a second quarter 2011 special charge of $50 million to increase asbestos and environmental reserves.

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

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

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

D. Fair Value Measurements

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

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

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

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

AFG s management is responsible for the valuation process and uses data from outside sources (including nationally recognized pricing services and broker/dealers) in establishing fair value. Valuation techniques utilized by pricing services and prices obtained from external sources are reviewed by AFG s internal investment professionals who are familiar with the securities being priced and the markets in which they trade to ensure the fair value determination is representative of an exit price. To validate the appropriateness of the prices obtained, these investment managers consider widely published indices (as benchmarks), recent trades, changes in interest rates, general economic conditions and the credit quality of the specific issuers.

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

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

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

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

During the second quarter of 2011, there were no significant transfers between Level 1 and Level 2. Approximately 3% of the total assets measured at fair value on June 30, 2011, were Level 3 assets. Approximately 33% of these assets were MBS whose fair values were determined primarily using non-binding broker quotes; the balance was primarily private placement debt securities whose fair values were determined internally using significant unobservable inputs, including the evaluation of underlying collateral and issuer creditworthiness, as well as certain Level 2 inputs such as comparable yields and multiples on similar publicly traded issues. The fair values of the liabilities of managed investment entities were determined using non-binding broker quotes, which were reviewed by AFG s investment professionals.

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Changes in balances of Level 3 financial assets and liabilities during the second quarter and first six months of 2011 and 2010 are presented below (in millions). The transfers into and out of Level 3 were due to changes in the availability of market observable inputs. All transfers are reflected in the table at fair value as of the end of the reporting period.

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

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

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

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

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	Balance at Dec. 31, 2009	Consolidate Managed Inv. Entities	Total realized/unrealized gains (losses) included in Net income	Total realized/unrealized gains (losses) included in Other comp. income (loss)	Purchases, sales, issuances and settlements	Transfer into Level 3	Transfer out of Level 3	Balance at 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)

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

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

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

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

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E. Investments

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

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

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

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The following tables show gross unrealized losses (in millions) on fixed maturities and equity securities by investment category and length of time that individual securities have been in a continuous unrealized loss position at June 30, 2011 and December 31, 2010.

	Less Than Twelve Months			Twelve Months or More		
	Unrealized Loss	Fair Value	Fair Value as % of Cost	Unrealized Loss	Fair Value	Fair Value as % of Cost
June 30, 2011						
Fixed maturities:						
U.S. Government and government agencies	$	$ 38	100%	$	$	%
States, municipalities and political subdivisions	(12)	665	98%	(3)	46	94%
Foreign government		1	100%			%
Residential MBS	(20)	629	97%	(97)	466	83%
Commercial MBS	(1)	102	99%	(1)	11	92%
All other corporate	(19)	1,066	98%	(8)	116	94%
Total fixed maturities	$ (52)	$ 2,501	98%	$ (109)	$ 639	85%
Common Stocks	$ (5)	$ 47	90%	$	$	%
Perpetual Preferred Stocks	$	$ 5	100%	$ (4)	$ 41	91%
December 31, 2010						
Fixed maturities:						
U.S. Government and government agencies	$ (1)	$ 86	99%	$	$	%
States, municipalities and political subdivisions	(38)					