

AMERICAN FINANCIAL GROUP INC  
Form 10-Q  
August 08, 2007

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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, 2007

Commission File

No. 1-13653

AMERICAN FINANCIAL GROUP, INC.

Incorporated under  
the Laws of Ohio

IRS Employer I.D.  
No. 31-1544320

One East Fourth Street, Cincinnati, Ohio 45202  
(513) 579-2121

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

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

Large Accelerated Filer  Accelerated Filer  Non-Accelerated Filer

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

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As of August 1, 2007, there were 119,315,627 shares of the Registrant's Common Stock outstanding, excluding 14.9 million shares owned by subsidiaries.

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AMERICAN FINANCIAL GROUP, INC.

TABLE OF CONTENTS

|   | <u>Page</u> |
|---|-------------|
| <b><u>Part I - Financial Information</u></b>                                |             |
| <u>Item 1 - Financial Statements:</u>                                       |             |
| <u>Consolidated Balance Sheet</u>   | <u>2</u>    |
| <u>Consolidated Statement of Earnings</u>                                   | <u>3</u>    |
| <u>Consolidated Statement of Changes in Shareholders' Equity</u>            | <u>4</u>    |
| <u>Consolidated Statement of Cash Flows</u>                                 | <u>5</u>    |
| <u>Notes to Consolidated Financial Statements</u>                           | <u>6</u>    |
| <u>Item 2 - Management's Discussion and Analysis of Financial Condition</u> |             |
| <u>and Results of Operations</u>  | <u>16</u>   |
| <u>Item 3 - Quantitative and Qualitative Disclosure of Market Risk</u>      | <u>28</u>   |
|   | <u>28</u>   |

Item 4 - Controls and Procedures

**Part II - Other Information**

Item 2 - Unregistered Sales of Equity Securities and Use of Proceeds 29

Item 4 - Submission of Matters to a Vote of Security Holders 29

Item 5 - Other Information 29

Item 6 - Exhibits 30

Signature 30

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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)

|  | <u>June 30,</u><br><u>2007</u> | <u>December 31,</u><br><u>2006</u> |
|--|--------------------------------|------------------------------------|
| Assets:  |                                |                                    |
| Cash and cash equivalents  | \$ 679.5                       | \$ 1,329.0                         |
| Investments:   |                                |                                    |
| Fixed maturities:  |                                |                                    |
| Available for sale - at fair value<br>(amortized cost - \$15,499.2 and \$14,663.0) | 15,237.3                       | 14,624.3                           |
| Trading - at fair value  | 279.8                          | 276.4                              |
| Equity securities - at fair value<br>(cost - \$803.0 and \$606.4)                  | 920.5                          | 729.4                              |
| Mortgage loans   | 299.1                          | 264.5                              |

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|   |                   |                   |
|---|-------------------|-------------------|
| Policy loans  | 269.2             | 267.1             |
|   | <u>274.6</u>      | <u>248.3</u>      |
| Real estate and other investments                             |                   |                   |
| Total cash and investments                                    | 17,960.0          | 17,739.0          |
| Recoverables from reinsurers and prepaid reinsurance premiums | 3,660.9           | 3,625.2           |
| Agents' balances and premiums receivable                      | 700.1             | 599.4             |
| Deferred policy acquisition costs                             | 1,342.6           | 1,266.9           |
| Other receivables   | 318.1             | 425.0             |
| Variable annuity assets (separate accounts)                   | 717.2             | 700.5             |
| Prepaid expenses and other assets                             | 820.5             | 577.3             |
|   | <u>176.5</u>      | <u>167.8</u>      |
| Goodwill  |                   |                   |
|   | <u>\$25,695.9</u> | <u>\$25,101.1</u> |
| Liabilities and Capital:                                      |                   |                   |
| Unpaid losses and loss adjustment expenses                    | \$ 6,077.9        | \$ 6,027.7        |
| Unearned premiums   | 1,782.1           | 1,653.9           |
| Annuity benefits accumulated                                  | 9,829.1           | 9,456.7           |
| Life, accident and health reserves                            | 1,446.4           | 1,414.7           |
| Payable to reinsurers   | 302.9             | 314.9             |
| Long-term debt  | 897.3             | 921.0             |
| Variable annuity liabilities (separate accounts)              | 717.2             | 700.5             |
| Accounts payable, accrued expenses and other liabilities      | <u>1,384.4</u>    | <u>1,398.9</u>    |
| Total liabilities   | 22,437.3          | 21,888.3          |
| Minority interest   | 288.5             | 283.9             |
| Shareholders' Equity:   |                   |                   |
| Common Stock, no par value                                    |                   |                   |
| - 200,000,000 shares authorized                               |                   |                   |
| - 119,266,409 and 119,303,928 shares outstanding              | 119.3             | 119.3             |
| Capital surplus   | 1,236.8           | 1,220.5           |
| Retained earnings   | 1,655.7           | 1,533.6           |
| Accumulated other comprehensive income (loss), net of tax     | <u>(41.7)</u>     | <u>55.5</u>       |
| Total shareholders' equity                                    | <u>2,970.1</u>    | <u>2,928.9</u>    |
|   | <u>\$25,695.9</u> | <u>\$25,101.1</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<br><u>June 30,</u> |              | Six months ended<br><u>June 30,</u> |                |
|---|---------------------------------------|--------------|-------------------------------------|----------------|
|   | <u>2007</u>                           | <u>2006</u>  | <u>2007</u>                         | <u>2006</u>    |
| Income:   |                                       |              |                                     |                |
| Property and casualty insurance premiums                | \$ 633.5                              | \$615.0      | \$1,273.3                           | \$1,194.1      |
| Life, accident and health premiums                      | 103.4                                 | 75.6         | 210.0                               | 157.6          |
| Investment income                                       | 249.0                                 | 233.5        | 494.8                               | 465.4          |
| Realized gains (losses) on securities                   | 14.0                                  | (7.5)        | 18.7                                | 22.3           |
| Other income  | <u>92.0</u>                           | <u>78.4</u>  | <u>174.7</u>                        | <u>151.7</u>   |
|   | 1,091.9                               | 995.0        | 2,171.5                             | 1,991.1        |
| Costs and Expenses:                                     |                                       |              |                                     |                |
| Property and casualty insurance:                        |                                       |              |                                     |                |
| Losses and loss adjustment expenses                     | 354.8                                 | 373.4        | 681.7                               | 710.5          |
| Commissions and other underwriting expenses             | 208.5                                 | 168.6        | 418.7                               | 341.9          |
| Annuity benefits  | 90.4                                  | 84.0         | 179.2                               | 166.8          |
| Life, accident and health benefits                      | 85.4                                  | 66.6         | 170.9                               | 134.2          |
| Annuity and supplemental insurance acquisition expenses | 40.7                                  | 30.2         | 85.2                                | 63.8           |
| Interest charges on borrowed money                      | 17.7                                  | 17.1         | 35.8                                | 35.6           |
| Other operating and general expenses                    | <u>181.9</u>                          | <u>108.5</u> | <u>292.6</u>                        | <u>221.9</u>   |
|   | <u>979.4</u>                          | <u>848.4</u> | <u>1,864.1</u>                      | <u>1,674.7</u> |
| Operating earnings before income taxes                  | 112.5                                 | 146.6        | 307.4                               | 316.4          |
| Provision for income taxes                              | <u>36.8</u>                           | <u>41.7</u>  | <u>109.1</u>                        | <u>101.3</u>   |

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|   |                 |                 |                 |                  |
|---|-----------------|-----------------|-----------------|------------------|
| Net operating earnings                          | 75.7            | 104.9           | 198.3           | 215.1            |
| Minority interest expense                       | (10.1)          | (7.2)           | (18.6)          | (15.0)           |
| Equity in net losses of investee,<br>net of tax | <u> (.3</u>     | <u> (.5</u>     | <u> (.8</u>     | <u> (1.0</u>     |
|   | )               | )               | )               | )                |
| Earnings from continuing operations             | 65.3            | 97.2            | 178.9           | 199.1            |
| Discontinued operations, net of tax             | <u> 1.7</u>     | <u> 25.7</u>    | <u> 1.7</u>     | <u> 25.3</u>     |
| Net Earnings                                    | <u> \$ 67.0</u> | <u> \$122.9</u> | <u> \$180.6</u> | <u> \$ 224.4</u> |
| Basic earnings per Common Share:                |                 |                 |                 |                  |
| Continuing operations                           | \$ .55          | \$ .83          | \$1.50          | \$1.70           |
| Discontinued operations                         | <u> .01</u>     | <u> .21</u>     | <u> .01</u>     | <u> .21</u>      |
| Net earnings available to Common Shares         | <u> \$ .56</u>  | <u> \$1.04</u>  | <u> \$1.51</u>  | <u> \$1.91</u>   |
| Diluted earnings per Common Share:              |                 |                 |                 |                  |
| Continuing operations                           | \$ .53          | \$ .81          | \$1.46          | \$1.66           |
| Discontinued operations                         | <u> .01</u>     | <u> .21</u>     | <u> .01</u>     | <u> .21</u>      |
| Net earnings available to Common Shares         | <u> \$ .54</u>  | <u> \$1.02</u>  | <u> \$1.47</u>  | <u> \$1.87</u>   |
| Average number of Common Shares:                |                 |                 |                 |                  |
| Basic   | 119.6           | 117.8           | 119.5           | 117.6            |
| Diluted   | 122.4           | 120.4           | 122.4           | 119.7            |
| Cash dividends per Common Share                 | \$ .10          | \$ .092         | \$ .20          | \$ .183          |

3

AMERICAN FINANCIAL GROUP, INC. 10-Q

AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY (unaudited)

(Dollars in Millions)

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|   | Common<br><u>Shares</u> | Common Stock<br>and Capital<br><u>Surplus</u> | Retained<br><u>Earnings</u> | Accumulated<br>Other<br>Comprehensive<br><u>Income (Loss)</u> | <u>Total</u>     |
|---|-------------------------|---|-----------------------------|---|------------------|
| Balance at December 31, 2006                                      | 119,303,928             | \$1,339.8                                     | \$1,533.6                   | \$ 55.5   | \$2,928.9        |
| Cumulative effect of accounting change                            | -                       | -   | (14.9)                      | -   | (14.9)           |
| Net earnings  | -                       | -   | 180.6                       | -   | 180.6            |
| Other comprehensive income, net of tax:                           |                         |   |                             |   |                  |
| Change in unrealized gain (loss)                                  |                         |   |                             |   |                  |
| on securities   | -                       | -   | -                           | (112.7)   | (112.7)          |
| Change in foreign currency translation                            | -                       | -   | -                           | 12.7  | 12.7             |
| Change in unrealized pension and other<br>postretirement benefits | -                       | -   | -                           | 2.8   | <u>2.8</u>       |
| <br>Total comprehensive income                                    |                         |   |                             |   | <br>83.4         |
| Dividends on Common Stock   | -                       | -   | (23.9)                      | -   | (23.9)           |
| Shares issued:  |                         |   |                             |   |                  |
| Exercise of stock options   | 590,784                 | 13.9  | -                           | -   | 13.9             |
| Dividend reinvestment plan  | 80,224                  | 2.7   | -                           | -   | 2.7              |
| Employee stock purchase plan                                      | 17,488                  | .6  | -                           | -   | .6               |
| Deferred compensation distributions                               | 31,863                  | 1.1   | -                           | -   | 1.1              |
| Directors fees paid in stock                                      | 9,965                   | .4  | -                           | -   | .4               |
| Stock incentive plan  | 114,594                 | 3.9   | -                           | -   | 3.9              |
| Other stock-based compensation expense                            | -                       | 5.1   | -                           | -   | 5.1              |
| Shares acquired and retired                                       | (855,939)               | (9.6)   | (19.1)                      | -   | (28.7)           |
| Shares tendered in option exercises                               | (26,498)                | (.3)  | (.6)                        | -   | (.9)             |
| Capital transactions of subsidiaries                              | <u>-</u>                | <u>(1.5)</u>                                  | <u>-</u>                    | <u>-</u>  | <u>(1.5)</u>     |
|   | )                       |   |                             | )   |                  |
| Balance at June 30, 2007  | <u>119,226,409</u>      | <u>\$1,356.1</u>                              | <u>\$1,655.7</u>            | <u>(\$ 41.7)</u>  | <u>\$2,970.1</u> |
| <br>Balance at December 31, 2005                                  | 117,101,271             | \$1,272.7                                     | \$1,134.1                   | \$ 50.8   | \$2,457.6        |
| Net earnings  | -                       | -   | 224.4                       | -   | 224.4            |
| Other comprehensive loss,<br>net of tax:                          |                         |   |                             |   |                  |
| Change in unrealized gain on securities                           | -                       | -   | -                           | (210.5)   | <u>(210.5)</u>   |

|                                      |                    |                  |                  |                  |                  |
|--------------------------------------|--------------------|------------------|------------------|------------------|------------------|
| Total comprehensive income           |                    |                  |                  |                  | 13.9             |
| Dividends on Common Stock            | -                  | -                | (21.6)           | -                | (21.6)           |
| Shares issued:                       |                    |                  |                  |                  |                  |
| Exercise of stock options            | 767,547            | 17.4             | -                | -                | 17.4             |
| Dividend reinvestment plan           | 99,539             | 2.6              | -                | -                | 2.6              |
| Employee stock purchase plan         | 18,766             | .5               | -                | -                | .5               |
| Deferred compensation distributions  | 63,162             | 1.6              | -                | -                | 1.6              |
| Directors fees paid in stock         | 12,780             | .4               | -                | -                | .4               |
| Shares tendered in option exercises  | (192,021)          | (2.1)            | (3.3)            | -                | (5.4)            |
| Stock-based compensation expense     | -                  | 3.3              | -                | -                | 3.3              |
| Capital transactions of subsidiaries | -                  | 1.2              | -                | -                | 1.2              |
| Other                                | <u>-</u>           | <u>3.8</u>       | <u>-</u>         | <u>-</u>         | <u>3.8</u>       |
| Balance at June 30, 2006             | <u>117,871,044</u> | <u>\$1,301.4</u> | <u>\$1,333.6</u> | <u>(\$159.7)</u> | <u>\$2,475.3</u> |

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4

AMERICAN FINANCIAL GROUP, INC. 10-Q

AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF CASH FLOWS (UNAUDITED)

(In Millions)

|  | Six months ended |             |
|--|------------------|-------------|
|  | <u>June 30,</u>  |             |
|  | <u>2007</u>      | <u>2006</u> |
| Operating Activities:                                    |                  |             |
| Net earnings   | \$ 180.6         | \$ 224.4    |
| Adjustments:   |                  |             |
| Equity in net losses of investee                         | .8               | 1.0         |
| Minority interest  | 18.9             | 20.8        |
| Depreciation and amortization                            | 95.2             | 77.3        |
| Annuity benefits   | 179.2            | 166.8       |
| Realized gains on investing activities                   | (35.1)           | (84.1)      |
| Net purchases/sales of trading securities                | (41.0)           | (13.0)      |
| Deferred annuity and life policy acquisition costs       | (103.2)          | (66.9)      |
| Decrease (increase) in reinsurance and other receivables | (19.7)           | 29.3        |

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|   |              |              |
|---|--------------|--------------|
| Decrease (increase) in other assets       | (195.1)      | 17.7         |
| Increase in insurance claims and reserves | 209.2        | 243.0        |
| Decrease in payable to reinsurers         | (12.0)       | (34.9)       |
| Decrease in other liabilities             | (15.6)       | (82.8)       |
| Other, net                                | <u>9.7</u>   | <u>11.7</u>  |
| Net cash provided by operating activities | <u>271.9</u> | <u>510.3</u> |

Investing Activities

|   |                  |                |
|---|------------------|----------------|
| :   |                  |                |
| Purchases of and additional investments in:                   |                  |                |
| Fixed maturity investments                                    | (1,946.4)        | (1,635.4)      |
| Equity securities   | (224.4)          | (125.8)        |
| Subsidiaries  | (1.7)            | (2.6)          |
| Real estate, property and equipment                           | (13.8)           | (23.2)         |
| Maturities and redemptions of fixed maturity investments      | 667.3            | 499.5          |
| Sales of:   |                  |                |
| Fixed maturity investments                                    | 433.4            | 824.3          |
| Equity securities   | 97.6             | 113.8          |
| Subsidiary  | -                | 37.5           |
| Real estate, property and equipment                           | 22.9             | 34.4           |
| Decrease in securities lending collateral                     | 5.2              | -              |
| Cash and cash equivalents of businesses acquired or sold, net | -                | 100.0          |
| Increase in other investments                                 | <u>(54.8)</u>    | <u>(29.9)</u>  |
|   | )                | )              |
| Net cash used in investing activities                         | <u>(1,014.7)</u> | <u>(207.4)</u> |
|   | )                | )              |

Financing Activities

|   |             |                |
|---|-------------|----------------|
| :   |             |                |
| Annuity receipts                                    | 817.4       | 515.4          |
| Annuity surrenders, benefits and withdrawals        | (691.7)     | (592.0)        |
| Net transfers from variable annuity assets          | 31.9        | 7.2            |
| Additional long-term borrowings                     | 92.0        | 26.2           |
| Reductions of long-term debt                        | (117.3)     | (130.7)        |
| Decrease in securities lending obligation           | (5.2)       | -              |
| Issuances of Common Stock                           | 13.3        | 11.8           |
| Repurchases of Common Stock                         | (28.7)      | -              |
| Cash dividends paid on Common Stock                 | (21.2)      | (19.0)         |
| Other, net  | <u>2.8</u>  | <u>1.6</u>     |
| Net cash provided by (used in) financing activities | <u>93.3</u> | <u>(179.5)</u> |

|  |                 |                 |
|--|-----------------|-----------------|
|  | )               |                 |
| Net Increase (Decrease) in Cash and Cash Equivalents | (649.5)         | 123.4           |
| Cash and cash equivalents at beginning of period     | <u>1,329.0</u>  | <u>471.9</u>    |
| Cash and cash equivalents at end of period           | <u>\$ 679.5</u> | <u>\$ 595.3</u> |

5

## AMERICAN FINANCIAL GROUP, INC. 10-Q

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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INDEX TO NOTES

|  |   |
|--|---|
| A. <u>Accounting Policies</u>                  | E. <u>Long-Term Debt</u>                |
| B. <u>Acquisitions and Sales of Operations</u> | F. <u>Shareholders' Equity</u>          |
| C. <u>Segments of Operations</u>               | G. <u>Income Taxes</u>                  |
| D. <u>Deferred Policy Acquisition Costs</u>    | H. <u>Discontinued Operations</u>       |
|  | I. <u>Commitments and Contingencies</u> |

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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. All acquisitions have been treated as purchases. The results of operations of companies since their formation or acquisition are included in the consolidated financial statements.

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.

### Stock Split

All shares and per share amounts (except number of shares authorized and the stated value of \$1.00 per share) presented in the financial statements have been adjusted for all periods presented to reflect the effect of a three-for-two Common Stock split on December 15, 2006.

### Investments

Fixed maturity and equity securities classified as "available for sale" are reported at fair value with unrealized gains and losses reported as a separate component of shareholders' equity. Fixed maturity and equity securities classified as "trading" are reported at fair value with changes in unrealized holding gains or losses during the period included in investment income. Loans receivable are carried primarily at the aggregate unpaid balance. Premiums and discounts on fixed maturity securities are amortized using the interest method; mortgage-backed securities 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, a provision for impairment is charged to earnings (included in realized gains) and the cost basis of that investment is reduced.

Certain AFG subsidiaries loan fixed maturity and equity securities to other institutions for short periods of time. The borrower is required to provide collateral on which AFG earns investment income, net of a fee to the lending agent. AFG records the collateral held (included in other assets) and the liability to return the collateral (included in other liabilities) in its

Balance Sheet at fair value. The securities loaned remain a recorded asset on AFG's Balance Sheet. At June 30, 2007, the fair value of collateral held was approximately \$154 million and the fair value of securities loaned plus accrued interest was approximately \$151 million.

### Derivatives

Derivatives included in AFG's Balance Sheet are recorded at fair value and consist primarily of (i) the interest component of certain life reinsurance contracts (included in other liabilities), (ii) interest rate swaps (included in debt), and (iii) 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 current earnings.

The terms of the interest rate swaps match those of the debt; therefore, the swaps are considered to be (and are accounted for as) 100% effective fair value hedges. Both the swaps and the hedged debt are adjusted for changes in fair value by offsetting amounts. Accordingly, since the swaps are included with long-term debt in the Balance Sheet, the only effect on AFG's financial statements is that the interest expense on the hedged debt is recorded based on the variable rate.

### 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. Income on reinsurance assumed is recognized based on reports received from ceding companies.

Subsidiaries of AFG's 81%-owned subsidiary, Great American Financial Resources, Inc. ("GAFRI"), cede life insurance policies to a third party on a funds withheld basis whereby GAFRI retains 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. GAFRI 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. GAFRI classifies the securities related to these transactions 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. 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 would first be recognized by charging any unamortized acquisition costs to expense to the extent required to eliminate the deficiency. If the premium deficiency was greater than unamortized acquisition costs, a liability would be 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. 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. 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 (Loss), 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. DPAC includes the present value of future profits on business in force of insurance companies acquired by GAFRI, which 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. The present value of future profits 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.

#### 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.

### **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 GAFRI earns a fee. Investment funds are selected and may be changed only by the policyholder, who retains all investment risk.

### **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 reports 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.

### **Minority Interest**

For Balance Sheet purposes, minority interest represents the interests of noncontrolling shareholders in consolidated entities. In the Statement of Earnings, minority interest expense represents such shareholders' interest in the earnings of those entities.

### **Income Taxes**

AFG files consolidated federal income tax returns that include all U.S. subsidiaries that are at least 80%-owned, except for certain life insurance subsidiaries that have been owned for less than five years.

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. Interest and penalties related to these unrecognized tax benefits are recognized as a component of tax expense.

AFG implemented FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes (an interpretation of FASB Statement No. 109)" ("FIN 48") on January 1, 2007. FIN 48 sets forth criteria for recognition and measurement of tax positions taken or expected to be taken in a tax return. FIN 48 requires that companies recognize the impact of a tax position if that position is more

AMERICAN FINANCIAL GROUP, INC. 10-Q

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

likely than not of being sustained on audit, based on the technical merits of the position. FIN 48 also provides guidance on derecognition, classification, interest, penalties, accounting in interim periods and disclosure. The cumulative effect of applying FIN 48 was recorded as a reduction to retained earnings at January 1, 2007 and is shown separately in the Statement of Changes in Shareholders' Equity. See *Note G - "Income Taxes."*

Stock-Based Compensation

All share-based grants are recognized as compensation expense based on their calculated "fair value" at the date of grant over the vesting period. AFG uses the Black-Scholes pricing model to measure the fair value of employee stock options. See *Note F - "Shareholders' Equity"* for further information on stock options.

Benefit Plans

AFG provides retirement benefits to qualified employees of participating companies through the AFG 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 (in millions):

|   | <u>Three months ended</u><br><u>June 30,</u> |             | <u>Six months ended</u><br><u>June 30,</u> |             |
|---|--|-------------|--|-------------|
|   | <u>2007</u>                                  | <u>2006</u> | <u>2007</u>                                | <u>2006</u> |
| Adjustments to net earnings:            |  |             |  |             |
| Dilution of majority-owned subsidiaries | (\$0.4)                                      | (\$0.4)     | (\$0.9)                                    | (\$0.5)     |

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|   |     |     |       |     |
|---|-----|-----|-------|-----|
| Assumed issuance of shares under deferred compensation plan | -   | 0.2 | (0.1) | -   |
| Adjustments to weighted average common shares:              |     |     |       |     |
| Stock-based compensation plans                              | 2.8 | 2.6 | 2.9   | 2.1 |

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.

**Acquisitions and Sales of Operations**

**Great American Financial Resources**

In May 2007, AFG and GAFRI (an 81%-owned subsidiary) entered into a definitive merger agreement under which GAFRI would acquire all of the outstanding GAFRI shares not currently held by AFG at a price of \$24.50 per share in cash, for a total purchase price of approximately \$225 million. AFG

10

AMERICAN FINANCIAL GROUP, INC. 10-Q

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

expects the merger to be completed in September 2007 and expects that GAFRI will use excess capital plus borrowings from AFG to fund the transaction.

**Ceres Group, Inc.**

In August 2006, GAFRI acquired Ceres Group, Inc. ("Ceres") for \$204.4 million in cash (plus approximately \$8 million in direct transaction costs). In connection with the acquisition, Ceres reinsured 100% of its major medical business and 50% of its in-force senior business, which focuses primarily on sales of Medicare supplement and other supplemental insurance products to the senior market. As a result of the reinsurance, Ceres has exited the major medical business. Following the acquisition, Ceres paid a \$60 million return of capital distribution to GAFRI. In the second quarter of 2007, goodwill related to Ceres increased by \$8.8 million due to a refinement of the purchase price allocation.

**Chatham Bars Inn**

In June 2006, GAFRI sold a resort hotel located on Cape Cod for \$166 million. See Note H - "Discontinued Operations."

Old Standard Life Fixed Annuity Business

In January 2006, GAFRI acquired the fixed annuity business written by Old Standard Life Insurance Company through a reinsurance transaction. As part of the assets transferred in the reinsurance transaction, GAFRI acquired the stock of Old West Annuity and Life Insurance Company. In total, the transaction resulted in an increase of approximately \$280 million in both annuity benefits accumulated and cash and investments.

Great American Life Assurance Company of Puerto Rico

GAFRI completed the sale of its subsidiary, Great American Life Assurance Company of Puerto Rico ("GAPR"), for \$37.5 million in cash in January 2006. GAFRI acquired GAPR in 1997 for approximately \$50 million. During 2005, GAFRI received \$100 million in dividends from GAPR and recorded a \$3.4 million loss on the anticipated sale.

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.

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 and professional liability and customized programs for small to mid-sized businesses, (iii) Specialty financial, which includes risk management insurance programs for lending and leasing institutions, surety and fidelity products and trade credit insurance, and (iv) California workers' compensation. 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.

AMERICAN FINANCIAL GROUP, INC. 10-Q

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

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

| Three months ended |             | Six months ended |             |
|--------------------|-------------|------------------|-------------|
| <u>June 30,</u>    |             | <u>June 30,</u>  |             |
| <u>2007</u>        | <u>2006</u> | <u>2007</u>      | <u>2006</u> |

Revenues

Property and casualty insurance:

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|                                     |                  |                |                  |                  |
|-------------------------------------|------------------|----------------|------------------|------------------|
| Premiums earned:                    |                  |                |                  |                  |
| Specialty                           |                  |                |                  |                  |
| Property and transportation         | \$ 238.8         | \$225.1        | \$ 467.4         | \$ 425.1         |
| Specialty casualty                  | 212.2            | 197.3          | 423.4            | 385.5            |
| Specialty financial                 | 112.4            | 97.5           | 226.8            | 193.7            |
| California workers' compensation    | 58.7             | 75.8           | 121.5            | 153.1            |
| Other                               | 11.3             | 18.8           | 33.9             | 35.6             |
| Other lines                         | <u>.1</u>        | <u>.5</u>      | <u>.3</u>        | <u>1.1</u>       |
|                                     | 633.5            | 615.0          | 1,273.3          | 1,194.1          |
| Investment income                   | 86.8             | 81.1           | 170.7            | 160.7            |
| Realized gains                      | 7.0              | 1.3            | 9.7              | 27.3             |
| Other                               | <u>48.9</u>      | <u>50.9</u>    | <u>99.3</u>      | <u>97.9</u>      |
|                                     | 776.2            | 748.3          | 1,553.0          | 1,480.0          |
| Annuity and supplemental insurance: |                  |                |                  |                  |
| Investment income                   | 159.5            | 150.4          | 318.3            | 300.8            |
| Life, accident and health premiums  | 103.4            | 75.5           | 210.0            | 157.6            |
| Realized gains (losses)             | 8.1              | (8.8)          | 10.0             | (5.1)            |
| Other                               | <u>31.8</u>      | <u>21.7</u>    | <u>58.9</u>      | <u>46.2</u>      |
|                                     | 302.8            | 238.8          | 597.2            | 499.5            |
| Other                               | <u>12.9</u>      | <u>7.9</u>     | <u>21.3</u>      | <u>11.6</u>      |
|                                     | <u>\$1,091.9</u> | <u>\$995.0</u> | <u>\$2,171.5</u> | <u>\$1,991.1</u> |

Operating Earnings Before Income Taxes

Property and casualty insurance:

|                             |         |         |         |         |
|-----------------------------|---------|---------|---------|---------|
| Underwriting:               |         |         |         |         |
| Specialty                   |         |         |         |         |
| Property and transportation | \$ 26.1 | \$ 31.1 | \$ 64.7 | \$ 73.2 |
| Specialty casualty          | 67.3    | 28.4    | 126.3   | 43.0    |

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|  |                 |                |                 |                 |
|--|-----------------|----------------|-----------------|-----------------|
| Specialty financial                            | 10.6            | .6             | 14.3            | 1.4             |
| California workers' compensation               | 11.6            | 16.3           | 25.1            | 28.8            |
| Other (a)                                      | (1.0)           | .5             | (12.4)          | .3              |
| Other lines (b)                                | <u>(44.4)</u>   | <u>(3.9)</u>   | <u>(45.1)</u>   | <u>(5.0)</u>    |
|  | )               | )              | )               | )               |
|  | 70.2            | 73.0           | 172.9           | 141.7           |
| Investment income, realized gains<br>and other | <u>72.2</u>     | <u>75.3</u>    | <u>156.8</u>    | <u>173.1</u>    |
|  | 142.4           | 148.3          | 329.7           | 314.8           |
| Annuity and supplemental insurance             | 35.0            | 18.6           | 66.1            | 48.1            |
| Other (c)                                      | <u>(64.9)</u>   | <u>(20.3)</u>  | <u>(88.4)</u>   | <u>(46.5)</u>   |
|  | )               | )              | )               | )               |
|  | <u>\$ 112.5</u> | <u>\$146.6</u> | <u>\$ 307.4</u> | <u>\$ 316.4</u> |

(a) Includes a first quarter 2007 charge of \$13.5 million to adjust a retroactive reinsurance gain.

(b) Includes a second quarter 2007 charge of \$44.2 million to increase asbestos and environmental reserves.

(c) Includes holding company expenses and a second quarter 2007 charge of \$41 million related to asbestos and environmental liabilities at former railroad and manufacturing operations.

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As discussed in Note A - "Accounting Policies," deferred policy acquisition costs related to annuities are adjusted for changes in unrealized gains (losses) on securities.

Included in deferred policy acquisition costs in AFG's Balance Sheet are \$75.1 million and \$95.0 million at June 30, 2007, and December 31, 2006, respectively, representing the present value of future profits ("PVFP") related to acquisitions by AFG's annuity and supplemental insurance business. In the second quarter of 2007, PVFP was reduced by \$12.3 million due to a refinement of the purchase price allocation for the August 2006 Ceres acquisition. The PVFP amounts are net of \$78.1 million and \$70.5 million of accumulated amortization. Amortization of the PVFP was \$2.4 million in the second quarter and \$7.6 million during the first six months of 2007 and \$1.6 million in the second quarter and \$3.3 million in the first six months of 2006, respectively. The increase in amortization compared to the 2006 periods reflects the acquisition of Ceres.

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

|  | June 30,<br><u>2007</u> | December 31,<br><u>2006</u> |
|--|-------------------------|-----------------------------|
| <b>Holding Company:</b>  |                         |                             |
| AFG 7-1/8% Senior Debentures due April 2009                            | \$173.1                 | \$182.9                     |
| AFG Senior Convertible Notes due June 2033                             | 189.7                   | 189.7                       |
| AFG 7-1/8% Senior Debentures due February 2034                         | 115.0                   | 115.0                       |
| AFG 7-1/8% Senior Debentures due December 2007                         | 59.5                    | 59.5                        |
| Other  | <u>3.7</u>              | <u>3.8</u>                  |
|  | <u>541.0</u>            | <u>550.9</u>                |
| <b>Subsidiaries</b>  |                         |                             |
| :  |                         |                             |
| GAFRI 7-1/2% Senior Debentures due November 2033                       | 112.5                   | 112.5                       |
| GAFRI 7-1/4% Senior Debentures due January 2034                        | 86.3                    | 86.3                        |
| GAFRI 6-7/8% Senior Notes due June 2008                                | 28.5                    | 31.5                        |
| GAFRI borrowings under AFG/GAFRI credit facility                       | 16.0                    | -                           |
| Notes payable secured by real estate                                   | 67.7                    | 67.8                        |
| American Premier Underwriters 10-7/8% Subordinated Notes due May 2011  | 8.0                     | 8.1                         |
| Other  | <u>2.3</u>              | <u>6.9</u>                  |
|  | <u>321.3</u>            | <u>313.1</u>                |
| <b>Payable to Subsidiary Trusts:</b>                                   |                         |                             |
| GAFRI 7.35% Subordinated Debentures due May 2033                       | 20.0                    | 20.0                        |
| GAFRI 8-7/8% Subordinated Debentures                                   | -                       | 22.0                        |
| National Interstate Variable Rate Subordinated Debentures due May 2033 | <u>15.0</u>             | <u>15.0</u>                 |

|                |                |
|----------------|----------------|
| <u>35.0</u>    | <u>57.0</u>    |
| <u>\$897.3</u> | <u>\$921.0</u> |

At June 30, 2007, scheduled principal payments on debt for the balance of 2007 and the subsequent five years were as follows: 2007 - \$60.5 million; 2008 - \$29.2 million; 2009 - \$174.6 million; 2010 - \$2.9 million; 2011 - \$25.1 million; and 2012 - \$1.4 million.

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

|                                    | June 30,<br><u>2007</u> | December 31,<br><u>2006</u> |
|------------------------------------|-------------------------|-----------------------------|
| Unsecured obligations              | \$829.6<br><u>67.7</u>  | \$853.2<br><u>67.8</u>      |
| Obligations secured by real estate | <u>\$897.3</u>          | <u>\$921.0</u>              |

13

## AMERICAN FINANCIAL GROUP, INC. 10-Q

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

On March 1, 2007, GAFRI used funds borrowed under the AFG/GAFRI bank credit facility to redeem its \$22 million in outstanding 8-7/8% Subordinated Debentures due 2027 for \$22.9 million.

In March 2006, AFG and GAFRI replaced their existing credit agreements with a five-year revolving credit facility under which they can borrow a combined \$500 million. AFG and GAFRI have agreed not to borrow more than \$325 million and \$200 million, respectively, under the credit facility and AFG has agreed to guarantee amounts borrowed by GAFRI. Amounts borrowed bear interest at rates ranging from 0.5% to 1.25% over LIBOR based on AFG's credit rating. At June 30, 2007, GAFRI had \$16 million in borrowings outstanding under the credit facility (interest rate of 6.1% at June 30, 2007).

To achieve a desired balance between fixed and variable rate debt, GAFRI has entered into interest rate swaps that effectively convert its 6-7/8% fixed rate Senior Notes to a floating rate of 3-month LIBOR plus 2.9%.

AFG's Senior Convertible Notes were issued at a price of 37.153% of the principal amount due at maturity. Interest is payable semiannually at a rate of 4% of issue price per year through June 2008, after which interest

at 4% annually will be accrued and added to the carrying value of the Notes. The Notes are redeemable at AFG's option at any time on or after June 2, 2008, at accreted value ranging from \$371.53 per Note to \$1,000 per Note at maturity. Generally, holders may convert each Note into 17.2524 shares of AFG Common Stock (at \$21.53 per share currently) (i) if the average market price of AFG Common Stock to be received upon conversion exceeds 120% of the accreted value (\$25.84 per share currently) for a specified period, (ii) if the credit rating of the Notes is significantly lowered, or, (iii) if AFG calls the notes for redemption. Based on the market price of AFG's Common Stock during the quarter ended June 30, 2007, the Notes are currently convertible through September 30, 2007. AFG has delivered cash in lieu of Common Stock upon conversion of the Notes and intends to continue to do so. Accordingly, shares issuable upon conversion of the Notes are not treated as dilutive.

F.

**Shareholders' Equity** In December 2006, AFG completed a three-for-two common stock split. See "Stock Split" in Note A - "Accounting Policies." 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

The components of accumulated other comprehensive income (loss) were as follows (in millions):

|  | June 30,<br><u>2007</u> | December 31,<br><u>2006</u> |
|--|-------------------------|-----------------------------|
| Net unrealized gain (loss) on securities             | (\$62.0)                | \$50.7                      |
| Foreign currency translation adjustment              | 17.0                    | 4.3                         |
|  | <u>3.3</u>              | <u>.5</u>                   |
| Unrealized pension and other postretirement benefits |                         |                             |
|  | <u>(\$41.7)</u>         | <u>\$55.5</u>               |
| Total accumulated other comprehensive income (loss)  |                         |                             |

#### Stock Incentive Plans

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 quarter of 2007, AFG issued 114,594 shares of Common Stock and granted stock options for 1.2 million shares of Common Stock (at a strike price of \$36.57) under the Stock Incentive 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 (after consideration of other factors). The fair value of options granted in the first quarter of 2007 was \$10.46 per share based on the following assumptions: expected dividend yield - 1.2%; expected volatility - 21.5%; expected term - 6 1/2 years; risk-free rate - 4.7%.

Total compensation expense related to stock incentive plans of AFG and its two public subsidiaries was as follows: second quarter of 2007 and 2006 - \$4.1 million and \$2.6 million; six months of 2007 and 2006 - \$10.7 million and \$4.8 million, respectively. Stock-based compensation expense for the first six months of 2007 includes \$3.9 million in first quarter non-deductible stock awards.

G.

**Income Taxes** AFG increased its liability for unrecognized tax benefits and reduced retained earnings by \$14.9 million for the cumulative effect of implementing the provisions of FIN 48 on January 1, 2007. Total unrecognized income tax benefits at January 1, 2007, were \$47.5 million, including \$9.5 million for interest and municipal penalties. Included in this balance are \$43.4 million of unrecognized benefits that, if recognized, would reduce AFG's effective tax rate. Other than the municipal settlement discussed below, these amounts did not change materially as of June 30, 2007, and no significant changes to the liability are anticipated within the next 12 months.

As of January 1, 2007, AFG's 2004, 2005 and 2006 tax years remain subject to examination by the IRS. In addition, AFG has several tax years for which there are ongoing disputes. AFG has subsidiaries in various states, cities and provinces that are currently under audit for years ranging from 1995 through 2004. In April 2007, AFG signed a settlement agreement with a municipality. As a result of this settlement, AFG reduced its liability for unrecognized income tax benefits by \$5.7 million (\$3.7 million net of federal tax effect) in the second quarter of 2007.

H.

**Discontinued Operations** In the second quarter of 2006, GAFRI sold Chatham Bars Inn, its resort-hotel property located on Cape Cod for \$166 million. The results of operations of this investment property and the \$25.8 million gain on sale (after tax and minority interest) are presented as discontinued operations in the Statement of Earnings. Discontinued operations for 2007 represent additional gains on operations sold in previous years, primarily the settlement of a contingency associated with the Chatham sale.

**Commitments and Contingencies** Except as discussed in *Management's Discussion and Analysis - "Asbestos and Environmental Reserve Charge,"* there have been no significant changes to the matters discussed and referred to in *Note M - "Commitments and Contingencies"* of AFG's 2006 Annual Report on Form 10-K.

15

AMERICAN FINANCIAL GROUP, INC. 10-Q

ITEM 2

Management's Discussion and Analysis

of Financial Condition and Results of Operations

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INDEX TO MD&A

|                            | <u>Page</u> | <u>Page</u> |
|----------------------------|-------------|-------------|
| Forward-Looking Statements | 16          | 22          |
| Results of Operations      |             |             |

|                                 |    |                              |    |
|---------------------------------|----|------------------------------|----|
| Overview                        | 16 | General                      | 22 |
| Critical Accounting Policies    | 17 | Income Items                 | 22 |
| Liquidity and Capital Resources | 18 | Expense Items                | 26 |
| Sources of Funds                | 18 | Recent Accounting Standard   | 27 |
| Investments                     | 19 | Proposed Accounting Standard | 28 |
| Uncertainties                   | 22 |                              |    |

## FORWARD-LOOKING STATEMENTS

The Private Securities Litigation Reform Act of 1995 provides a safe harbor for forward-looking statements. This safe harbor does not apply to statements with respect to the pending transaction with GAFRI. Some of the forward-looking statements can be identified by the use of words such as "anticipates", "believes", "expects", "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 increases; and improved loss experience.

Actual results could differ materially from those contained in or implied by such forward-looking statements for a variety of factors including:

- ◆ changes in economic conditions, including interest rates, performance of securities markets, and the availability of capital;
- ◆ regulatory actions;
- ◆ changes in the legal environment affecting AFG or its customers;
- ◆ tax law changes;
- ◆ levels of natural catastrophes, terrorist events (including any nuclear, biological, chemical, or radiological events), incidents of war and other major losses;
- ◆ development of insurance loss reserves and other reserves, particularly with respect to amounts associated with asbestos and environmental claims;
- ◆ the unpredictability of possible future litigation;
- ◆ trends in persistency, mortality and morbidity;
- ◆ availability of reinsurance and ability of reinsurers to pay their obligations;
- ◆ competitive pressures, including the ability to obtain rate increases; and
- ◆ changes in debt and claims paying ratings.

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.

## 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

of Financial Condition and Results of Operations - Continued

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.

At June 30, 2007, AFG (parent) had approximately \$160 million in cash and securities and no amounts borrowed under the AFG/GAFRI bank line of credit. GAFRI had \$16 million borrowed under this line at June 30, 2007.

### Results of Operations

Through the operations of its subsidiaries, AFG is engaged primarily in property and casualty insurance, and in the sale of traditional fixed, indexed and variable annuities and a variety of supplemental insurance products.

AFG's net earnings for the second quarter and first six months of 2007 were \$67.0 million (\$.54 per share, diluted) and \$180.6 million (\$1.47 per share, diluted), respectively, compared to \$122.9 million (\$1.02 per share, diluted) and \$224.4 million (\$1.87 per share) reported in the same periods of 2006. These results reflect higher earnings from the Company's ongoing insurance operations, lower gains from sales of real estate, and the effect of charges to strengthen reserves for asbestos and other environmental exposures ("A&E") within the property and casualty insurance run-off operations and A&E reserves related to former railroad and manufacturing operations.

### CRITICAL ACCOUNTING POLICIES

Significant accounting policies are summarized in Note A to the financial statements. The preparation of financial statements 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 determination of "other-than-temporary" impairment on investments.

For a discussion of these policies, see *Management's Discussion and Analysis - "Critical Accounting Policies" in AFG's 2006 Form 10-K*.

## LIQUIDITY AND CAPITAL RESOURCES

Ratios

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

|                                       | June 30,    | <u>December 31,</u> |             |
|---------------------------------------|-------------|---------------------|-------------|
|                                       | <u>2007</u> | <u>2006</u>         | <u>2005</u> |
| Long-term debt                        | \$ 897      | \$ 921              | \$1,000     |
| Total capital (*)                     | 4,291       | 4,160               | 3,703       |
| Ratio of debt to total capital:       |             |                     |             |
| Including debt secured by real estate | 20.9%       | 22.1%               | 27.0%       |
| Excluding debt secured by real estate | 19.7%       | 20.9%               | 26.3%       |

(\*) Includes long-term debt, minority interest and shareholders' equity (excluding unrealized gains (losses) related to fixed maturity investments).

AFG's ratio of earnings to fixed charges, including annuity benefits as a fixed charge, was 2.39 for the six months ended June 30, 2007 and 2.62 for the entire year of 2006. Excluding annuity benefits, this ratio was 8.24 and 9.15, respectively. Although the ratio excluding interest on annuities 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.

Sources of Funds

## Parent Holding Company Liquidity

Management believes AFG has sufficient resources to meet its liquidity requirements. If funds generated from operations, including dividends and tax payments from subsidiaries, are insufficient to meet fixed charges in any period, AFG would be required to utilize parent company cash and marketable securities or generate cash through borrowings, sales of other assets, or similar transactions.

In March 2006, AFG and GAFRI replaced their existing credit agreements with a five-year revolving credit facility under which they can borrow a combined \$500 million. AFG and GAFRI have agreed not to borrow more than \$325 million and \$200 million, respectively, under the credit facility and AFG has agreed to guarantee amounts borrowed by GAFRI. GAFRI had \$16 million in borrowings outstanding under this agreement at June 30, 2007, bearing interest at a rate of 6.1% at June 30, 2007.

In addition to parent company cash and marketable securities of approximately \$160 million, AFG can borrow approximately \$230 million on its bank line and maintain its desired debt to total capital ratio of less than 25%.

Under a currently effective shelf registration statement, AFG can offer additional equity or debt securities. The shelf registration provides AFG with greater flexibility to access the capital markets from time to time as market and other conditions permit.

AMERICAN FINANCIAL GROUP, INC. 10-Q

Management's Discussion and Analysis

of Financial Condition and Results of Operations - Continued

**Subsidiary Liquidity**

On March 1, 2007, GAFRI used funds borrowed under the AFG/GAFRI bank credit line to redeem its \$22 million in outstanding 8-7/8% Subordinated Debentures for \$22.9 million in cash.

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 GAFRI's 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, GAFRI 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 GAFRI's annuity products.

AFG believes its insurance subsidiaries maintain sufficient liquidity to pay claims and benefits and operating expenses, as well as meet commitments in the event of unforeseen events such as reserve deficiencies, inadequate premium rates or reinsurer insolvencies.

**Investments**

AFG's investment portfolio at June 30, 2007, contained \$15.2 billion in "Fixed maturities" classified as available for sale and \$921 million in "Equity securities," all carried at fair value with unrealized gains and losses reported as a separate component of shareholders' equity on an after-tax basis. At June 30, 2007, AFG had a pretax net unrealized loss of \$262 million on fixed maturities and a pretax net unrealized gain of \$118 million on other stocks.

Approximately 94% of the fixed maturities held by AFG at June 30, 2007, 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 a high quality investment portfolio should generate a stable and predictable investment return.

Since fixed maturities and stocks are carried at fair value in the balance sheet, there is virtually no effect on financial condition upon the sale and ultimate realization of unrealized gains and losses.

## AMERICAN FINANCIAL GROUP, INC. 10-Q

## Management's Discussion and Analysis

of Financial Condition and Results of Operations - Continued

Summarized information for the unrealized gains and losses recorded in AFG's Balance Sheet at June 30, 2007, is shown in the following table (dollars in millions). Approximately \$196 million of available for sale "Fixed maturities" had no unrealized gains or losses at June 30, 2007.

|  | Securities<br>With<br>Unrealized<br><u>Gains</u> | Securities<br>With<br>Unrealized<br><u>Losses</u> |
|--|--|---|
| <u>Available for Sale Fixed Maturities</u>   |  |   |
| Fair value of securities   | \$2,958  | \$12,083  |
| Amortized cost of securities   | \$2,884  | \$12,419  |
| Gross unrealized gain (loss)   | \$ 74  | (\$ 336)  |
| Fair value as % of amortized cost  | 103%   | 97%   |
| Number of security positions   | 886  | 1,978   |
| Number individually exceeding<br>\$2 million gain or loss                            | -  | 5   |
| Concentration of gains (losses) by type or<br>industry (exceeding 5% of unrealized): |  |   |
| Mortgage-backed securities   | \$14.3   | (\$133.3)   |
| Banks, savings and credit institutions   | 5.6  | (53.5)  |
| U.S. Government and government agencies  | 1.1  | (16.9)  |
| State and municipal  | 2.9  | (19.5)  |
| Insurance companies  | 4.3  | (19.0)  |
| Gas and electric services  | 9.5  | (18.7)  |
| Air transportation and courier services  | 4.2  | (0.5)   |
| Percentage rated investment grade  | 85%  | 97%   |

Over 99% of AFG's mortgage-backed securities are rated "AAA." At June 30, 2007, approximately 3% of AFG's fixed maturity portfolio was invested in mortgage-backed securities in which the underlying collateral is sub-prime mortgages. At that date, the net unrealized loss on these securities was approximately \$8.3 million. The securities are collateralized by fixed-rate mortgages and have an overall average life of less than 2 1/2 years. None of the securities have been subject to downgrades or "watch listing" by rating agencies. At June 30, 2007, AFG had no collateralized debt obligations secured by residential mortgages. Investments in private partnerships and hedge funds (included in other investments) were less than 0.2% of AFG's total cash and investments at June 30, 2007.

The table below sets forth the scheduled maturities of AFG's available for sale fixed maturity securities at June 30, 2007, based on their fair values. Asset-backed securities and other securities with sinking funds are reported at average maturity. Actual maturities may differ from contractual maturities because certain securities may be called or prepaid by the issuers.

|                                    | Securities<br>With<br>Unrealized<br><u>Gains</u> | Securities<br>With<br>Unrealized<br><u>Losses</u> |
|------------------------------------|--|---|
| <u>Maturity</u>                    |  |   |
| One year or less                   | 10%  | 4%  |
| After one year through five years  | 39   | 21  |
| After five years through ten years | 29   | 34  |
| After ten years                    | <u>9</u>   | <u>5</u>  |
| <br>                               |  |   |
| Mortgage-backed securities         | 87<br><u>13</u>                                  | 64<br><u>36</u>                                   |
|                                    | <u>100</u>                                       | <u>100</u>  |
|                                    | %  | %   |

20

AMERICAN FINANCIAL GROUP, INC. 10-Q

Management's Discussion and Analysis

of Financial Condition and Results of Operations - Continued

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

|  | Aggregate<br>Fair<br><u>Value</u> | Aggregate<br>Unrealized<br><u>Gain (Loss)</u> | Fair<br>Value as<br>% of Cost<br><u>Basis</u> |
|--|-----------------------------------|---|---|
| <u>Fixed Maturities at June 30, 2007</u> |                                   |   |   |
| Securities with unrealized gains:        |                                   |   |   |
| Exceeding \$500,000 (24 issues)          | \$ 203                            | \$ 19   | 110%  |
| Less than \$500,000 (862 issues)         | <u>2,755</u>                      | <u>55</u>                                     | 102   |
|  | <u>\$ 2,958</u>                   | <u>\$ 74</u>                                  | 103%  |

|                                    |                 |                |     |
|------------------------------------|-----------------|----------------|-----|
| Securities with unrealized losses: |                 |                |     |
| Exceeding \$500,000 (177 issues)   | \$ 3,643        | (\$159)        | 96% |
| Less than \$500,000 (1,801 issues) | <u>8,440</u>    | <u>(177)</u>   | 98  |
|                                    | <u>\$12,083</u> | <u>(\$336)</u> | 97% |

The following table summarizes (dollars in millions) the unrealized loss for all fixed maturity securities with unrealized losses by issuer quality and length of time those securities have been in an unrealized loss position.

|   | Aggregate<br>Fair<br><u>Value</u> | Aggregate<br>Unrealized<br><u>Loss</u> | Fair<br>Value as<br>% of Cost<br><u>Basis</u> |
|---|-----------------------------------|--|---|
| <u>Fixed Maturities with Unrealized Losses at June 30, 2007</u> |                                   |  |   |
| Investment grade with losses for:                               |                                   |  |   |
| One year or less (766 issues)                                   | \$ 4,503                          | (\$ 80)                                | 98%   |
| Greater than one year (1,120 issues)                            | <u>7,222</u>                      | <u>(248)</u>                           | 97  |
|   | <u>\$11,725</u>                   | <u>(\$328)</u>                         | 97%   |
| Non-investment grade with losses for:                           |                                   |  |   |
| One year or less (54 issues)                                    | \$ 180                            | (\$ 3)                                 | 98%   |
| Greater than one year (38 issues)                               | <u>178</u>                        | <u>(5)</u>                             | 97  |
|   | <u>\$ 358</u>                     | <u>(\$ 8)</u>                          | 98%   |

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. The determination of whether unrealized losses are "other than temporary" requires judgment based on subjective as well as objective factors. A listing of factors considered and resources used is contained in the discussion of "Investments" under Management's Discussion and Analysis in AFG's 2006 Form 10-K.

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 mature or recover in value. Although AFG has the ability to continue holding its investments with unrealized losses, its intent to hold

them may change due to deterioration in the issuers' creditworthiness, decisions to lessen exposure to a particular issuer or industry, asset/liability management decisions, market movements, changes in views about appropriate asset allocation or the desire to offset taxable realized gains. Should AFG's ability or intent change with regard to a particular security, a charge for impairment would likely be required. While it is not possible to accurately predict if or when a specific security will become impaired, charges for other than temporary impairment could be material to

21

AMERICAN FINANCIAL GROUP, INC. 10-Q

Management's Discussion and Analysis

of Financial Condition and Results of Operations - Continued

results of operations in a future period. Management believes it is not likely that future impairment charges will have a significant effect on AFG's liquidity.

During the first half of 2006, AFG realized a loss of \$444,000 on the sale of a fixed maturity security that had an unrealized loss greater than \$500,000 at December 31, 2006. The fair value of this security increased by \$177,000 from year-end 2006 to the sale date.

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 2006 Form 10-K.

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 \$112.5 million for the second quarter of 2007 compared to \$146.6 million for the 2006 second quarter. A \$37.7 million improvement in Specialty property and casualty underwriting results compared to the 2006 quarter was more than offset by charges of \$44.2 million to strengthen reserves for A&E exposure within the property and casualty insurance run-off operations and \$43.0 million to increase A&E reserves related to former railroad and manufacturing operations. Results for the second quarter of 2007 also include \$14.0 million in net realized gains on securities compared to net realized losses of \$7.5 million in the 2006 quarter.

Six month pretax operating earnings decreased by \$9.0 million compared to 2006 reflecting a \$71.3 million improvement in Specialty property and casualty insurance underwriting results which was more than offset by the second quarter A&E charges discussed above.

Property and Casualty Insurance - Underwriting

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AFG reports its Specialty insurance business in the following sub-segments: (i) Property and transportation, (ii) Specialty casualty, (iii) Specialty financial and (iv) California workers' compensation.

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 policy holder dividends to premiums. A combined ratio under 100% is indicative of an underwriting profit. The combined ratio does not reflect investment income, other income or federal income taxes.

22

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

#### Management's Discussion and Analysis

#### of Financial Condition and Results of Operations - Continued

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

|                                      | Three months ended |              | Six months ended |                |
|--------------------------------------|--------------------|--------------|------------------|----------------|
|                                      | <u>June 30,</u>    |              | <u>June 30,</u>  |                |
|                                      | <u>2007</u>        | <u>2006</u>  | <u>2007</u>      | <u>2006</u>    |
| <u>Gross Written Premiums (GAAP)</u> |                    |              |                  |                |
| Property and transportation          | \$421              | \$400        | \$ 744           | \$ 718         |
| Specialty casualty                   | 350                | 367          | 711              | 742            |
| Specialty financial                  | 139                | 135          | 277              | 254            |
| California workers' compensation     | 61                 | 75           | 129              | 160            |
| Other                                | <u>1</u>           | <u>3</u>     | <u>-</u>         | <u>-</u>       |
|                                      | <u>\$972</u>       | <u>\$980</u> | <u>\$1,861</u>   | <u>\$1,874</u> |

Net Written Premiums (GAAP)

|                                  |              |              |                |                |
|----------------------------------|--------------|--------------|----------------|----------------|
| Property and transportation      | \$277        | \$268        | \$ 522         | \$ 499         |
| Specialty casualty               | 209          | 206          | 425            | 408            |
| Specialty financial              | 121          | 104          | 236            | 197            |
| California workers' compensation | 57           | 71           | 122            | 151            |
| Other                            | <u>17</u>    | <u>23</u>    | <u>32</u>      | <u>40</u>      |
|                                  | <u>\$681</u> | <u>\$672</u> | <u>\$1,337</u> | <u>\$1,295</u> |

Combined Ratios (GAAP)

|  |       |       |       |       |
|--|-------|-------|-------|-------|
| Property and transportation              | 89.1% | 86.2% | 86.2% | 82.7% |
| Specialty casualty                       | 68.3  | 85.6  | 70.1  | 88.8  |
| Specialty financial                      | 90.6  | 99.4  | 93.8  | 99.3  |
| California workers' compensation         | 80.2  | 78.5  | 79.4  | 81.2  |
| Total Specialty                          | 81.8  | 87.5  | 82.9  | 87.7  |
| Aggregate (including discontinued lines) | 88.9% | 88.1% | 86.4% | 88.1% |

Net written premiums for the Specialty insurance operations increased 1% for the second quarter and 3% for the first six months compared to the same periods in 2006. Premium growth continues to be impacted by the effect of significant rate declines in the California workers' compensation business. Excluding that business, the net written premiums of the other specialty groups grew 4% for the quarter and 6% for the six months compared to the 2006 periods. Apart from rate decreases in the California workers' compensation business, average rate levels in AFG's other specialty operations were down about 2% through the first half of the year.

The Specialty insurance operations generated an underwriting profit of \$114.6 million in the 2007 second quarter, \$37.7 million higher than the same quarter a year earlier, resulting from a higher amount of favorable reserve development and lower catastrophe losses. The results for the 2007 quarter include \$45.0 million (7.1 points) of favorable reserve development and \$5.0 million (0.8 points) of catastrophe losses, principally from severe storms in the northeastern and Midwestern parts of the United States. The results for the 2006 quarter include \$12.2 million (2.0 points) of favorable development and \$11.6 million (1.9 points) of catastrophe losses. Underwriting profit of the specialty insurance operations was \$218.0 million for the first six months of 2007, 49% above the 2006 period, primarily reflecting the positive impact of more favorable reserve development within the Specialty casualty group and lower catastrophe losses.

## Property and transportation

gross written premiums for the 2007 three and six month periods were 5% and 4% higher than in the respective 2006 periods. Premium growth was reduced by the impact of exiting the earthquake-exposed

## AMERICAN FINANCIAL GROUP, INC. 10-Q

## Management's Discussion and Analysis

of Financial Condition and Results of Operations - Continued

excess property business, which was heavily reinsured, in the early part of 2006. Excluding that effect, gross written premiums for the 2007 three and six month periods were up 10% and 9%, respectively, over the 2006 periods due to growth in the crop, transportation and inland marine operations. Net written premiums were 4% and 5% higher than the respective 2006 periods. The combined ratio increased 2.9 points for the quarter and 3.5 points for the six months compared to the 2006 periods reflecting lower underwriting profits in the agricultural and trucking insurance operations which more than offset a significant improvement within the inland and ocean marine operations. The six-month results include \$20.7 million (4.4 points) of favorable reserve development compared to \$27 million (6.4 points) in the 2006 period.

**Specialty casualty**

gross written premiums for the 2007 three and six month periods were 5% and 4% below the same 2006 periods due primarily to volume reductions in the excess and surplus and general liability lines resulting from stronger competition within these commercial casualty markets. Net written premiums were 1% and 4% higher than the respective 2006 periods due primarily to lower premiums ceded under reinsurance agreements. The 17.3 point improvement for the quarter and 18.7 point improvement for the six months in the combined ratio compared to the 2006 periods reflect \$38.9 million (18.3 points) of favorable reserve development in the 2007 quarter and \$80.4 million (19.0 points) for the six months of 2007 compared to negligible development in the 2006 periods. The 2007 favorable development was primarily in the general liability and excess and surplus businesses.

**Specialty financial**

gross and net written premiums for the 2007 second quarter were up 3% and 15%, respectively, over the same period last year. Volume growth in the financial institutions, lease and loan and surety operations were partly offset by lower premiums resulting from the run-off of the residual value insurance ("RVI") business. The higher net written premium growth rate resulted from greater premium retention in the group's lease and loan operations. These factors, plus new business volume in the fidelity and crime operations during the 2007 first quarter, contributed to the strong premium growth through the first half of 2007. The 8.8 point improvement for the quarter and 5.5 point improvement for the six months in the combined ratio compared to the 2006 periods reflect significant improvement in the financial institutions, fidelity and crime and lease and loan operations, as well as better results within the run-off RVI business. Excluding the RVI business, this group's combined ratio was 89.3% for the first six months of 2007.

**California workers' compensation**

gross written premiums were down 19% for both the second quarter and the six months compared to the 2006 periods, reflecting the effect of significantly lower premium rates. These rate reductions averaged about 24% through the first half of this year and demonstrate the positive effects of reform legislation in lowering workers' compensation costs for employers. Net written premiums for the second quarter and first six months of 2007 were about 20% below the same 2006 periods. This business' underwriting margins continue to benefit from the improved claims environment resulting from the California workers' compensation reform legislation. The second

quarter of 2007 includes 9.0 points of favorable prior year development while the 2006 second quarter includes 2.2 points of favorable development. Results for the first six months of 2007 include 8.2 points of favorable development compared to less than a point in the 2006 period. Due to the long-tail nature of this business, AFG continues to be conservative in recognizing the benefits from the reform legislation until a higher percentage of claims are paid and the ultimate impact of reforms can be determined.

24

AMERICAN FINANCIAL GROUP, INC. 10-Q

Management's Discussion and Analysis

of Financial Condition and Results of Operations - Continued

Asbestos and Environmental Reserve Charge

AFG recently completed the previously announced comprehensive study of its asbestos and environmental exposures relating to the run-off operations of its property and casualty group and its exposures related to former railroad and manufacturing operations and sites. Similar studies were completed in 2005 and 2003, respectively. The studies were done with the aid of respected outside actuarial and engineering firms and specialty outside counsel.

As a result of the study, AFG recorded a \$44.2 million charge (net of reinsurance) to increase the property and casualty group's asbestos reserves by \$30.8 million and its environmental reserves by \$13.4 million. At June 30, 2007, the property and casualty group's A&E reserves were \$455.6 million, net of reinsurance recoverables. At that date, AFG's three year survival ratio was 17.4 times paid losses for the asbestos reserves and 11.4 times paid losses for the total A&E reserves. These ratios compare favorably with A.M. Best's most recent report on A&E survival ratios (March 2007) which were 9.0 for asbestos and 8.0 for total industry A&E reserves. Excluding amounts associated with the settlements of asbestos related coverage litigation for A.P. Green Industries (see "*Legal Proceedings*" in *AFG's 2006 Form 10-K*) and another large claim, AFG's three year survival ratio was 10.6 and 7.8 times paid losses for the asbestos reserves and total A&E reserves, respectively.

The primary causes of the increase

in asbestos reserves were an increase in settlement amounts attributable to mesothelioma claims, the impact of a large case settlement (in principle) with an installer of material containing asbestos, and continuing uncertainties related to non-product liability exposures. These trends were partially offset by lower than anticipated notices of new accounts and favorable development in our assumed reinsurance run-off operations. The primary reason for the increase in environmental reserves was a reassessment of the potential amount of loss related to certain environmental sites owned by a single insured.

In addition to the property and casualty group, the study encompassed reserves for asbestos and environmental exposures of our former railroad and manufacturing operations. As a result of the study, AFG recorded a \$43.0 million charge (included in other expenses) to increase the A&E reserves related to these former operations. The \$19.0 million increase in asbestos reserves was the result of increasing estimates of the cost of mesothelioma claims partially offset by lower estimated overall claim counts. The \$24.0 million increase in environmental reserves was due primarily to increased clean up estimates at certain former railroad and manufacturing sites.

The study relied on a ground-up exposure analysis. With respect to asbestos, it considered products and non-products exposures, paid claims history, the pattern of new claims, settlements and projected development. The asbestos legal

climate remains very difficult to predict. While some progress has been made in state asbestos tort reform and judicial rulings, that progress has been somewhat offset by increased claims costs, increased defense costs, the assertion of non-products theories and an expanding pool of plaintiffs and defendants.

Life, Accident and Health Premiums and Benefits

The increase in life, accident and health premiums and benefits in the second quarter and first six months of 2007 compared to the same 2006 periods reflects the August 2006 acquisition of Ceres. For the six months, the effect of the Ceres acquisition was partially offset by the effect of the January 2006 sale of GAPR. The Ceres acquisition broadens GAFRI's distribution in both the independent agent and captive agent channels.

25

AMERICAN FINANCIAL GROUP, INC. 10-Q

Management's Discussion and Analysis

of Financial Condition and Results of Operations - Continued

Investment Income

The increase in investment income for the second quarter and first six months of 2007 compared to the same periods in 2006 reflects an increase in average cash and investments of approximately \$1.3 billion (8%) for the second quarter and \$1.4 billion (9%) for the six months.

Realized Gains

Realized capital gains have been an important part of the return on investments. Individual assets are sold creating gains and losses as market opportunities exist. Realized gains for 2006 includes a \$23.6 million pretax gain in the first quarter on the sale of AFG's interest in The Cincinnati Reds.

Realized gains on securities include provisions for other than temporary impairment of securities still held as follows: second quarter of 2007 and 2006 - \$2.2 million and \$2.8 million; six months of 2007 and 2006 - \$11.3 million and \$5.8 million, respectively.

Real Estate Operations

AFG's subsidiaries are engaged in a variety of real estate operations including hotels, marinas, apartments and office buildings; they also own several parcels of land. Revenues and expenses of these operations, including gains and losses on disposal, are included in AFG's Statement of Earnings as shown below (in millions).

| Three months ended |             | Six months ended |             |
|--------------------|-------------|------------------|-------------|
| <u>June 30,</u>    |             | <u>June 30,</u>  |             |
| <u>2007</u>        | <u>2006</u> | <u>2007</u>      | <u>2006</u> |

|                                      |        |        |        |        |
|--------------------------------------|--------|--------|--------|--------|
| Other income                         | \$26.6 | \$24.0 | \$47.5 | \$45.1 |
| Other operating and general expenses | 16.5   | 17.1   | 31.7   | 31.5   |
| Interest charges on borrowed money   | 1.1    | .3     | 2.1    | .7     |
| Minority interest expense            | .3     | .8     | .1     | 2.2    |

Income from real estate operations includes net pretax gains on the sale of real estate assets of \$7.5 million in the second quarter and \$13.5 million in the first six months of 2007 compared to \$6.2 million and \$13.2 million for the 2006 periods.

#### Real Estate Operations - Discontinued

In June 2006, GAFRI sold Chatham Bars Inn, a resort hotel located on Cape Cod, Massachusetts, for \$166 million. After sales expenses, contingencies and the write-off of certain deferred acquisition costs on annuities associated with the gain recognition, GAFRI recognized a pretax gain of approximately \$48.7 million. In the second quarter of 2007, GAFRI received an additional escrow payment in connection with the sale. Chatham's 2006 operating results and the gains on the sale of Chatham are reported as discontinued operations in the Statement of Earnings.

#### Other Income

The \$13.6 million increase for the second quarter and \$23.0 million for the first six months of 2007 compared to the 2006 periods is due primarily to fee income generated from reinsurance agreements entered into in connection with the Ceres acquisition in August 2006 and higher fee income resulting from growth in the annuity business and the property and casualty dealer services business.

#### Annuity Benefits

Annuity benefits reflect amounts accrued on annuity policyholders' funds accumulated. On its deferred annuities (annuities in the accumulation phase), GAFRI generally credits interest 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), GAFRI accrues additional reserves for (i) persistency and premium bonuses and (ii) excess benefits expected to be paid

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

#### Management's Discussion and Analysis

#### of Financial Condition and Results of Operations - Continued

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

Annuity benefits increased \$6.4 million for the second quarter and \$12.4 million the first six months of 2007 compared to the 2006 periods, reflecting higher sales of fixed-indexed annuities, partially offset by a lower

average crediting rate.

### Annuity and Supplemental Insurance Acquisition Expenses

Annuity and supplemental insurance acquisition expenses include amortization of annuity, supplemental insurance and life business deferred policy acquisition costs ("DPAC") as well as a portion of commissions on sales of insurance products. Annuity and supplemental insurance acquisition expenses also include amortization of the present value of future profits of businesses acquired ("PVFP"). The \$10.5 million and \$21.4 million increases in annuity and supplemental insurance acquisition expenses for the second quarter and first six months of 2007, respectively, compared to the 2006 periods reflect the growth in GAFRI's business as well as the acquisition of Ceres in August 2006.

The vast majority of GAFRI'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.

### Other Operating and General Expenses

Other operating and general expenses increased \$73.4 million (68%) for the second quarter and \$70.7 million (32%) for the first six months of 2007 compared to the 2006 periods. Other operating and general expenses for the second quarter of 2007 include a \$43.0 million charge to increase liabilities related to asbestos and environmental exposures related to AFG's former railroad and manufacturing operations and a \$12.5 million charge related to a consumer services contract in AFG's warranty business. For a discussion of the study that resulted in the A&E charge, see "*Asbestos and Environmental Reserve Charge*" under *Results of Operations - "Property and Casualty Insurance - Underwriting."* Other operating and general expenses also include \$1.4 million and \$6.3 million in losses on retirement of debt in the first six months of 2007 and 2006, respectively.

### Income Taxes

Income tax expense reflects benefits of \$3.5 million in the second quarter of 2007 and \$8.7 million in the second quarter of 2006 related to the favorable resolution of certain tax issues.

### Recent Accounting Standard

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities," which permits entities to irrevocably elect to report certain financial assets and liabilities (including most insurance contracts) at fair value and recognize the unrealized gains and losses on such items in earnings. SFAS No. 159 is effective January 1, 2008, for calendar year companies. AFG is currently evaluating whether it will elect the fair value option for any of its eligible assets or liabilities.

Proposed Accounting Standard

Convertible Notes

The FASB has proposed an amendment to SFAS No. 128, "Earnings per Share." Currently, SFAS No. 128 allows companies issuing securities that can be settled in cash or stock (such as AFG's convertible notes) to exclude the issuable shares from the calculation of diluted earnings per share when there is a stated intent and ability to deliver cash in lieu of stock upon settlement or conversion. The proposed statement would require companies to assume settlement in stock (despite the ability and intent to settle in cash) and include those shares in the calculation of diluted earnings per share. The FASB is expected to issue a revised proposal in the third quarter of 2007.

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ITEM 3

Quantitative and Qualitative Disclosure of Market Risk

As of June 30, 2007, there were no material changes to the information provided in Item 7A - "Quantitative and Qualitative Disclosure of Market Risk" of AFG's 2006 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 2007 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 2007 that has materially affected, or is reasonably likely to materially affect, AFG's internal controls over financial reporting.

## PART II

## OTHER INFORMATION

## ITEM 2

Unregistered Sales of Equity Securities and Use of Proceeds

## Issuer Purchases of Equity Securities

AFG repurchased 444,300 shares of its Common Stock at an average price of \$34.33 per share in June 2007 under its publicly announced share repurchase program. AFG may repurchase 4.2 million additional shares under this Program, which has been approved by AFG's Board of Directors.

Under AFG's shareholder-approved Stock Option Plan, 1,068 shares of AFG Common Stock were tendered at \$35.32 per share in connection with the exercise of stock options in May 2007.

## ITEM 4

Submission of Matters to a Vote of Security Holders

AFG's Annual Meeting of Shareholders was held on May 17, 2007; there were three matters voted upon: (Item 1) election of nine directors, (Item 2) ratifying Ernst & Young LLP as independent registered public accounting firm and (Item 3) approval of the 2007 Annual Senior Executive Bonus Plan.

The votes cast for, against, withheld and the number of abstentions as to each matter voted on at the 2007 Annual Meeting is set forth below:

| <u>Name</u>          | <u>For</u>  | <u>Against</u> | <u>Withheld</u> | <u>Abstain</u> |
|----------------------|-------------|----------------|-----------------|----------------|
| Item 1               |             |                |                 |                |
| Kenneth C. Ambrecht  | 104,841,439 | N/A            | 554,105         | N/A            |
| Theodore H. Emmerich | 104,132,644 | N/A            | 1,262,901       | N/A            |
| James E. Evans       | 101,795,992 | N/A            | 3,599,553       | N/A            |
| Terry S. Jacobs      | 104,851,937 | N/A            | 543,607         | N/A            |
| Carl H. Lindner      | 100,523,760 | N/A            | 4,871,783       | N/A            |
| Carl H. Lindner III  | 103,711,308 | N/A            | 1,684,235       | N/A            |
| S. Craig Lindner     | 103,698,307 | N/A            | 1,697,237       | N/A            |
| William R. Martin    | 104,141,600 | N/A            | 1,253,944       | N/A            |
| William W. Verity    | 102,504,510 | N/A            | 2,891,034       | N/A            |
| Item 2               | 105,166,837 | 167,573        | N/A             | 61,078         |
| Item 3               | 99,864,791  | 5,340,688      | N/A             | 190,003        |

N/A - Not Applicable

ITEM 5

Other Information

Because AFG does not foresee the need to raise capital through equity issuances in the near future, it has exercised its right to terminate the equity distribution agreement with UBS Securities LLC.

29

AMERICAN FINANCIAL GROUP, INC. 10-Q

PART II

OTHER INFORMATION - CONTINUED

ITEM 6

Exhibits

Number

Exhibit Description

Computation of ratios of earnings to fixed charges.

12

Certification of the Co-Chief Executive Officer pursuant

31(a)

to section 302(a) of the Sarbanes-Oxley Act of 2002.

Certification of the Co-Chief Executive Officer pursuant

31(b)

to section 302(a) of the Sarbanes-Oxley Act of 2002.

Certification of the Chief Financial Officer pursuant to

31(c)

section 302(a) of the Sarbanes-Oxley Act of 2002.

Certification of the Co-Chief Executive Officers and Chief

32

Financial Officer pursuant to section 906 of the Sarbanes-Oxley Act of 2002.

Signature

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

American Financial Group, Inc.

August 8, 2007

BY: s/Keith A. Jensen

Keith A. Jensen  
Senior Vice President  
(principal financial and  
accounting officer)

30