

AMERICAN FINANCIAL GROUP INC
Form 10-Q
November 07, 2008

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

FORM 10-Q

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

For the Quarterly Period Ended
September 30, 2008

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, a non-accelerated filer or a smaller reporting company:

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

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

As of November 1, 2008, there were 115,535,313 shares of the Registrant's Common Stock outstanding, excluding 14.9 million shares owned by subsidiaries.

AMERICAN FINANCIAL GROUP, INC.

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PART I

ITEM I - FINANCIAL STATEMENTS

AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEET (unaudited)

(Dollars In Millions)

| | September 30, <u>2008</u> | December 31, <u>2007</u> |
|--|------------------------------|-----------------------------|
| Assets: | | |
| Cash and cash equivalents | \$ 1,193.6 | \$ 815.9 |
| Investments: | | |
| Fixed maturities: | | |
| Available for sale - at fair value (amortized cost - \$15,829.9 and \$15,188.1) | 14,645.3 | 15,140.7 |
| Trading - at fair value | 295.6 | 274.1 |
| Equity securities - at fair value: | | |
| Common stocks (cost - \$305.1 and \$723.4) | 377.9 | 750.7 |
| Preferred stocks (cost - \$185.2 and \$191.1) | 138.5 | 172.6 |
| Mortgage loans | 329.5 | 358.8 |
| Policy loans | 279.2 | 273.2 |
| | <u>294.3</u> | <u>268.1</u> |
| Real estate and other investments | | |
| Total cash and investments | 17,553.9 | 18,054.1 |
| Recoverables from reinsurers and prepaid reinsurance premiums | 3,980.7 | 3,664.1 |

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| | | |
|---|-------------------|-------------------|
| Agents' balances and premiums receivable | 998.8 | 560.6 |
| Deferred policy acquisition costs | 2,055.4 | 1,394.4 |
| Other receivables | 541.3 | 475.4 |
| Variable annuity assets (separate accounts) | 524.4 | 692.5 |
| Other assets | 1,060.3 | 762.0 |
| | <u>209.8</u> | <u>204.4</u> |
| Goodwill | | |
| | <u>\$26,924.6</u> | <u>\$25,807.5</u> |
| Liabilities and Capital: | | |
| Unpaid losses and loss adjustment expenses | \$ 6,568.0 | \$ 6,168.4 |
| Unearned premiums | 2,039.1 | 1,668.2 |
| Annuity benefits accumulated | 10,580.5 | 10,096.6 |
| Life, accident and health reserves | 1,552.3 | 1,483.7 |
| Payable to reinsurers | 531.2 | 363.8 |
| Long-term debt | 952.2 | 936.9 |
| Variable annuity liabilities (separate accounts) | 524.4 | 692.5 |
| Accounts payable, accrued expenses and other liabilities | <u>1,285.8</u> | <u>1,251.4</u> |
| Total liabilities | 24,033.5 | 22,661.5 |
| Minority interest | 114.5 | 99.9 |
| Shareholders' Equity: | | |
| Common Stock, no par value | | |
| - 200,000,000 shares authorized | | |
| - 115,442,774 and 113,499,080 shares outstanding | 115.4 | 113.5 |
| Capital surplus | 1,229.9 | 1,186.5 |
| Retained earnings | 1,817.7 | 1,733.5 |
| Accumulated other comprehensive income (loss), net of tax | <u>(386.4)</u> | <u>12.6</u> |
| Total shareholders' equity | <u>2,776.6</u> | <u>3,046.1</u> |
| | <u>\$26,924.6</u> | <u>\$25,807.5</u> |

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CONSOLIDATED STATEMENT OF EARNINGS (unaudited)

(In Millions, Except Per Share Data)

| | Three months ended | | Nine months ended | |
|---|----------------------|----------------|----------------------|----------------|
| | | | <u>September 30,</u> | |
| | <u>September 30,</u> | | | |
| | <u>2008</u> | <u>2007</u> | <u>2008</u> | <u>2007</u> |
| Income: | | | | |
| Property and casualty insurance premiums | \$ 850.6 | \$ 757.5 | \$2,104.4 | \$2,030.8 |
| Life, accident and health premiums | 109.3 | 105.6 | 325.9 | 315.6 |
| Investment income | 283.1 | 252.7 | 820.3 | 747.5 |
| Realized gains (losses) on securities | (150.1) | (7.1) | (293.5) | 11.6 |
| Other income | <u>77.0</u> | <u>78.4</u> | <u>231.8</u> | <u>237.8</u> |
| | 1,169.9 | 1,187.1 | 3,188.9 | 3,343.3 |
| Costs and Expenses: | | | | |
| Property and casualty insurance: | | | | |
| Losses and loss adjustment expenses | 551.8 | 436.0 | 1,185.8 | 1,117.7 |
| Commissions and other underwriting expenses | 226.0 | 219.7 | 659.0 | 638.4 |
| Annuity benefits | 100.9 | 94.5 | 287.6 | 273.7 |
| Life, accident and health benefits | 81.1 | 87.1 | 253.8 | 258.0 |
| Annuity and supplemental insurance acquisition expenses | 46.1 | 40.0 | 140.9 | 125.2 |
| Interest charges on borrowed money | 16.3 | 17.8 | 52.3 | 53.6 |
| Other operating and general expenses | <u>119.7</u> | <u>108.8</u> | <u>355.5</u> | <u>387.4</u> |
| | <u>1,141.9</u> | <u>1,003.9</u> | <u>2,934.9</u> | <u>2,854.0</u> |
| Operating earnings before income taxes | 28.0 | 183.2 | 254.0 | 489.3 |
| Provision for income taxes | <u>9.5</u> | <u>62.7</u> | <u>91.4</u> | <u>171.3</u> |
| Net operating earnings | 18.5 | 120.5 | 162.6 | 318.0 |
| Minority interest | <u>2.4</u> | <u>(7.8)</u> | <u>(5.4)</u> | <u>(26.4)</u> |
| |) |) |) | |
| Earnings from continuing operations | 20.9 | 112.7 | 157.2 | 291.6 |

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| | | | | |
|---|----------------|-----------------|-----------------|-----------------|
| Discontinued operations, net of tax | <u>—</u> | <u>—</u> | <u>—</u> | <u>1.7</u> |
| Net Earnings | <u>\$ 20.9</u> | <u>\$ 112.7</u> | <u>\$ 157.2</u> | <u>\$ 293.3</u> |
| Basic earnings per Common Share: | | | | |
| Continuing operations | \$.18 | \$.96 | \$ 1.38 | \$ 2.46 |
| Discontinued operations | <u>—</u> | <u>—</u> | <u>—</u> | <u>.01</u> |
| Net earnings available to Common Shares | <u>\$.18</u> | <u>\$.96</u> | <u>\$ 1.38</u> | <u>\$ 2.47</u> |
| Diluted earnings per Common Share: | | | | |
| Continuing operations | \$.18 | \$.93 | \$ 1.34 | \$ 2.39 |
| Discontinued operations | <u>—</u> | <u>—</u> | <u>—</u> | <u>.01</u> |
| Net earnings available to Common Shares | <u>\$.18</u> | <u>\$.93</u> | <u>\$ 1.34</u> | <u>\$ 2.40</u> |
| Average number of Common Shares: | | | | |
| Basic | 115.2 | 117.6 | 114.0 | 118.9 |
| Diluted | 116.9 | 119.8 | 117.0 | 121.6 |
| Cash dividends per Common Share | \$.125 | \$.10 | \$.375 | \$.30 |

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AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY (unaudited)

(Dollars in Millions)

| | <u>Common</u> <u>Shares</u> | <u>Common Stock</u> <u>and Capital</u> <u>Surplus</u> | <u>Retained</u> <u>Earnings</u> | <u>Accumulated</u> <u>Other</u> <u>Comprehensive</u> <u>Income (Loss)</u> | <u>Total</u> |
|------------------------------|--------------------------------|---|------------------------------------|--|--------------|
| Balance at December 31, 2007 | 113,499,080 | \$1,300.0 | \$1,733.5 | \$ 12.6 | \$3,046.1 |
| Net earnings | - | - | 157.2 | - | 157.2 |

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| | | | | | |
|---|--------------------|------------------|------------------|------------------|------------------|
| Other comprehensive income (loss), net of tax: | | | | | |
| Change in unrealized gain (loss) | | | | | |
| on securities | - | - | - | (389.0) | (389.0) |
| Change in foreign currency translation | - | - | - | (10.2) | (10.2) |
| Change in unrealized pension and other postretirement benefits | - | - | - | .2 | <u>.2</u> |
| Total comprehensive loss | | | | | (241.8) |
| Dividends on Common Stock | - | - | (42.7) | - | (42.7) |
| Shares issued: | | | | | |
| Redemption of convertible notes | 2,364,640 | 24.4 | - | - | 24.4 |
| Exercise of stock options | 1,234,365 | 24.9 | - | - | 24.9 |
| Other benefit plans | 186,024 | 5.2 | - | - | 5.2 |
| Dividend reinvestment plan | 209,297 | 5.5 | - | - | 5.5 |
| Other stock-based compensation expense | - | 7.7 | - | - | 7.7 |
| Shares acquired and retired | (1,803,000) | (20.7) | (26.7) | - | (47.4) |
| Shares tendered in option exercises | (247,632) | (2.8) | (3.6) | - | (6.4) |
| Capital transactions of subsidiaries | <u>-</u> | <u>1.1</u> | <u>-</u> | <u>-</u> | <u>1.1</u> |
| Balance at September 30, 2008 | <u>115,442,774</u> | <u>\$1,345.3</u> | <u>\$1,817.7</u> | <u>(\$386.4)</u> | <u>\$2,776.6</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 | - | - | 293.3 | - | 293.3 |
| Other comprehensive income, net of tax: | | | | | |
| Change in unrealized gain (loss) | | | | | |
| on securities | - | - | - | (71.1) | (71.1) |
| Change in foreign currency translation | - | - | - | 20.6 | 20.6 |
| Change in unrealized pension and other postretirement benefits | - | - | - | 2.9 | <u>2.9</u> |
| Total comprehensive income | | | | | 245.7 |
| Dividends on Common Stock | - | - | (35.8) | - | (35.8) |
| Shares issued: | | | | | |
| Exercise of stock options | 641,460 | 14.9 | - | - | 14.9 |
| Other benefit plans | 185,534 | 6.4 | - | - | 6.4 |
| Dividend reinvestment plan | 126,523 | 4.0 | - | - | 4.0 |

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| | | | | | |
|---|--------------------|------------------|------------------|----------------|------------------|
| Other stock-based compensation expense | - | 7.1 | - | - | 7.1 |
| Shares acquired and retired | (4,700,139) | (53.2) | (80.2) | - | (133.4) |
| Shares tendered in option exercises | (26,498) | (.3) | (.6) | - | (.9) |
| Effect of minority interest repurchased | - | - | - | (8.0) | (8.0) |
| Capital transactions of subsidiaries | <u>-</u> | <u>(1.1)</u> | <u>-</u> | <u>-</u> | <u>(1.1)</u> |
| |) | | |) | |
| Balance at September 30, 2007 | <u>115,530.808</u> | <u>\$1,317.6</u> | <u>\$1,695.4</u> | <u>(\$.1)</u> | <u>\$3,012.9</u> |

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AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF CASH FLOWS (UNAUDITED)

(In Millions)

| | Nine months ended | |
|--|----------------------|--------------|
| | <u>September 30,</u> | <u>2007</u> |
| | <u>2008</u> | <u>2007</u> |
| Operating Activities: | | - |
| Net earnings | \$ 157.2 | \$ 293.3 |
| Adjustments: | | |
| Minority interest | 5.4 | 26.7 |
| Depreciation and amortization | 185.8 | 139.7 |
| Annuity benefits | 287.6 | 273.7 |
| Realized (gains) losses on investing activities | 287.2 | (26.9) |
| Net (purchases) sales of trading securities | 47.5 | (34.8) |
| Deferred annuity and life policy acquisition costs | (143.3) | (154.6) |
| Increase in reinsurance and other receivables | (657.0) | (321.1) |
| Increase in other assets | (74.7) | (178.6) |
| Increase in insurance claims and reserves | 672.1 | 483.8 |
| Increase in payable to reinsurers | 165.8 | 96.6 |
| Increase (decrease) in other liabilities | (71.3) | 10.3 |
| Other, net | <u>2.9</u> | <u>12.9</u> |
| Net cash provided by operating activities | <u>865.2</u> | <u>621.0</u> |

Investing Activities

| | | |
|--|----------------|------------------|
| : | | |
| Purchases of and additional investments in: | | |
| Fixed maturity investments | (4,998.5) | (2,894.6) |
| Equity securities | (138.5) | (416.4) |
| Subsidiaries | (112.2) | (239.7) |
| Real estate, property and equipment | (35.9) | (25.0) |
| Maturities and redemptions of fixed maturity investments | 1,534.6 | 1,125.5 |
| Sales of: | | |
| Fixed maturity investments | 2,670.3 | 1,164.1 |
| Equity securities | 334.6 | 125.4 |
| Real estate, property and equipment | 8.5 | 24.0 |
| Decrease in securities lending collateral | 43.7 | 11.2 |
| Cash and cash equivalents of businesses acquired | 44.3 | - |
| Increase in other investments | <u>(10.8)</u> | <u>(108.5)</u> |
| |) |) |
| Net cash used in investing activities | <u>(659.9)</u> | <u>(1,234.0)</u> |
| |) |) |

Financing Activities

| | | |
|--|------------------|-----------------|
| : | | |
| Annuity receipts | 1,275.9 | 1,204.5 |
| Annuity surrenders, benefits and withdrawals | (1,049.9) | (1,057.3) |
| Net transfers from variable annuity assets | 39.6 | 51.3 |
| Additional long-term borrowings | 600.0 | 142.0 |
| Reductions of long-term debt | (584.9) | (167.5) |
| Decrease in securities lending obligation | (43.7) | (11.2) |
| Issuances of Common Stock | 20.6 | 14.5 |
| Repurchases of Common Stock | (47.4) | (133.4) |
| Cash dividends paid on Common Stock | (37.2) | (31.7) |
| Other, net | <u>(0.6)</u> | <u>2.0</u> |
| |) |) |
| Net cash provided by financing activities | <u>172.4</u> | <u>13.2</u> |
| Net Increase (Decrease) in Cash and Cash Equivalents | 377.7 | (599.8) |
| Cash and cash equivalents at beginning of period | <u>815.9</u> | <u>1,329.0</u> |
| Cash and cash equivalents at end of period | <u>\$1,193.6</u> | <u>\$ 729.2</u> |

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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| E. | <u>Intangible Assets</u> | | |

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.

Fair Value Measurements

Effective January 1, 2008, AFG adopted Statement of Financial Accounting Standards ("SFAS") No. 157, "Fair Value Measurements." SFAS 157 defines fair value as the price that would be received to sell an asset or paid to transfer a liability (an exit price) in an orderly transaction between market participants on the measurement date. The standard establishes a hierarchy of valuation techniques based on whether the assumptions that market participants would use in pricing the asset or liability ("inputs") are observable

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or unobservable. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect AFG's assumptions about the assumptions market participants would use in pricing the asset or liability. In 2008, the FASB delayed the effective date of SFAS 157 for all nonrecurring fair value measurements of nonfinancial assets and liabilities until fiscal years beginning after November 15, 2008. Adoption of SFAS 157 did not have a significant impact on AFG's financial condition or results of operations.

Investments

Fixed maturity and equity securities classified as "available for sale" are reported at fair value with unrealized gains and losses included in a separate component of shareholders' equity. Fixed maturity and equity securities classified as "trading" are reported at fair value with changes in unrealized holding gains or losses during the period included in investment income. Loans receivable are carried primarily at the aggregate unpaid balance.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

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 at the balance sheet date, a provision for impairment is charged to earnings (included in realized gains (losses)) and the cost basis of that investment is reduced.

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) in its Balance Sheet at fair value. The obligation to return the collateral is included in other liabilities. The securities loaned remain a recorded asset on AFG's Balance Sheet. The fair value of collateral held was approximately \$89 million at September 30, 2008, and \$139 million at December 31, 2007. The fair value of securities loaned plus accrued interest was approximately \$96 million and \$139 million at those dates.

Derivatives

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

Goodwill

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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.

Certain annuity and supplemental insurance subsidiaries cede life insurance policies to a third party on a funds withheld basis whereby the subsidiaries retain the assets (securities) associated with the reinsurance contracts. Interest is credited to the reinsurer based on the actual investment performance of the retained assets. These reinsurance contracts are considered to contain embedded derivatives (that must be adjusted to fair value) because the yield on the payables is based on specific blocks of the ceding companies'

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

assets, rather than the overall creditworthiness of the ceding company. AFG determined that changes in the fair value of the underlying portfolios of fixed maturity securities is an appropriate measure of the value of the embedded derivative. The securities related to these transactions are classified as "trading." The adjustment to fair value on the embedded derivatives offsets the investment income recorded on the adjustment to fair value of the related trading portfolios.

Deferred Policy Acquisition Costs ("DPAC")

Policy acquisition costs (principally commissions, premium taxes and other marketing and underwriting expenses) related to the production of new business are deferred. 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 on securities result in adjustments to the amortization of DPAC related to annuities, such adjustments are reflected as components of realized gains (losses).

DPAC related to annuities is also adjusted, net of tax, for the change in amortization that would have been recorded if the unrealized gains (losses) from securities had actually been realized. This adjustment is included in unrealized gains (losses) on marketable securities, a component of "Accumulated Other Comprehensive Income (Loss), net of tax" in the shareholders' equity section of the Balance Sheet. In light of the increasing significance of unrealized losses on fixed maturity securities during the third quarter of 2008, AFG refined its method of estimating the impact of unrealized losses on DPAC, more closely aligning the impact with the expected gross profits over the lives of the related annuity contracts. This refinement impacted the accumulated other comprehensive income (loss) component of shareholders' equity at September 30, 2008, but had no impact on net earnings. Had this change in estimate been made at June 30, 2008, shareholders' equity would have been 4% higher due to a reduction in "other comprehensive loss" of approximately \$120 million for the six-month period then ended.

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

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

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

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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 AFG 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

Deferred income taxes are calculated using the liability method. Under this method, deferred income tax assets and liabilities are determined

based on differences between financial reporting and tax bases and are measured using enacted tax rates. Deferred tax assets are recognized if it is more likely than not that a benefit will be realized.

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

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 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.

Stock-Based Compensation

All share-based grants are recognized as compensation expense over their vesting periods based on their calculated "fair value" at the date of grant. AFG uses the Black-Scholes pricing model to measure the fair value of employee stock options. See Note G - "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> <u>September 30.</u> | | <u>Nine months ended</u> <u>September 30.</u> | |
|---|---|-------------|--|-------------|
| | <u>2008</u> | <u>2007</u> | <u>2008</u> | <u>2007</u> |
| Adjustments to net earnings: | | | | |
| Dilution of majority-owned subsidiaries | \$ - | (\$).1 | (\$).1 | (\$1.0) |
| Assumed issuance of shares under deferred compensation plan | - | (.6) | .2 | (.8) |
| Adjustments to weighted average common shares: | | | | |

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| | | | | |
|--------------------------------|-----|-----|-----|-----|
| Stock-based compensation plans | 1.7 | 2.3 | 1.9 | 2.7 |
| Convertible notes | - | - | 1.1 | - |

AFG's weighted average diluted shares outstanding excludes the following anti-dilutive potential common shares related to stock compensation plans: third

quarter of 2008 and 2007 - 3.9 million and 2.5 million; nine months of 2008 and 2007 - 4.2 million and 1.1 million, respectively.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

Statement of Cash Flows

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

B.

Acquisitions of Subsidiaries

Marketform Group

In January 2008, AFG paid \$75 million in cash (including transaction costs) to acquire approximately 67% of Marketform Group Limited, an agency that focuses on medical malpractice and other specialty property and casualty insurance products outside of the United States using a Lloyd's platform. As part of the acquisition, AFG also provided a \$46 million letter of credit and became a corporate member in Lloyd's Syndicate 2468, which is managed by Marketform. Approximately \$36 million of the acquisition cost was recorded as an intangible asset for the present value of future profits from the acquired business and is being amortized over the estimated retention period of seven years. This business generated \$81 million in net written premiums for the first nine months of 2008.

Strategic Comp Holdings

AFG acquired Strategic Comp Holdings, LLC in January 2008 for \$37 million in cash. Additional contingent consideration could be due after seven years based on achieving certain operating milestones. Strategic Comp, headquartered in Louisiana, is a provider of workers' compensation programs for mid-size to large commercial accounts. The entire purchase price was recorded as intangible renewal rights and is being amortized over the estimated retention period of seven years. This acquisition resulted in a \$9 million increase in net written premiums and generated fee income of \$.6 million for the first nine months of 2008.

Great American Financial Resources

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In September 2007, Great American Financial Resources, Inc. ("GAFRI") completed the acquisition of the 9.2 million shares (19%) of its common stock not previously owned by AFG at a price of \$24.50 per share in cash. Total cost of the acquisition (\$239 million), including cash paid for vested options and merger costs, was provided by AFG (parent company). The acquisition resulted in a \$217 million reduction of minority interest and an increase of \$28 million in goodwill.

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.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

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

| | Three months ended | | Nine months ended | |
|----------------------------------|----------------------|-------------|----------------------|-------------|
| | <u>September 30.</u> | | <u>September 30.</u> | |
| | <u>2008</u> | <u>2007</u> | <u>2008</u> | <u>2007</u> |
| Revenues | | | | |
| Property and casualty insurance: | | | | |
| Premiums earned: | | | | |
| Specialty | | | | |
| Property and transportation | \$ 457.6 | \$ 350.1 | \$ 915.9 | \$ 817.5 |
| Specialty casualty | 199.1 | 206.6 | 611.3 | 630.0 |
| Specialty financial | 123.7 | 125.1 | 369.9 | 351.9 |
| California workers' compensation | 51.6 | 57.1 | 155.3 | 178.6 |
| Other | 18.5 | 18.5 | 51.7 | 52.4 |

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| | | | | |
|-------------------------------------|------------------|------------------|------------------|------------------|
| Other lines | <u>.1</u> | <u>.1</u> | <u>.3</u> | <u>.4</u> |
| | 850.6 | 757.5 | 2,104.4 | 2,030.8 |
| Investment income | 98.1 | 89.6 | 296.3 | 260.3 |
| Realized gains (losses) | (57.7) | (4.6) | (133.1) | 5.1 |
| Other | <u>42.7</u> | <u>42.6</u> | <u>124.7</u> | <u>126.6</u> |
| | 933.7 | 885.1 | 2,392.3 | 2,422.8 |
| Annuity and supplemental insurance: | | | | |
| Investment income | 183.0 | 161.2 | 523.7 | 479.5 |
| Life, accident and health premiums | 109.3 | 105.6 | 325.9 | 315.6 |
| Realized gains (losses) | (93.0) | (6.2) | (157.8) | 3.8 |
| Other | <u>29.8</u> | <u>33.1</u> | <u>90.4</u> | <u>92.0</u> |
| | 229.1 | 293.7 | 782.2 | 890.9 |
| Other | <u>7.1</u> | <u>8.3</u> | <u>14.4</u> | <u>29.6</u> |
| | <u>\$1,169.9</u> | <u>\$1,187.1</u> | <u>\$3,188.9</u> | <u>\$3,343.3</u> |

Operating Earnings Before Income Taxes

Property and casualty insurance:

Underwriting:

Specialty

| | | | | |
|----------------------------------|-----------|--------------|--------------|---------------|
| Property and transportation | \$ 12.0 | \$ 58.5 | \$ 63.6 | \$ 123.2 |
| Specialty casualty | 46.6 | 39.0 | 143.1 | 165.3 |
| Specialty financial | (1.9) | 8.2 | 19.8 | 22.5 |
| California workers' compensation | 10.5 | 12.8 | 33.7 | 37.9 |
| Other (a) | 4.7 | (13.7) | 7.3 | (26.1) |
| Other lines (b) | <u>.9</u> | <u>(3.0)</u> | <u>(7.9)</u> | <u>(48.1)</u> |

| | | | |
|------|-------|-------|-------|
|) |) |) |) |
| 72.8 | 101.8 | 259.6 | 274.7 |

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| | | | | |
|---------------------------------------|----------------|-----------------|-----------------|-----------------|
| Investment and other operating income | 83.3 | 79.3 | 252.4 | 226.4 |
| Realized gains (losses) | <u>(57.7)</u> | <u>(4.6)</u> | <u>(133.1)</u> | <u>5.1</u> |
| |) |) |) | |
| | 98.4 | 176.5 | 378.9 | 506.2 |
| Annuity and supplemental insurance: | | | | |
| Operations (c) | 49.2 | 34.7 | 120.3 | 103.8 |
| Realized gains (losses) | <u>(93.0)</u> | <u>(6.2)</u> | <u>(157.8)</u> | <u>3.8</u> |
| |) |) |) | |
| | (43.8) | 28.5 | (37.5) | 107.6 |
| Other (c)(d) | <u>(26.6)</u> | <u>(21.8)</u> | <u>(87.4)</u> | <u>(124.5)</u> |
| |) |) |) |) |
| | <u>\$ 28.0</u> | <u>\$ 183.2</u> | <u>\$ 254.0</u> | <u>\$ 489.3</u> |

- (a) Includes a benefit of \$9.0 million in the first nine months of 2008 and a charge of \$25.5 million in the first nine months of 2007 related to retroactive reinsurance gains.
- (b) Includes a second quarter 2008 charge of \$12.0 million and a second quarter 2007 charge of \$44.2 million to increase asbestos and environmental reserves.
- (c) GAFRI's \$2.0 million second quarter 2007 environmental liabilities charge and holding company interest and debt expense of \$5.2 million for the 2007 third quarter and \$16.2 million for the first nine months of 2007 were reclassified from "Annuity and supplemental insurance" to "Other" to be consistent with the current year presentation.
- (d) Includes second quarter charges of \$3.0 million in 2008 and \$43.0 million in 2007 related to asbestos and environmental liabilities at former railroad and manufacturing operations.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

D. Fair Value Measurements

The framework established in SFAS 157 for measuring fair value is based on inputs used in estimating fair value. The three levels of the hierarchy are as follows:

Level 1 - Quoted prices for identical assets or liabilities in active markets (markets in which transactions occur with sufficient frequency and volume to provide pricing information on an ongoing basis).

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Level 2 - Quoted prices for similar instruments in active markets; quoted prices for identical or similar assets or liabilities in inactive markets (markets in which there are few transactions, the prices are not current, price quotations vary substantially over time or among market makers, or in which little information is released publicly); and valuations based on other significant inputs that are observable in active markets.

Level 3 - Valuations derived from valuation techniques in which one or more significant inputs are unobservable. The unobservable inputs may include management's own assumptions about the assumptions market participants would use based on the best information available in the circumstances.

AFG's Level 1 financial instruments consist primarily of publicly traded equity securities, highly liquid government bonds and separate account assets and liabilities for which quoted market prices in active markets are available. AFG's Level 2 financial instruments include primarily corporate and municipal fixed maturity securities and mortgage-backed securities priced using observable inputs. Level 2 inputs include benchmark yields, reported trades, corroborated broker/dealer quotes, issuer spreads and benchmark securities. When non-binding broker quotes can be corroborated by comparison to similar securities priced using observable inputs, they are classified as Level 2. AFG's Level 3 is comprised of financial instruments whose fair value is estimated based on non-binding broker quotes or internally developed using significant inputs not based on, or corroborated by, readily available market information. AFG's management is responsible for the valuation process and uses data from outside sources in establishing fair value. This data is reviewed by internal investment professionals who determine appropriate fair value measurements.

Assets and liabilities measured at fair value on September 30, 2008, are summarized below (in millions):

| | <u>Level 1</u> | <u>Level 2</u> | <u>Level 3</u> | <u>Total</u> |
|--|----------------|-----------------|----------------|-----------------|
| Assets: | | | | |
| Fixed maturities: | | | | |
| Available for sale ("AFS") | \$ 346 | \$13,634 | \$665 | \$14,645 |
| Trading | - | 291 | 5 | 296 |
| Equity securities | 331 | 126 | 59 | 516 |
| Separate account assets (a) | 524 | - | - | 524 |
| Other investments | - | 11 | - | 11 |
| Other assets | <u>34</u> | <u>49</u> | <u>6</u> | <u>89</u> |
| | | | | |
| Total assets accounted for at fair value | <u>\$1,235</u> | <u>\$14,111</u> | <u>\$735</u> | <u>\$16,081</u> |
| | | | | |
| Liabilities: | | | | |
| Derivatives embedded in annuity | | | | |
| benefits accumulated | <u>\$ -</u> | <u>\$ -</u> | <u>\$111</u> | <u>\$ 111</u> |

(a) Separate account liabilities equal the fair value for separate account assets.

Approximately 4-1/2% of the total assets measured at fair value were Level 3 assets. Approximately 44% of these assets were mortgage-backed securities whose fair values were determined primarily using non-binding broker quotes; the balance was primarily private placement debt and equity securities whose fair values were determined internally using significant unobservable inputs,

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

including the evaluation of underlying collateral and issuer creditworthiness, as well as certain Level 2 inputs such as comparable yields and multiples on similar publicly traded issues.

Changes in balances of Level 3 financial assets and liabilities during the third quarter and first nine months of 2008 are presented below (in millions). Transfers into (out of) Level 3 are due to a change in the availability of market observable inputs for individual securities.

| | <u>Fixed Maturities</u> | | Equity | Other | Embedded |
|---|-------------------------|----------------|-------------------|---------------|--------------------|
| | <u>AFS</u> | <u>Trading</u> | <u>Securities</u> | <u>Assets</u> | <u>Derivatives</u> |
| Balance at July 1, 2008 | \$682 | \$ 10 | \$ 60 | \$ 3 | \$124 |
| Total realized/unrealized gains (losses): | | | | | |
| Included in net income | (15) | (1) | - | - | (16) |
| Included in other comprehensive | | | | | |
| income (loss) | (20) | - | (1) | - | - |
| Purchases, sales, issuances and settlements | 44 | - | - | - | 3 |
| Transfers into (out of) Level 3 | <u>(26)</u> | <u>(4)</u> | <u>-</u> | <u>3</u> | <u>-</u> |
| |) |) | | | |
| Balance at September 30, 2008 | <u>\$665</u> | <u>\$ 5</u> | <u>\$ 59</u> | <u>\$ 6</u> | <u>\$111</u> |

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| | | | | | |
|---|--------------|-------------|-------------|-------------|--------------|
| Balance at January 1, 2008 | \$527 | \$ 11 | \$ 56 | \$ 5 | \$155 |
| Total realized/unrealized gains (losses): | | | | | |
| Included in net income | 3 | (1) | - | (1) | (61) |
| Included in other comprehensive | | | | | |
| income (loss) | (39) | - | (1) | - | - |
| Purchases, sales, issuances and settlements | 164 | (1) | (10) | (1) | 17 |
| Transfers into (out of) Level 3 | <u>10</u> | <u>(4)</u> | <u>14</u> | <u>3</u> | <u>-</u> |
| | |) | | | |
| Balance at September 30, 2008 | <u>\$665</u> | <u>\$ 5</u> | <u>\$59</u> | <u>\$ 6</u> | <u>\$111</u> |

E.

Intangible Assets Included in deferred policy acquisition costs in AFG's Balance Sheet are \$331.0 million and \$249.1 million at September 30, 2008, and December 31, 2007, respectively, representing the present value of future profits ("PVFP") related to acquisitions by AFG's annuity and supplemental insurance business. The PVFP amounts include adjustments related to unrealized gains and losses on securities and are net of \$110.9 million and \$88.1 million of accumulated amortization. Amortization of the PVFP was \$6.5 million in the third quarter and \$22.8 million during the first nine months of 2008 and \$1.9 million in the third quarter and \$9.5 million in the first nine months of 2007, respectively. The increase in amortization for the 2008 periods compared to the 2007 periods reflects an increase in PVFP under purchase accounting for the September 2007 acquisition of the GAFRI common stock not previously owned by AFG.

Included in other assets in AFG's Balance Sheet at September 30, 2008, is \$82.3 million in amortizable intangible assets (net of accumulated amortization of \$32.0 million) related to property and casualty insurance acquisitions, primarily the 2008 acquisitions of Marketform and Strategic Comp. Amortization of these intangibles was \$6.1 million in the third quarter and \$18.2 million during the first nine months of 2008 compared to \$2.3 million in the third quarter and \$5.1 million in the first nine months of 2007.

F.

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

| | September 30, <u>2008</u> | December 31, <u>2007</u> |
|--|------------------------------|-----------------------------|
| Direct obligations of AFG: | | |
| 7-1/8% Senior Debentures due April 2009 | \$173.3 | \$173.2 |
| 7-1/8% Senior Debentures due February 2034 | 115.0 | 115.0 |
| Senior Convertible Notes | - | 189.7 |
| Borrowings under bank credit facility | 350.0 | 95.0 |
| Other | <u>2.9</u> | <u>2.9</u> |
| | <u>641.2</u> | <u>575.8</u> |

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

| | September 30, <u>2008</u> | December 31, <u>2007</u> |
|--|------------------------------|-----------------------------|
| Subsidiaries | | |
| : | | |
| Obligations of AAG Holding (guaranteed by AFG): | | |
| 7-1/2% Senior Debentures due November 2033 | 112.5 | 112.5 |
| 7-1/4% Senior Debentures due January 2034 | 86.3 | 86.3 |
| 6-7/8% Senior Notes | - | 28.5 |
| Borrowings under bank credit facility | - | 21.0 |
| Notes payable secured by real estate due 2008 through 2016 | 67.1 | 67.5 |
| National Interstate bank credit facility | 15.0 | - |
| American Premier Underwriters 10-7/8% Subordinated Notes due May 2011 | 7.9 | 8.0 |
| Other | <u>2.2</u> | <u>2.3</u> |
| | <u>291.0</u> | <u>326.1</u> |
| Payable to Subsidiary Trusts: | | |
| AAG Holding 7.35% Subordinated Debentures due May 2033 | 20.0 | 20.0 |
| National Interstate Subordinated Debentures | <u>-</u> | <u>15.0</u> |
| | <u>20.0</u> | <u>35.0</u> |
| | <u>\$952.2</u> | <u>\$936.9</u> |

At September 30, 2008, scheduled principal payments on debt for the balance of 2008 and the subsequent five years were as follows: 2008 - \$.3 million; 2009 - \$174.6 million; 2010 - \$1.3 million; 2011 - \$359.1 million; 2012 - \$16.4 million; and 2013 - \$1.5 million.

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

| | September 30, | December 31, |
|------------------------------------|------------------------|------------------------|
| | - | - |
| | <u>2008</u> | <u>2007</u> |
| Unsecured obligations | \$885.1 <u>67.1</u> | \$869.4 <u>67.5</u> |
| Obligations secured by real estate | <u>\$952.2</u> | <u>\$936.9</u> |

AFG has a revolving credit facility under which it can borrow up to \$500 million through March 2011. Amounts borrowed bear interest at rates ranging from .5% to 1.25% (currently .75%) over LIBOR based on AFG's credit rating. At September 30, 2008, AFG had \$350 million in borrowings outstanding under the credit facility (interest rate of 4.4% at September 30, 2008).

In July 2008, AFG entered into a 364 day revolving credit facility under which it can borrow up to \$120 million at an interest rate of 2.25% over LIBOR. No amounts have been borrowed under this credit facility.

In the second quarter of 2008, AFG paid \$189.7 million in cash and issued 2.4 million shares of Common Stock to redeem its Senior Convertible Notes. AFG paid cash in lieu of Common Stock for all conversions of the Notes prior to the redemption. Since AFG had previously expressed its intent to use cash for the accreted value of the Notes and the option to use stock for the conversion premium, shares issuable for amounts in excess of the accreted value of the Notes are included in AFG's calculation of diluted earnings per share for the first nine months of 2008.

In May 2008, National Interstate borrowed \$15 million under its credit facility to redeem its \$15 million in outstanding variable rate Subordinated Debentures due May 2033. In June 2008, GAFRI paid \$28.5 million to redeem its outstanding 6-7/8% Senior Notes at maturity.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

G.

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

In the first nine months of 2008, AFG repurchased approximately 1.8 million shares of its Common Stock for \$47.4 million. In the second quarter of 2008, AFG issued 2.4 million shares of Common Stock in connection with the redemption of its Senior Convertible Notes.

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Accumulated Other Comprehensive Income (Loss), Net of Tax

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

| | September 30, — | December 31, <u>2007</u> |
|---|--------------------|-----------------------------|
| | <u>2008</u> | |
| Net unrealized loss on securities | (\$407.4) | (\$18.4) |
| Foreign currency translation adjustment | 17.7 | 27.9 |
| Unrealized pension and other | <u>3.3</u> | <u>3.1</u> |
| postretirement benefits | | |
| Total accumulated other | <u>(\$386.4)</u> | <u>\$12.6</u> |
| comprehensive income (loss) | | |

Net Unrealized Loss on Securities

In addition to adjusting equity securities and fixed maturity securities classified as "available for sale" to fair value, SFAS 115 requires that deferred policy acquisition costs related to annuities and certain other balance sheet amounts be adjusted to the extent that unrealized gains and losses from securities would result in adjustments to those balances had the unrealized gains or losses actually been realized. The following table shows the components of the net unrealized loss on securities that is included in Accumulated Other Comprehensive Income (Loss) in the table above.

| | <u>Pre-tax</u> | <u>Deferred Tax and Minority Interest</u> | <u>Net</u> |
|-----------------------------------|-------------------|---|------------------|
| <u>September 30, 2008</u> | | | |
| Unrealized gain (loss) on: | | | |
| Fixed maturity securities | (\$1,184.6) | \$417.5 | (\$767.1) |
| Equity securities | 26.1 | (7.7) | 18.4 |
| Securities lending collateral | (7.8) | 5.1 | (2.7) |
| Deferred policy acquisition costs | 542.1 | (189.8) | 352.3 |
| Annuity benefits and other | <u>(12.7)</u> | <u>4.4</u> | <u>(8.3)</u> |
| liabilities) |) |) | |
| | <u>(\$ 636.9)</u> | <u>\$229.5</u> | <u>(\$407.4)</u> |
| <u>December 31, 2007</u> | | | |
| Unrealized gain (loss) on: | | | |
| Fixed maturity securities | (\$ 47.4) | \$ 16.5 | (\$ 30.9) |
| Equity securities | 8.8 | (1.9) | 6.9 |

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| | | | |
|-----------------------------------|------------------|----------------|------------------|
| Securities lending collateral | (2.0) | 1.3 | (0.7) |
| Deferred policy acquisition costs | 10.7 | (3.7) | 7.0 |
| Annuity benefits and other | | | |
| | <u>(1.0)</u> | <u>.3</u> | <u>(.7)</u> |
| liabilities |) |) | |
| | <u>(\$ 30.9)</u> | <u>\$ 12.5</u> | <u>(\$ 18.4)</u> |

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 nine months of 2008, AFG issued 70,000 shares of Common Stock and granted stock options for 1.5 million shares of Common Stock (at an average exercise price of \$27.21) under the Stock Incentive Plan.

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AMERICAN FINANCIAL GROUP, INC. 10-Q

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

AFG uses the Black-Scholes option pricing model to calculate the "fair value" of its option grants. Expected volatility is based on historical volatility over a period equal to the expected term. The expected term was estimated based on historical exercise patterns and post vesting cancellations. The fair value of options granted during 2008 was \$7.93 per share based on the following assumptions: expected dividend yield - 1.8%; expected volatility - 28%; expected term - 7.5 years; risk-free rate - 3.2%.

Total compensation expense related to stock incentive plans of AFG and its subsidiaries was as follows: third quarter of 2008 and 2007 - \$3.3 million and \$2.5 million, respectively; nine months of 2008 and 2007 - \$11.8 million and \$13.2 million, respectively. Stock-based compensation expense for the first nine months of 2008 and 2007 includes \$2.0 million and \$3.9 million, respectively, in first quarter non-deductible stock awards.

Commitments and Contingencies Establishing insurance reserves related to environmental exposures, asbestos and other mass tort claims is subject to uncertainties that are significantly greater than those presented by other types of claims. In addition, accruals (included in other liabilities) have been recorded for various environmental and occupational injury and disease claims and other contingencies arising out of the railroad operations disposed of by American Premier's predecessor, Penn Central Transportation Company, and its subsidiaries, prior to its bankruptcy reorganization in 1978 and certain manufacturing operations disposed of by American Premier and GAFRI. Except as discussed in *Management's Discussion and Analysis - "Asbestos and Environmental Reserve Charges,"* there have been no significant changes to the matters discussed and referred to in Note K - "Commitments and Contingencies" of AFG's 2007 Annual Report on Form 10-K.

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AMERICAN FINANCIAL GROUP, INC. 10-Q

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

• **Condensed Consolidating Information**

In connection with GAFRI's acquisition of its publicly held common stock in September 2007, AFG has guaranteed all of the outstanding debt of GAFRI and GAFRI's wholly-owned subsidiary, AAG Holding Company, Inc. In addition, GAFRI guarantees AAG Holding's public debt. The AFG and GAFRI guarantees are full and unconditional and joint and several. Condensed consolidating financial statements for AFG are as follows:

CONDENSED CONSOLIDATING BALANCE SHEET

(In millions)

| <u>September 30, 2008</u> | <u>AFG</u> | <u>GAFRI</u> | <u>AAG Holding</u> | <u>All Other Subs</u> | <u>Consol. Entries</u> | <u>Consolidated</u> |
|---|------------------|------------------|--------------------|-----------------------|------------------------|---------------------|
| Assets: | | | | | | |
| Cash and investments | \$ 61.0 | \$ 10.3 | \$ - | \$17,484.2 | (\$ 1.6) | \$17,553.9 |
| Recoverables from reinsurers and prepaid reinsurance premiums | - | - | - | 3,980.7 | - | 3,980.7 |
| Agents' balances and premiums receivable | - | - | - | 998.8 | - | 998.8 |
| Deferred policy acquisition costs | - | - | - | 2,055.4 | - | 2,055.4 |
| Other assets | 14.3 | 17.5 | 6.4 | 2,155.3 | 142.3 | 2,335.8 |
| Investment in subsidiaries and affiliates | <u>3,492.2</u> | <u>997.8</u> | <u>1,072.5</u> | <u>720.7</u> | <u>(6,283.2)</u> | <u>-</u> |
| | <u>\$3,567.5</u> | <u>\$1,025.6</u> | <u>\$1,078.9</u> | <u>\$27,395.1</u> | <u>(\$6,142.5)</u> | <u>\$26,924.6</u> |
| Liabilities and Capital: | | | | | | |
| Unpaid losses, loss adjustment expenses and unearned premiums | \$ - | \$ - | \$ - | \$ 8,607.1 | \$ - | \$ 8,607.1 |
| Annuity, life, accident and health benefits and reserves | - | - | - | 12,134.4 | (1.6) | 12,132.8 |
| Long-term debt | 641.2 | .7 | 219.4 | 91.3 | (.4) | 952.2 |
| Other liabilities | <u>149.7</u> | <u>68.9</u> | <u>108.8</u> | <u>2,297.3</u> | <u>(168.8)</u> | <u>2,455.9</u> |
| | 790.9 | 69.6 | 328.2 | 23,130.1 | (170.8) | 24,148.0 |

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| | | | | | | |
|----------------------------|------------------|------------------|------------------|-------------------|--------------------|-------------------|
| Total shareholders' equity | <u>2,776.6</u> | <u>956.0</u> | <u>750.7</u> | <u>4,265.0</u> | <u>(5,971.7)</u> | <u>2,776.6</u> |
| | | | | |) | |
| | <u>\$3,567.5</u> | <u>\$1,025.6</u> | <u>\$1,078.9</u> | <u>\$27,395.1</u> | <u>(\$6,142.5)</u> | <u>\$26,924.6</u> |

December 31, 2007

Assets:

| | | | | | | |
|--|------------------|------------------|------------------|-------------------|--------------------|-------------------|
| Cash and investments | \$ 52.8 | \$ 4.6 | \$ - | \$17,998.5 | (\$ 1.8) | \$18,054.1 |
| Recoverables from reinsurers and prepaid reinsurance premiums | - | - | - | 3,664.1 | - | 3,664.1 |
| Agents' balances and premiums receivable | - | - | - | 560.6 | - | 560.6 |
| Deferred policy acquisition costs | - | - | - | 1,394.4 | - | 1,394.4 |
| Other assets | 14.0 | 18.4 | 6.5 | 2,003.4 | 92.0 | 2,134.3 |
| Investment in subsidiaries and affiliates | <u>3,764.5</u> | <u>1,168.5</u> | <u>1,316.6</u> | <u>1,111.9</u> | <u>(7,361.5)</u> | <u>-</u> |
| | | | | |) | |
| | <u>\$3,831.3</u> | <u>\$1,191.5</u> | <u>\$1,323.1</u> | <u>\$26,732.9</u> | <u>(\$7,271.3)</u> | <u>\$25,807.5</u> |

Liabilities and Capital:

| | | | | | | |
|--|------------------|------------------|------------------|-------------------|--------------------|-------------------|
| Unpaid losses, loss adjustment expenses and unearned premiums | \$ - | \$ - | \$ - | \$ 7,836.6 | \$ - | \$ 7,836.6 |
| Annuity, life, accident and health benefits and reserves | - | - | - | 11,582.1 | (1.8) | 11,580.3 |
| Long-term debt | 575.8 | .8 | 340.4 | 91.7 | (71.8) | 936.9 |
| Other liabilities | <u>209.4</u> | <u>75.5</u> | <u>108.9</u> | <u>2,269.0</u> | <u>(255.2)</u> | <u>2,407.6</u> |
| | | | | |) | |
| | 785.2 | 76.3 | 449.3 | 21,779.4 | (328.8) | 22,761.4 |
| Total shareholders' equity | <u>3,046.1</u> | <u>1,115.2</u> | <u>873.8</u> | <u>4,953.5</u> | <u>(6,942.5)</u> | <u>3,046.1</u> |
| | | | | |) | |
| | <u>\$3,831.3</u> | <u>\$1,191.5</u> | <u>\$1,323.1</u> | <u>\$26,732.9</u> | <u>(\$7,271.3)</u> | <u>\$25,807.5</u> |

AMERICAN FINANCIAL GROUP, INC. 10-Q

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

CONDENSED CONSOLIDATING INCOME STATEMENT

(In millions)

| FOR THE THREE MONTHS ENDED <u>SEPTEMBER 30, 2008</u> | <u>AFG</u> | <u>GAFRI</u> | <u>AAG Holding</u> | <u>All Other Subs</u> | <u>Consol. Entries</u> | <u>Consolidated</u> |
|---|-------------|---------------|------------------------|---------------------------|----------------------------|---------------------|
| Income | | | | | | |
| : | | | | | | |
| Property and casualty insurance premiums | \$ - | \$ - | \$ - | \$ 850.6 | \$ - | \$ 850.6 |
| Life, accident and health premiums | - | - | - | 109.3 | - | 109.3 |
| Realized gains (losses) | .7 | - | - | (153.4) | 2.6 | (150.1) |
| Investment and other income | 1.6 | 2.4 | - | 361.5 | (5.4) | 360.1 |
| Equity in earnings of subsidiaries | <u>50.3</u> | <u>(47.6)</u> | <u>(43.0)</u> | <u>-</u> | <u>40.3</u> | <u>-</u> |
| |) |) | | | | |
| | 52.6 | (45.2) | (43.0) | 1,168.0 | 37.5 | 1,169.9 |
| Costs and Expenses: | | | | | | |
| Insurance benefits and expenses | - | - | - | 1,005.9 | - | 1,005.9 |
| Interest charges on borrowed money | 12.5 | - | 6.5 | 3.2 | (5.9) | 16.3 |
| Other expenses | <u>9.7</u> | <u>3.7</u> | <u>1.9</u> | <u>101.9</u> | <u>.1</u> | <u>117.3</u> |
| | <u>22.2</u> | <u>.7</u> | <u>8.4</u> | <u>1,111.0</u> | <u>(5.8)</u> | <u>1,139.5</u> |
| | | | |) | | |
| Earnings before income taxes | 30.4 | (48.9) | (51.4) | 57.0 | 43.3 | 30.4 |
| Provision for income taxes | <u>9.5</u> | <u>18.7</u> | <u>(14.7)</u> | <u>23.7</u> | <u>9.7</u> | <u>9.5</u> |
| |) |) | | | | |

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| | | | | | | |
|--|----------------|-----------------|------------------|-----------------|------------------|---------------------|
| Net Earnings (Loss) | <u>\$ 20.9</u> | <u>(\$ 0.2)</u> | <u>(\$ 36.7)</u> | <u>\$ 33.3</u> | <u>\$ 33.6</u> | <u>\$ 20.9</u> |
| | | | | | | |
| FOR THE THREE MONTHS ENDED | | | AAG | All Other | Consol. | |
| <u>SEPTEMBER 30, 2007</u> | <u>AFG</u> | <u>GAFRI</u> | <u>Holding</u> | <u>Subs</u> | <u>Entries</u> | <u>Consolidated</u> |
| | | | | | | |
| Income | | | | | | |
| : | | | | | | |
| Property and casualty insurance premiums | \$ - | \$ - | \$ - | \$ 757.5 | \$ - | \$ 757.5 |
| Life, accident and health premiums | - | - | - | 105.6 | - | 105.6 |
| Realized gains (losses) | 3.7 | (.2) | - | (11.8) | 1.2 | (7.1) |
| Investment and other income | 1.8 | 3.9 | - | 341.5 | (16.1) | 331.1 |
| Equity in earnings of subsidiaries | <u>194.9</u> | <u>21.9</u> | <u>26.2</u> | <u>10.0</u> | <u>(253.0)</u> | <u>-</u> |
| | | | |) | | |
| | 200.4 | 25.6 | 26.2 | 1,202.8 | (267.9) | 1,187.1 |
| | | | | | | |
| Costs and Expenses: | | | | | | |
| Insurance benefits and expenses | - | - | - | 877.3 | - | 877.3 |
| Interest charges on borrowed money | 19.2 | .2 | 8.8 | 4.1 | (14.5) | 17.8 |
| Other expenses | <u>5.8</u> | <u>2.8</u> | <u>1.1</u> | <u>105.0</u> | <u>1.9</u> | <u>116.6</u> |
| | <u>25.0</u> | <u>3.0</u> | <u>9.9</u> | <u>986.4</u> | <u>(12.6)</u> | <u>1,011.7</u> |
| | | | |) | | |
| Earnings before income taxes | 175.4 | 22.6 | 16.3 | 216.4 | (255.3) | 175.4 |
| Provision for income taxes | <u>62.7</u> | <u>6.1</u> | <u>1.8</u> | <u>66.3</u> | <u>(74.2)</u> | <u>62.7</u> |
| | | | |) | | |
| Net Earnings | <u>\$112.7</u> | <u>\$16.5</u> | <u>\$ 14.5</u> | <u>\$ 150.1</u> | <u>(\$181.1)</u> | <u>\$ 112.7</u> |

AMERICAN FINANCIAL GROUP, INC. 10-Q

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

CONDENSED CONSOLIDATING INCOME STATEMENT

(In millions)

| FOR THE NINE MONTHS ENDED <u>SEPTEMBER 30, 2008</u> | <u>AFG</u> | <u>GAFRI</u> | <u>AAG Holding</u> | <u>All Other Subs</u> | <u>Consol. Entries</u> | <u>Consolidated</u> |
|--|--------------|---------------|------------------------|---------------------------|----------------------------|---------------------|
| Income | | | | | | |
| : | | | | | | |
| Property and casualty insurance premiums | \$ - | \$ - | \$ - | \$2,104.4 | \$ - | \$2,104.4 |
| Life, accident and health premiums | - | - | - | 325.9 | - | 325.9 |
| Realized gains (losses) | (2.5) | - | - | (293.5) | 2.5 | (293.5) |
| Investment and other income | (.3) | 9.2 | - | 1,068.8 | (25.6) | 1,052.1 |
| Equity in earnings of subsidiaries | <u>322.0</u> | <u>(51.2)</u> | <u>(32.7)</u> | <u>-</u> | <u>(238.1)</u> | <u>-</u> |
| |) |) | |) | | |
| | 319.2 | (42.0) | (32.7) | 3,205.6 | (261.2) | 3,188.9 |
| Costs and Expenses: | | | | | | |
| Insurance benefits and expenses | - | - | - | 2,527.1 | - | 2,527.1 |
| Interest charges on borrowed money | 45.3 | .1 | 22.3 | 11.1 | (26.5) | 52.3 |
| Other expenses | <u>25.3</u> | <u>14.1</u> | <u>4.5</u> | <u>317.8</u> | <u>(.8)</u> | <u>360.9</u> |
| | | | |) | | |
| | <u>70.6</u> | <u>14.2</u> | <u>26.8</u> | <u>2,856.0</u> | <u>(27.3)</u> | <u>2,940.3</u> |
| | | | |) | | |
| Earnings (loss) before income taxes | 248.6 | (56.2) | (59.5) | 349.6 | (233.9) | 248.6 |
| Provision (credit) for income taxes | <u>91.4</u> | <u>(20.8)</u> | <u>(17.8)</u> | <u>131.0</u> | <u>(92.4)</u> | <u>91.4</u> |

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)))

Net Earnings (Loss) \$157.2 (\$35.4) (\$41.7) \$ 218.6 (\$141.5) \$ 157.2

FOR THE NINE MONTHS ENDED
SEPTEMBER 30, 2007

| | <u>AFG</u> | <u>GAFRI</u> | <u>AAG Holding</u> | <u>All Other Subs</u> | <u>Consol. Entries</u> | <u>Consolidated</u> |
|--|--------------|--------------|--------------------|-----------------------|------------------------|---------------------|
| Income | | | | | | |
| : | | | | | | |
| Property and casualty insurance premiums | \$ - | \$ - | \$ - | \$2,030.8 | \$ - | \$2,030.8 |
| Life, accident and health premiums | - | - | - | 315.6 | - | 315.6 |
| Realized gains (losses) | 2.6 | (.3) | - | 5.4 | 3.9 | 11.6 |
| Investment and other income | 7.2 | 14.0 | (3.4) | 1,011.3 | (43.8) | 985.3 |
| Equity in earnings of subsidiaries | <u>540.0</u> | <u>83.0</u> | <u>106.9</u> | <u>36.8</u> | <u>(766.7)</u> | <u>-</u> |
| | 549.8 | 96.7 | 103.5 | 3,399.9 | (806.6) | 3,343.3 |
| Costs and Expenses: | | | | | | |
| Insurance benefits and expenses | - | - | - | 2,413.0 | - | 2,413.0 |
| Interest charges on borrowed money | 56.9 | .3 | 27.6 | 12.0 | (43.2) | 53.6 |
| Other expenses | <u>30.0</u> | <u>9.4</u> | <u>2.9</u> | <u>362.5</u> | <u>9.0</u> | <u>413.8</u> |
| | <u>86.9</u> | <u>9.7</u> | <u>30.5</u> | <u>2,787.5</u> | <u>(34.2)</u> | <u>2,880.4</u> |
| Earnings before income taxes | 462.9 | 87.0 | 73.0 | 612.4 | (772.4) | 462.9 |
| Provision for income taxes | <u>171.3</u> | <u>27.6</u> | <u>21.1</u> | <u>196.7</u> | <u>(245.4)</u> | <u>171.3</u> |

)

| | | | | | | |
|-------------------------------------|----------------|---------------|----------------|-----------------|------------------|-----------------|
| Earnings from continuing operations | 291.6 | 59.4 | 51.9 | 415.7 | (527.0) | 291.6 |
| Discontinued operations | <u>1.7</u> | <u>1.9</u> | <u>-</u> | <u>1.9</u> | <u>(3.8)</u> | <u>1.7</u> |
| | | | | |) | |
| Net Earnings | <u>\$293.3</u> | <u>\$61.3</u> | <u>\$ 51.9</u> | <u>\$ 417.6</u> | <u>(\$530.8)</u> | <u>\$ 293.3</u> |

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AMERICAN FINANCIAL GROUP, INC. 10-Q

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

CONDENSED CONSOLIDATING STATEMENT OF CASH FLOWS

(In millions)

| FOR THE NINE MONTHS ENDED <u>SEPTEMBER 30, 2008</u> | <u>AFG</u> | <u>GAFRI</u> | <u>AAG Holding</u> | <u>All Other Subs</u> | <u>Consol. Entries</u> | <u>Consolidated</u> |
|--|--------------|---------------|--------------------|-----------------------|------------------------|---------------------|
| Operating Activities: | | | | | | |
| Net earnings (loss) | \$157.2 | (\$ 35.4) | (\$ 41.7) | \$ 218.6 | (\$141.5) | \$ 157.2 |
| Adjustments: | | | | | | |
| Equity in net (earnings) loss of subsidiaries | (204.7) | 28.8 | 24.1 | - | 151.8 | - |
| Dividends from subsidiaries | 263.0 | .3 | 72.5 | - | (335.8) | - |
| Other adjustments, net | <u>7.8</u> | <u>(11.2)</u> | <u>3.0</u> | <u>718.7</u> | <u>(10.3)</u> | <u>708.0</u> |
| |) | | | |) | |
| Net cash provided by (used in) operating activities | <u>223.3</u> | <u>(17.5)</u> | <u>57.9</u> | <u>937.3</u> | <u>(335.8)</u> | <u>865.2</u> |
| |) | | | |) | |
| Investing Activities: | | | | | | |

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| | | | | | | |
|--|----------------|----------------|----------------|-------------------|---------------|-------------------|
| Purchase of investments, property and equipment | (4.5) | (43.8) | - | (5,124.6) | - | (5,172.9) |
| Purchase of subsidiaries | - | - | - | (112.2) | - | (112.2) |
| Capital contributions to subsidiaries | (210.2) | (111.6) | (100.0) | - | 421.8 | - |
| Maturities and redemptions of fixed maturity investments | .1 | 5.8 | - | 1,548.7 | (20.0) | 1,534.6 |
| Sale of investments, property and equipment | 4.7 | 37.9 | - | 2,970.8 | - | 3,013.4 |
| Other, net | <u>(2.5)</u> | <u>(1.5)</u> | <u>-</u> | <u>81.2</u> | <u>-</u> | <u>77.2</u> |
| |) |) | | | | |
| Net cash provided by (used in) investing activities | <u>(212.4)</u> | <u>(113.2)</u> | <u>(100.0)</u> | <u>(636.1)</u> | <u>401.8</u> | <u>(659.9)</u> |
| |) |) |) | |) | |
| Financing Activities: | | | | | | |
| Annuity receipts | - | - | - | 1,275.9 | - | 1,275.9 |
| Annuity surrenders, benefits and withdrawals | - | - | - | (1,049.9) | - | (1,049.9) |
| Net transfers from variable annuity assets | - | - | - | 39.6 | - | 39.6 |
| Additional long-term borrowings | 585.0 | - | - | 15.0 | - | 600.0 |
| Reductions of long-term debt | (519.9) | (.1) | (69.5) | (15.4) | 20.0 | (584.9) |
| Issuances of Common Stock | 19.5 | - | - | 1.1 | - | 20.6 |
| Capital contribution from parent | - | 135.0 | 111.6 | 175.2 | (421.8) | - |
| Repurchases of Common Stock | (47.4) | - | - | - | - | (47.4) |
| Cash dividends paid | (37.2) | - | - | (335.8) | 335.8 | (37.2) |
| Other, net | <u>-</u> | <u>-</u> | <u>-</u> | <u>(44.3)</u> | <u>-</u> | <u>(44.3)</u> |
| | | |) | |) | |
| Net cash provided by (used in) financing activities | <u>-</u> | <u>134.9</u> | <u>42.1</u> | <u>61.4</u> | <u>(66.0)</u> | <u>172.4</u> |
| | | | |) | | |
| Net increase in cash and cash equivalents | 10.9 | 4.2 | - | 362.6 | - | 377.7 |
| Cash and cash equivalents at beginning of period | <u>15.6</u> | <u>2.6</u> | <u>-</u> | <u>797.7</u> | <u>-</u> | <u>815.9</u> |
| Cash and cash equivalents at end of period | <u>\$ 26.5</u> | <u>\$ 6.8</u> | <u>\$ -</u> | <u>\$ 1,160.3</u> | <u>\$ -</u> | <u>\$ 1,193.6</u> |

AMERICAN FINANCIAL GROUP, INC. 10-Q

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

CONDENSED CONSOLIDATING STATEMENT OF CASH FLOWS

(In millions)

| FOR THE NINE MONTHS ENDED <u>SEPTEMBER 30, 2007</u> | <u>AFG</u> | <u>GAFRI</u> | AAG <u>Holding</u> | All Other <u>Subs</u> | Consol. <u>Entries</u> | <u>Consolidated</u> |
|--|----------------|--------------|-----------------------|--------------------------|---------------------------|---------------------|
| Operating Activities: | | | | | | |
| Net earnings | \$293.3 | \$ 61.3 | \$ 51.9 | \$ 417.6 | (\$530.8) | \$ 293.3 |
| Adjustments: | | | | | | |
| Equity in net earnings of subsidiaries | (350.6) | (58.4) | (74.8) | (36.8) | 520.6 | - |
| Dividends from subsidiaries | 244.0 | 148.1 | 30.0 | - | (422.1) | - |
| Other adjustments, net | <u>(227.0)</u> | <u>239.7</u> | <u>(.4)</u> | <u>305.2</u> | <u>10.2</u> | <u>327.7</u> |
| |) | |) | | | |
| Net cash provided by (used in) | | | | | | |
| operating activities | <u>(40.3)</u> | <u>390.7</u> | <u>6.7</u> | <u>686.0</u> | <u>(422.1)</u> | <u>621.0</u> |
| |) | | | |) | |
| Investing Activities: | | | | | | |
| Purchase of investments, property and equipment | (4.8) | - | - | (3,348.5) | 17.3 | (3,336.0) |
| Purchase of subsidiaries | (.2) | (237.8) | - | (1.7) | - | (239.7) |
| Capital contribution to subsidiaries | (4.0) | (198.8) | - | - | 202.8 | - |
| Maturities and redemptions of fixed maturity investments | 5.0 | 32.2 | - | 1,143.7 | (55.4) | 1,125.5 |
| Sale of investments, property and equipment | 71.8 | 17.3 | - | 1,241.7 | (17.3) | 1,313.5 |
| Other, net | <u>2.6</u> | <u>-</u> | <u>-</u> | <u>(99.9)</u> | <u>-</u> | <u>(97.3)</u> |

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| | | | | | | |
|--|----------------|----------------|--------------|------------------|--------------|------------------|
| | | | | | | |
| Net cash provided by (used in) | | | | | | |
| investing activities | <u>70.4</u> | <u>(387.1)</u> | <u>-</u> | <u>(1,064.7)</u> | <u>147.4</u> | <u>(1,234.0)</u> |
| |) |) |) |) |) |) |
| Financing Activities: | | | | | | |
| Annuity receipts | - | - | - | 1,204.5 | - | 1,204.5 |
| Annuity surrenders, benefits and withdrawals | - | - | - | (1,057.3) | - | (1,057.3) |
| Net transfers from variable annuity assets | - | - | - | 51.3 | - | 51.3 |
| Additional long-term borrowings | 50.0 | - | 92.0 | - | - | 142.0 |
| Reductions of long-term debt | (60.5) | (.1) | (154.3) | (8.0) | 55.4 | (167.5) |
| Issuances of Common Stock | 13.5 | - | - | 1.0 | - | 14.5 |
| Capital contribution from parent | - | - | 198.8 | 4.0 | (202.8) | - |
| Repurchases of Common Stock | (133.4) | - | - | - | - | (133.4) |
| Cash dividends paid | (31.7) | - | (142.8) | (279.3) | 422.1 | (31.7) |
| Other, net | <u>-</u> | <u>2.8</u> | <u>-</u> | <u>(12.0)</u> | <u>-</u> | <u>(9.2)</u> |
| |) |) |) |) |) |) |
| Net cash provided by (used in) | | | | | | |
| financing activities | <u>(162.1)</u> | <u>2.7</u> | <u>(6.3)</u> | <u>(95.8)</u> | <u>274.7</u> | <u>13.2</u> |
| |) |) |) |) |) |) |
| Net increase (decrease) in cash and cash equivalents | (132.0) | 6.3 | .4 | (474.5) | - | (599.8) |
| Cash and cash equivalents at beginning of period | <u>146.0</u> | <u>2.8</u> | <u>-</u> | <u>1,180.2</u> | <u>-</u> | <u>1,329.0</u> |
| Cash and cash equivalents at end of period | <u>\$ 14.0</u> | <u>\$ 9.1</u> | <u>\$.4</u> | <u>\$ 705.7</u> | <u>\$ -</u> | <u>\$ 729.2</u> |

Management's Discussion and Analysis

of Financial Condition and Results of Operations

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FORWARD-LOOKING STATEMENTS

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

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

- ◆ changes in financial, political and economic conditions, including changes in interest rates and any extended economic recessions or expansions, performance of securities markets, our ability to estimate accurately the likelihood, magnitude and timing of any losses in connection with investments in the residential mortgage market, especially in the subprime sector, 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 activities (including any nuclear, biological, chemical or radiological events), incidents of war and other major losses;
- ◆ development of insurance loss reserves and establishment of other reserves, particularly with respect to amounts associated with asbestos and environmental claims;
- ◆ the unpredictability of future litigation if certain settlements do not become effective;
- ◆ trends in persistency, mortality and morbidity;
- ◆ availability of reinsurance and ability of reinsurers to pay their obligations;
- ◆ competitive pressures, including the ability to obtain adequate rates; and
- ◆ changes in AFG's credit ratings or the financial strength ratings assigned by major ratings agencies to our operating subsidiaries.

The forward-looking statements herein are made only as of the date of this report. The Company assumes no obligation to publicly update any forward-looking statements.

AMERICAN FINANCIAL GROUP, INC. 10-Q

Management's Discussion and Analysis

of Financial Condition and Results of Operations - Continued

OVERVIEW

Financial Condition

AFG is organized as a holding company with almost all of its operations being conducted by subsidiaries. AFG, however, has continuing cash needs for administrative expenses, the payment of principal and interest on borrowings, shareholder dividends, and taxes. Therefore, certain analyses are best done on a parent only basis while others are best done on a total enterprise basis. In addition, because most of its businesses are financial in nature, AFG does not prepare its consolidated financial statements using a current-noncurrent format. Consequently, certain traditional ratios and financial analysis tests are not meaningful.

Results of Operations

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

AFG's net earnings for the third quarter and first nine months of 2008 were \$20.9 million (\$.18 per share, diluted) and \$157.2 million (\$1.34 per share, diluted), respectively, compared to \$112.7 million (\$.93 per share, diluted) and \$293.3 million (\$2.40 per share, diluted) reported in the same periods of 2007. These results reflect net realized losses on investments in 2008, including other than temporary impairments. In addition, improved earnings in AFG's annuity and supplemental insurance operations and increased investment income were offset by lower property and casualty underwriting profits due in part to an increase in catastrophe losses.

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 valuation of investments, including the determination of "other-than-temporary" impairments.

For a discussion of these policies, see *Management's Discussion and Analysis - "Critical Accounting Policies" in AFG's 2007 Form 10-K.*

AMERICAN FINANCIAL GROUP, INC. 10-Q

Management's Discussion and Analysis

of Financial Condition and Results of Operations - Continued

LIQUIDITY AND CAPITAL RESOURCES

Ratios

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

| | September 30, | <u>December 31,</u> | |
|---------------------------------------|---------------|---------------------|-------------|
| | <u>2008</u> | <u>2007</u> | <u>2006</u> |
| Long-term debt | \$ 952 | \$ 937 | \$ 921 |
| Total capital (*) | 4,269 | 4,108 | 4,160 |
| Ratio of debt to total capital: | | | |
| Including debt secured by real estate | 22.3% | 22.8% | 22.1% |
| Excluding debt secured by real estate | 21.1% | 21.5% | 20.9% |

(*) 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 1.73 for the nine months ended September 30, 2008 and 2.40 for the entire year of 2007. Excluding annuity benefits, this ratio was 5.07 and 8.49, 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.

AFG can borrow up to \$500 million under its revolving credit facility, which expires in 2011. AFG had \$350 million in borrowings outstanding under this agreement at September 30, 2008, bearing interest at a rate of 4.4%. In October

2008, AFG borrowed an additional \$115 million under its credit facility and repurchased \$37.3 million of its 7-1/8% Senior Debentures due April 2009 for \$37.2 million. At October 31, 2008, AFG (parent) had enough cash and marketable securities to retire the remaining \$136 million in Senior Debentures due April 2009.

In July 2008, AFG entered into a 364 day credit facility under which it can borrow up to \$120 million at an interest rate of 2.25% over LIBOR. No amounts have been borrowed under this credit facility.

In the second quarter of 2008, AFG paid \$189.7 million in cash and issued 2.4 million shares of Common Stock to redeem its Senior Convertible Notes. The cash used in the redemption was funded primarily with borrowings under AFG's revolving credit facility.

In the first nine months of 2008, AFG repurchased approximately 1.8 million shares of its Common Stock for \$47.4 million.

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

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AMERICAN FINANCIAL GROUP, INC. 10-Q

Management's Discussion and Analysis

of Financial Condition and Results of Operations - Continued

Subsidiary Liquidity

In December 2007, National Interstate, a 53%-owned property and casualty insurance subsidiary, entered into a five-year unsecured credit agreement under which it can borrow up to \$75 million, subject to certain conditions. Amounts borrowed bear interest at rates ranging from .45% to .9% (currently .65%) over LIBOR based on National Interstate's credit rating. In May 2008, National Interstate borrowed \$15 million under the credit agreement to redeem its subordinated debentures at par.

In June 2008, GAFRI used cash on hand to redeem its \$28.5 million in 6-7/8% notes at maturity.

The liquidity requirements of AFG's insurance subsidiaries relate primarily to the liabilities associated with their products as well as operating costs and expenses, payments of dividends and taxes to AFG and contributions of capital to their subsidiaries. Historically, cash flows from premiums and investment income have provided more than sufficient funds to meet these requirements without requiring a sale of investments or contributions from AFG. Funds received in excess of cash requirements are generally invested in additional marketable securities. In addition, the insurance subsidiaries generally hold a significant amount of highly liquid, short-term investments.

The excess cash flow of AFG's property and casualty group allows it to extend the duration of its investment portfolio somewhat beyond that of its claim reserves.

In the annuity business, where profitability is largely dependent on earning a "spread" between invested assets and annuity liabilities, the duration of investments is generally maintained close to that of liabilities. With declining rates, AFG receives some protection (from spread compression) due to the ability to lower crediting rates, subject to guaranteed minimums. In a rising interest rate environment, significant protection from withdrawals exists in the form

of temporary and permanent surrender charges on AFG's annuity products.

AFG believes its insurance subsidiaries maintain sufficient liquidity to pay claims and benefits and operating expenses, 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 September 30, 2008, contained \$14.6 billion in "Fixed maturities" classified as available for sale and \$516.4 million in "Equity securities," all carried at fair value with unrealized gains and losses included in a separate component of shareholders' equity on an after-tax basis.

Management responsible for the valuation of AFG's portfolio uses data from pricing services and non-binding broker quotes in determining fair value. Prices obtained from these sources are reviewed by internal investment professionals who are familiar with the securities being priced and the markets in which they trade. Equity securities are generally priced using closing prices obtained from pricing services. For mortgage-backed securities, which comprise about one-third of AFG's fixed maturities, prices are generally obtained from two or three of these sources. If the prices vary, AFG's investment professionals select the price they believe most appropriate based on their knowledge of the market. For the other two-thirds of AFG's fixed maturities, 93% are priced using a pricing service and the balance is priced internally or by using a non-binding broker quote. Prices obtained from a broker or pricing service are adjusted only in cases where they are deemed not to be representative of an appropriate exit price (fewer than 1% of the securities).

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Management's Discussion and Analysis

of Financial Condition and Results of Operations - Continued

Increasing turmoil in the global financial markets has caused credit spreads (the difference in rates between U.S. government bonds and other fixed maturities) to widen significantly during the third quarter of 2008. These wider spreads were the primary cause of AFG's pretax net unrealized loss on fixed maturities rising from \$472 million at June 30, 2008, to \$1.2 billion at September 30, 2008.

Approximately 94% of the fixed maturities held by AFG at September 30, 2008, 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.

AFG's \$5.6 billion investment in mortgage-backed securities ("MBSs") represented approximately one-third of its fixed maturities at September 30, 2008. MBSs are subject to significant prepayment risk due to the fact that, in periods of declining interest rates, mortgages may be repaid more rapidly than scheduled as borrowers refinance higher rate mortgages to take advantage of lower rates. Approximately 97% of AFG's mortgage-backed securities are rated "AAA" or "AA." At September 30, 2008, AFG owned approximately \$437 million (representing 3% of AFG's total fixed maturity portfolio) of mortgage-backed securities in which

the underlying collateral is subprime mortgages. At that date, the net unrealized loss on these securities was approximately \$68 million. The securities are collateralized by substantially all fixed-rate mortgages and have an overall average life of approximately 4 years. At September 30, 2008, AFG owned approximately \$1.0 billion in Alt-A securities (risk profile between prime and subprime) with an average life of approximately 5 years, the vast majority of which are backed by fixed rate mortgages. The unrealized loss on Alt-A securities was \$124 million at September 30, 2008. Based on current information, management does not believe that AFG's ultimate loss on the subprime or Alt-A securities will be material to its financial condition.

At September 30, 2008, AFG owned approximately \$778 million in securities with credit enhancement provided by bond insurers, including \$546 million of insured municipal bonds, \$111 million in insured subprime securities (included in the \$437 million in total subprime exposure discussed above) and \$99 million in insured corporate bonds. Approximately 92% of the insured municipal bonds carry an explicit underlying rating (i.e. without credit enhancement) with an average of A+, and 63% of the corporate bonds carry an explicit underlying rating with an average of A-. None of the insured subprime securities carry an explicit underlying rating. Management does not believe the risk of loss on the securities without underlying credit ratings is material to AFG's financial condition.

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of Financial Condition and Results of Operations - Continued

Summarized information for the unrealized gains and losses recorded in AFG's Balance Sheet at September 30, 2008, is shown in the following table (dollars in millions). Approximately \$299 million of available for sale "Fixed maturities" and \$145 million of "Equity securities" had no unrealized gains or losses at September 30, 2008.

| | Securities With Unrealized <u>Gains</u> | Securities With Unrealized <u>Losses</u> |
|--|--|---|
| <u>Available for Sale Fixed Maturities</u> | | |
| Fair value of securities | \$3,213 | \$11,133 |
| Amortized cost of securities | \$3,125 | \$12,406 |
| Gross unrealized gain (loss) | \$ 88 | (\$ 1,273) |
| Fair value as % of amortized cost | 103% | 90% |
| Number of security positions | 1,029 | 1,850 |
| Number individually exceeding \$2 million gain or loss | 3 | 165 |
| Concentration of gains (losses) by type or industry (exceeding 5% of unrealized): | | |
| Mortgage-backed securities | \$ 34.3 | (\$ 515.1) |
| Banks, savings and credit institutions | 2.2 | (367.2) |

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| | | |
|---|------|--------|
| States and municipalities | 5.5 | (16.0) |
| Gas and electric services | 5.3 | (37.4) |
| Direct obligations of the U.S. Government | 13.3 | (.1) |
| Percentage rated investment grade | 97% | 94% |

Equity Securities

| | | |
|--|--------|---------|
| Fair value of securities | \$ 159 | \$ 212 |
| Cost of securities | \$ 67 | \$ 278 |
| Gross unrealized gain (loss) | \$ 92 | (\$ 66) |
| Fair value as % of cost | 237% | 76% |
| Number of security positions | 31 | 117 |
| Number of individually exceeding \$2 million gain or loss | 1 | 6 |

The table below sets forth the scheduled maturities of AFG's available for sale fixed maturity securities at September 30, 2008, based on their fair values. Asset-backed securities and other securities with sinking funds are reported at average maturity. Actual maturities may differ from contractual maturities because certain securities may be called or prepaid by the issuers.

| | Securities With Unrealized <u>Gains</u> | Securities With Unrealized <u>Losses</u> |
|---|--|---|
| <u>Maturity</u> | | |
| One year or less | 8% | 2% |
| After one year through five years | 56 | 19 |
| After five years through ten years | 10 | 33 |
| After ten years | <u>2</u> | <u>5</u> |
| | 76 | 59 |
| Mortgage-backed securities (average life of 5-1/2 years) | <u>24</u> | <u>41</u> |
| | <u>100</u> | <u>100</u> |
| | % | % |

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

| | Aggregate Fair <u>Value</u> | Aggregate Unrealized <u>Gain (Loss)</u> | Fair Value as % of Cost <u>Basis</u> |
|---|-----------------------------------|---|---|
| <u>Fixed Maturities at September 30, 2008</u> | | | |
| - | | | |
| Securities with unrealized gains: | | | |
| Exceeding \$500,000 (32 issues) | \$ 409 | \$ 32 | 108% |
| Less than \$500,000 (997 issues) | <u>2,804</u> | <u>56</u> | 102 |
| | <u>\$ 3,213</u> | <u>\$ 88</u> | 103% |
| Securities with unrealized losses: | | | |
| Exceeding \$500,000 (600 issues) | \$ 6,400 | (\$1,107) | 85% |
| Less than \$500,000 (1,250 issues) | <u>4,733</u> | <u>(166)</u> | 97 |
| | <u>\$11,133</u> | <u>(\$1,273)</u> | 90% |

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

| | Aggregate Fair <u>Value</u> | Aggregate Unrealized <u>Loss</u> | Fair Value as % of Cost <u>Basis</u> |
|--|-----------------------------------|--|---|
| <u>Securities with Unrealized Losses at September 30, 2008</u> | | | |
| Investment grade fixed maturities with losses for: | | | |
| Less than one year (1,356 issues) | \$ 8,432 | (\$ 749) | 92% |
| One year or longer (296 issues) | <u>2,043</u> | <u>(411)</u> | 83 |
| | <u>\$10,475</u> | <u>(\$1,160)</u> | 90% |

| | | | |
|--|---------------|-----------------|-----|
| Non-investment grade fixed maturities with losses for: | | | |
| Less than one year (116 issues) | \$ 356 | (\$ 44) | 89% |
| One year or longer (82 issues) | <u>302</u> | <u>(69)</u> | 81 |
| |) | | |
| | <u>\$ 658</u> | <u>(\$ 113)</u> | 85% |
| Common equity securities with losses for: | | | |
| Less than one year (42 issues) | \$ 111 | (\$ 16) | 87% |
| One year or longer (6 issues) | <u>6</u> | <u>(2)</u> | 78 |
| |) | | |
| | <u>\$ 117</u> | <u>(\$ 18)</u> | 87% |
| Perpetual preferred equity securities with losses for: | | | |
| Less than one year (32 issues) | \$ 70 | (\$ 30) | 70% |
| One year or longer (37 issues) | <u>25</u> | <u>(18)</u> | 58 |
| |) | | |
| | <u>\$ 95</u> | <u>(\$ 48)</u> | 66% |

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 2007 Form 10-K. With respect to the perpetual preferred equity securities with unrealized losses shown separately in the table above, management considered the hybrid nature of these investments, the fact that they continue to pay dividends and that they have maintained their investment grade ratings in concluding that the impairment was temporary.

Based on its analysis, management believes (i) AFG will recover its cost basis in the securities with unrealized losses and (ii) that AFG has the ability and intent to hold the securities until they recover in value. Although AFG has the ability to continue holding its investments with unrealized losses, its intent to hold them may change due to deterioration in the issuers' creditworthiness, decisions to lessen exposure to a particular issuer or industry, asset/liability management decisions, market movements, changes in views about appropriate asset allocation or the desire to offset taxable realized gains. Should AFG's ability or intent change with regard to a particular security, a charge for impairment would likely be required. While it is not possible to accurately predict if or when a specific security will become impaired, charges for other than temporary impairment could be material to results of operations in future periods. Management believes it is not likely that future impairment charges will have a significant effect on AFG's liquidity.

Uncertainties

Management believes that the areas posing the greatest risk of material loss are the adequacy of its insurance reserves and contingencies arising out of its former railroad and manufacturing operations. See *Management's Discussion and Analysis - "Uncertainties"* in AFG's 2007 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 \$28.0 million for the third quarter of 2008 and \$183.2 million for the 2007 third quarter. The decrease is primarily due to \$150 million in realized losses on investments in the 2008 period. The results also reflect higher earnings from annuity and supplemental insurance operations and higher investment income, both of which were offset by a \$32.9 million decline in Specialty property and casualty underwriting results (due primarily to catastrophe losses).

Nine month pretax operating earnings decreased \$235.3 million in 2008 compared to 2007, reflecting (i) realized losses on investments of \$293.5 million recorded in 2008, (ii) a \$55.3 million decline in Specialty property and casualty operations, (iii) an increase in investment income of \$72.8 million and (iv) a reduction of \$72.2 million in asbestos and environmental charges.

Property and Casualty Insurance - Underwriting

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 policyholder 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.

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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 | | Nine months ended | |
|--|----------------------|----------------|----------------------|----------------|
| | <u>September 30.</u> | | <u>September 30.</u> | |
| | <u>2008</u> | <u>2007</u> | <u>2008</u> | <u>2007</u> |
| <u>Gross Written Premiums (GAAP)</u> | | | | |
| Property and transportation | \$1,079 | \$ 775 | \$1,822 | \$1,519 |
| Specialty casualty | 323 | 319 | 983 | 1,030 |
| Specialty financial | 158 | 163 | 448 | 440 |
| California workers' compensation | 67 | 61 | 189 | 190 |
| Other | <u>(1</u> | <u>—1</u> | <u>(2</u> | <u>—1</u> |
| |) |) | | |
| | <u>\$1,626</u> | <u>\$1,319</u> | <u>\$3,440</u> | <u>\$3,180</u> |
| <u>Net Written Premiums (GAAP)</u> | | | | |
| Property and transportation | \$ 536 | \$ 393 | \$1,044 | \$ 915 |
| Specialty casualty | 210 | 195 | 636 | 620 |
| Specialty financial | 132 | 131 | 371 | 367 |
| California workers' compensation | 60 | 56 | 172 | 178 |
| Other | <u>22</u> | <u>23</u> | <u>56</u> | <u>55</u> |
| | <u>\$ 960</u> | <u>\$ 798</u> | <u>\$2,279</u> | <u>\$2,135</u> |

Combined Ratios (GAAP)

| | | | | |
|--|-------|-------|-------|-------|
| Property and transportation | 97.4% | 83.3% | 93.0% | 85.0% |
| Specialty casualty | 76.6 | 81.1 | 76.6 | 73.7 |
| Specialty financial | 101.6 | 93.4 | 94.6 | 93.6 |
| California workers' compensation | 79.7 | 77.5 | 78.3 | 78.7 |
| Total Specialty | 91.5 | 86.2 | 87.4 | 84.1 |
| Aggregate (including discontinued lines) | 91.3% | 86.6% | 87.7% | 86.5% |

Favorable (Unfavorable) Prior YearDevelopment

| | | | | |
|----------------------------------|-------------|-------------|--------------|-------------|
| Property and transportation | \$17 | \$13 | \$ 55 | \$34 |
| Specialty casualty | 27 | 16 | 88 | 96 |
| Specialty financial | 1 | 3 | 12 | 5 |
| California workers' compensation | 8 | 7 | 24 | 18 |
| Other specialty | <u>4</u> | <u>(12)</u> | <u>13</u> | <u>(27)</u> |
| |) | |) | |
| | 57 | 27 | 192 | 126 |
| Special A&E charges | - | - | (12) | (44) |
| Other | <u>1</u> | <u>(3)</u> | <u>4</u> | <u>(3)</u> |
| |) | |) | |
| | <u>\$58</u> | <u>\$24</u> | <u>\$184</u> | <u>\$79</u> |

Premium growth for the Specialty insurance operations has been impacted primarily by the Marketform operations, which were acquired in January 2008, and increases in crop insurance operations. Apart from rate decreases in the California workers' compensation business, average renewal rate levels in AFG's other specialty operations were down about 3% through the first nine months of the year.

The Specialty insurance operations generated underwriting profits of \$71.9 million and \$267.5 million in the third quarter and first nine months of 2008, respectively, compared to \$104.8 million and \$322.8 million for the same periods of 2007. Higher catastrophe losses, the effects of a softer market, increased losses in the run-off automobile residual value insurance ("RVI") operations and lower underwriting profits in the crop business more than offset higher favorable reserve development.

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of Financial Condition and Results of Operations - Continued

Pretax losses from catastrophes (principally wind-related storm damage from hurricanes Gustav and Ike and tornadoes in the Midwestern part of the United States) totaled \$37.5 million (4.4 points) for the third quarter and \$65.0 million (3.1 points) for the first nine months of 2008. By comparison, catastrophe losses for 2007 were negligible.

Property and transportation

gross and net written premiums increased significantly in the 2008 periods due to the effect of higher spring commodity pricing on crop insurance premiums. The property and transportation group reported an underwriting profit of \$12.0 million in the 2008 third quarter, \$46.5 million lower than the 2007 third quarter. The combined ratio of 97.4% for the quarter increased 14.1 points over the 2007 period as a result of higher catastrophe losses in the property and inland marine operations and lower underwriting profits in the crop operations, which were offset somewhat by higher favorable reserve development. Excluding the impact of catastrophes, AFG's underlying property and transportation businesses continued to have strong underwriting results. Results for the third quarter and first nine months of 2008 include \$29.8 million (6.5 points) and \$53.7 million (5.9 points), respectively, of catastrophe losses. Favorable reserve development in the Property and transportation group in the first nine months of 2008 is primarily due to lower than expected claim frequency in crop and ocean marine products and lower severity in farm losses. Favorable development in the comparable 2007 period relates primarily to lower than expected frequency and severity in specialty commercial automobile, ocean marine, inland marine and farm products.

Specialty casualty

net written premiums increased slightly for the 2008 periods due to greater retention in some of AFG's casualty operations, and the addition of Marketform in the first quarter of 2008. Decreases in gross written premiums through the 2008 third quarter are attributable to stronger competition in the excess and surplus lines and softening in the homebuilders market, offset somewhat by the addition of Marketform. This group reported an underwriting profit of \$46.6 million in the third quarter, a 19% improvement over the 2007 third quarter. The combined ratio improved 4.5 points to 76.6% for the quarter, reflecting improved underwriting results in the executive liability and alternative captive markets, and higher favorable reserve development partially offset by the effects of a softer market. Through the first nine months of 2008, the combined ratio increased as improved results in the executive liability and alternative captive markets were more than offset by lower underwriting profits in the general liability and excess and surplus lines operations and by lower favorable reserve development. Favorable reserve development in Specialty casualty in the first nine months of 2008 reflects lower severity on claims in the nursing home liability product, general liability, homebuilders and executive liability for large accounts as well as lower than expected frequency in homebuilders, executive liability for small accounts and the program (leisure camps, fairs and festivals, and sports and leisure) business. Favorable development for the comparable period in 2007 resulted from lower than expected frequency and severity in the nursing home liability product and general liability business.

Specialty financial

gross written premiums for the quarter decreased slightly from the prior period, primarily from declines in the lease and loan and financial institutions businesses, which were offset somewhat by higher premiums in other operations. Gross and net written premiums for the 2008 nine month period were comparable to the 2007 period. This group reported an underwriting loss of \$1.9 million for the third quarter of 2008. This group's combined ratio

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Management's Discussion and Analysis

of Financial Condition and Results of Operations - Continued

was 101.6%, an increase of 8.2 points over the 2007 third quarter. These results were driven in large measure by underwriting losses in the run-off RVI operations, which resulted from further declines in used SUV and luxury car prices. Through the first nine months of the year, improvements in AFG's surety and fidelity and crime operations and higher favorable reserve development helped to offset lower underwriting results in the RVI and financial institutions businesses. Favorable reserve development in Specialty financial during the first nine months of 2008 and 2007 resulted from lower than expected claim severity in the surety and fidelity and crime products.

California workers' compensation

gross and net written premiums increased for the quarter, as increased sales of the recently targeted excess workers' compensation products offset the effects of continued lower rates in the traditional workers compensation business. This group reported solid profitability with a combined ratio of 79.7% in the 2008 third quarter compared to 77.5% in the same period a year earlier. Through the first nine months of 2008, the combined ratio was 78.3%, a slight improvement over the 2007 period. The improved claims environment resulting from the California workers' compensation reform legislation has continued to benefit AFG's results as well as those of the industry. The California renewal rate reductions averaged about 15% through the first nine months of the year and indicates some moderation in rate reductions compared to the last several years. In October 2008, the California Insurance Commissioner approved a 5% average increase in premium rates effective January 1, 2009. AFG expects to file for a similar rate increase. The favorable reserve development in California workers' compensation in the first nine months of 2008 and 2007 reflects the continuing impact of the reform legislation passed in 2003 and 2004. As claims incurred in 2003 through 2005 are now reaching a higher percentage of settlement and maturity, management is able to estimate the ultimate costs of these claims with more precision. Current estimates of settlement costs are lower than originally anticipated.

Due to the long-tail nature of this business, AFG has been conservative in reserving for the favorable effects of the reform legislation on more recent claims until a higher percentage of claims are paid and the ultimate impact of reforms can be estimated with more precision.

Asbestos and Environmental Reserve

Charges During the second quarter of 2008, AFG completed its comprehensive internal review of asbestos and environmental exposures relating to the run-off operations of its property and casualty group and exposures related to former railroad and manufacturing operations and sites. Previous studies, which were done with the aid of outside actuarial and engineering firms and specialty outside counsel, were completed in 2007, 2005 and 2003, respectively.

As a result of the internal review, AFG recorded a \$12 million charge (net of reinsurance recoverables) to increase the property and casualty group's asbestos and environmental reserves in the second quarter of 2008. During the course of this review, there were no newly identified emerging trends or issues that management believes significantly impact the overall adequacy of AFG's A&E reserves. The modest increases were primarily due to reassessments of the potential loss on certain outstanding cases.

The review relied on a comprehensive exposure analysis by AFG's internal A&E claims specialists in consultation with in-house actuaries and outside specialty counsel. It considered products and non-products exposures, paid claims history, the pattern of new claims, settlements and projected development, as

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Management's Discussion and Analysis

of Financial Condition and Results of Operations - Continued

appropriate. As has been observed by others, the asbestos legal climate remains very difficult to predict. While progress continues to be made in state asbestos tort reform and judicial rulings, that progress has been somewhat offset by the lack of reform in certain jurisdictions, increased claims costs, increased defense costs, the assertion of non-products theories and an expanding pool of plaintiffs and defendants. Environmental claims likewise present challenges in prediction, due to uncertainty regarding the interpretation of insurance policies, complexities regarding multi-party involvements at sites, evolving clean up standards and protracted time periods required to assess the level of clean up required at contaminated sites.

At September 30, 2008, the property and casualty group's A&E reserves were \$405.9 million, net of reinsurance recoverables. At that date, AFG's three year survival ratio was 9.6 times paid losses for the asbestos reserves and 8.9 times paid losses for the total A&E reserves. These ratios compare favorably with A.M. Best's most recent report (published in 2007) on A&E survival ratios which were 8.6 for asbestos and 7.9 for total industry A&E reserves.

The 2007 A&E study resulted in a second quarter 2007 pretax charge of \$44.2 million (net of reinsurance) to increase the property and casualty group's A&E reserves.

Statutory Annuity Premiums

The following table summarizes AFG's annuity sales (in millions):

| Three months ended | | Nine months ended | |
|----------------------|-------------|----------------------|-------------|
| <u>September 30,</u> | | <u>September 30,</u> | |
| <u>2008</u> | <u>2007</u> | <u>2008</u> | <u>2007</u> |

403(b) Fixed and Indexed Annuities:

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| | | | | |
|------------------------------|--------------|--------------|----------------|----------------|
| First Year | \$ 10 | \$ 14 | \$ 34 | \$ 47 |
| Renewal | 36 | 30 | 121 | 104 |
| Single Sum | <u>41</u> | <u>43</u> | <u>101</u> | <u>103</u> |
| Subtotal | 87 | 87 | 256 | 254 |
| Non-403(b) Indexed Annuities | 142 | 214 | 442 | 686 |
| Non-403(b) Fixed Annuities | 99 | 68 | 250 | 204 |
| Bank Fixed Annuities | 138 | - | 291 | - |
| Variable Annuities | <u>20</u> | <u>17</u> | <u>64</u> | <u>60</u> |
| Total Annuity Premiums | <u>\$486</u> | <u>\$386</u> | <u>\$1,303</u> | <u>\$1,204</u> |

The increase in annuity premiums for the 2008 periods compared to the 2007 periods reflects increased annuity sales through the new bank distribution channel, as well as increased sales of traditional fixed annuities. These increases were partly offset by lower sales of indexed annuities in the single premium market.

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Management's Discussion and Analysis

of Financial Condition and Results of Operations - Continued

Life, Accident and Health Premiums and Benefits

The following table summarizes AFG's life, accident and health premiums and benefits as shown in the Consolidated Statement of Earnings (in millions):

| Three months ended | | Nine months ended | |
|----------------------|-------------|----------------------|-------------|
| <u>September 30,</u> | | <u>September 30,</u> | |
| <u>2008</u> | <u>2007</u> | <u>2008</u> | <u>2007</u> |

Premiums

Supplemental insurance operations

| | | | | |
|------------------------------|--------------|--------------|--------------|--------------|
| First year | \$ 21 | \$ 19 | \$ 61 | \$ 48 |
| Renewal | 81 | 79 | 242 | 243 |
| Life operations (in run-off) | <u>7</u> | <u>8</u> | <u>23</u> | <u>25</u> |
| | <u>\$109</u> | <u>\$106</u> | <u>\$326</u> | <u>\$316</u> |

Benefits

| | | | | |
|-----------------------------------|--------------|--------------|--------------|--------------|
| Supplemental insurance operations | \$ 70 | \$ 76 | \$217 | \$221 |
| Life operations (in run-off) | <u>11</u> | <u>11</u> | <u>37</u> | <u>37</u> |
| | <u>\$ 81</u> | <u>\$ 87</u> | <u>\$254</u> | <u>\$258</u> |

The decrease in life, accident and health benefits for the third quarter and first nine months of 2008 compared to the 2007 periods is due primarily to favorable results in AFG's long term care business.

Investment Income

The \$30.4 million and \$72.8 million increase in investment income for the third quarter and first nine months of 2008 compared to the same periods in 2007 reflect higher yields on certain fixed maturity investments and higher average cash and investments balances.

Realized Gains (Losses) on Securities

Net realized gains (losses) on securities consisted of the following (in millions):

| | Three months ended | | Nine months ended | |
|------------------------------|----------------------|-------------|----------------------|-------------|
| | <u>September 30,</u> | | <u>September 30,</u> | |
| | <u>2008</u> | <u>2007</u> | <u>2008</u> | <u>2007</u> |
| Net realized gains (losses) | | | | |
| on disposals | (\$ 64.8) | \$ 8.5 | (\$ 82.9) | \$38.5 |
| Charges for impairment | (117.6) | (18.2) | (288.0) | (29.5) |
| Changes in the fair value of | | | | |

| | | | | |
|-------------|------------------|-----------------|------------------|---------------|
| derivatives | 10.7 | 2.6 | 44.9 | 2.6 |
| Other(*) | <u>21.6</u> | <u>-</u> | <u>32.5</u> | <u>-</u> |
| | <u>(\$150.1)</u> | <u>(\$ 7.1)</u> | <u>(\$293.5)</u> | <u>\$11.6</u> |

(*) Adjustments to the amortization of annuity deferred policy acquisition costs related to realized gains and losses on securities are included in realized gains (losses).

Net realized losses on disposals for 2008 include third quarter losses of \$79.9 million on the sales of securities issued by Fannie Mae, Freddie Mac, Washington Mutual, Lehman Brothers and AIG. Approximately 21% and 45% of the impairment charges for the third quarter and first nine months of 2008, respectively, were attributable to investments in financial institutions, primarily banks and credit institutions. In addition, 28% of the third quarter 2008 impairment charges related to investments in communications companies.

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AMERICAN FINANCIAL GROUP, INC. 10-Q

Management's Discussion and Analysis

of Financial Condition and Results of Operations - ContinuedReal 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 <u>September 30,</u> | | Nine months ended <u>September 30,</u> | |
|--------------------------------------|--|-------------|---|-------------|
| | <u>2008</u> | <u>2007</u> | <u>2008</u> | <u>2007</u> |
| Other income | \$18.5 | \$17.3 | \$59.2 | \$64.8 |
| Other operating and general expenses | 16.6 | 17.2 | 49.1 | 48.9 |
| Interest charges on borrowed money | 1.0 | 1.0 | 3.1 | 3.1 |
| Minority interest expense | (.1) | (.1) | .1 | - |

Income from real estate operations includes net pretax gains on the sale of real estate assets of \$.5 million in the third quarter and \$6.4 million in the first nine months of 2008 compared to a \$.8 million loss and \$12.7 million gain for the 2007 periods.

Annuity Benefits

Annuity benefits reflect amounts accrued on annuity policyholders' funds accumulated. On deferred annuities (annuities in the accumulation phase), interest is generally credited to policyholders' accounts at current stated interest rates. Furthermore, for "two-tier" deferred annuities (annuities under which a higher interest amount can be earned if a policy is annuitized rather than surrendered), additional reserves are accrued for (i) persistency and premium bonuses and (ii) excess benefits expected to be paid for future deaths and annuitizations. 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.

The \$6.4 million and \$13.9 million increases in annuity benefits for the third quarter and first nine months of 2008, respectively, compared to the 2007 periods is due primarily to growth in the annuity business.

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 \$6.1 million and \$15.7 million increases in annuity and supplemental insurance acquisition expenses for the third quarter and first nine months in 2008, respectively, compared to the 2007 periods reflect growth as well as overall improved profitability in the annuity and supplemental insurance business.

The vast majority of the annuity and supplemental insurance group's DPAC asset relates to its fixed annuity, variable annuity and run-off life insurance lines of business. AFG does not expect a material write-off of DPAC related to its annuity businesses in 2008. AFG minimizes the stock market risk embedded in its indexed annuities by purchasing highly-matched over-the-counter call options. Since AFG's variable annuity business is relatively small and very few policies have living benefit or similar features, AFG expects any DPAC write-off related to variable annuities to be immaterial. However, 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

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The \$31.9 million decrease in other operating and general expenses for the first nine months of 2008 compared to the 2007 period reflects charges of \$3.0 million in the second quarter of 2008 compared to \$43.0 million in the second quarter of 2007 to increase liabilities for asbestos and environmental exposures related to AFG's former railroad and manufacturing operations. Other operating and general expenses also include a \$1.4 million loss on retirement of debt in the first nine months of 2007.

Minority Interest

Minority interest income of \$2.4 million for the third quarter of 2008 reflects the net loss recorded by National Interstate due to impairment charges on investments. Minority interest expense of \$7.8 million for the 2007 quarter includes minority interest in the previously publicly held shares of GAFRI that AFG acquired in September 2007. The \$21.0 million decrease in minority interest expense for the first nine months of 2008 compared to the 2007 period reflects lower earnings from National Interstate (including the effect of impairment charges) as well as the effect of the GAFRI acquisition.

Discontinued Operations

Discontinued operations for 2007 represent additional gains on operations sold in previous years, primarily the settlement of a contingency associated with the 2006 sale of Chatham Bars Inn.

Recent Accounting Standards

See AFG's 2007 Form 10-K for a discussion of certain accounting standards issued in 2007 and effective in 2009.

In March 2008, the FASB issued SFAS No. 161, "Disclosures about Derivative Instruments and Hedging Activities," which is effective January 1, 2009, for calendar year companies. SFAS No. 161 amends and expands the disclosure requirements of SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities." SFAS No. 161 requires qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about fair value amounts of gains and losses on derivative instruments and disclosures about credit-risk-related contingent features in derivative agreements.

In May 2008, the FASB issued FSP No. APB 14-1, "Accounting for Convertible Debt Instruments That May be Settled in Cash upon Conversion (Including Partial Cash Settlement)." FSP APB 14-1 requires an issuer of convertible debt instruments that may be settled for cash (including partial cash settlements) to separately account for the liability and equity components in a manner that reflects the issuer's nonconvertible debt borrowing rate at the date of issuance. The difference between the fair value of the debt component and the initial proceeds from issuance is recorded as a component of equity. The resulting debt discount would be amortized as additional interest expense over the period the debt is outstanding. FSP APB 14-1 is effective for fiscal years beginning after December 15, 2008 and shall be applied retrospectively to all periods presented. Accordingly, the new rule would change the accounting for AFG's Senior Convertible Notes which were redeemed in June 2008. AFG does not believe that the adoption of the new rule will result in material changes to its previously issued financial statements.

ITEM 3

Quantitative and Qualitative Disclosure of Market Risk

Other than the increase in unrealized losses on fixed maturity securities (as discussed in *Management's Discussion and Analysis - "Investments"*) and the decrease in the fair value of AFG's long-term debt, both related to the widening of credit spreads during the first nine months of 2008, there were no material changes to the information provided in Item 7A - "Quantitative and Qualitative Disclosure of Market Risk" of AFG's 2007 Form 10-K.

ITEM 4

Controls and Procedures

AFG's management, with participation of its Co-Chief Executive Officers and its principal financial officer, has evaluated AFG's disclosure controls and procedures (as defined in Exchange Act Rule 13a-15) as of the end of the period covered by this report. Based on that evaluation, AFG's Co-CEOs and principal financial officer concluded that the controls and procedures are effective. There have been no changes in AFG's internal control over financial reporting during the third fiscal quarter of 2008 that materially affected, or are reasonably likely to materially affect, AFG's internal control over financial reporting. AFG acquired Marketform Group Limited and Strategic Comp Holdings, LLC effective January 1, 2008. These companies have been excluded from management's assessment of internal control over financial reporting.

In the ordinary course of business, AFG and its subsidiaries routinely enhance their information systems by either upgrading current systems or implementing new systems. There has been no change in AFG's business processes and procedures during the third fiscal quarter of 2008 that has materially affected, or is reasonably likely to materially affect, AFG's internal controls over financial reporting.

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PART II

OTHER INFORMATION

ITEM 2

Unregistered Sales of Equity Securities and Use of Proceeds

Issuer Purchases of Equity Securities

AFG repurchased shares of its common stock during the first nine months of 2008 as follows:

| | Total Number of Shares Purchased as | Maximum Number of Shares that May |
|-------|---|---|
| Total | | |

| | <u>Number of Shares Purchased</u> | <u>Average Price Paid Per Share</u> | <u>Part of Publicly Announced Plans or Programs</u> | <u>Yet be Purchased Under the Plans Or Programs (a)</u> |
|-------------|---|---|---|---|
| 1st quarter | 1,003,000 | \$26.37 | 1,003,000 | 2,059,100 |
| 2nd quarter | 800,000 | \$26.22 | 800,000 | 1,259,100 |
| 3rd quarter | - | - | - | 1,259,100 |

(a) Represents the remaining shares that may be repurchased under the Plan authorized by AFG's Board of Directors in 2007.

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PART II

OTHER INFORMATION - CONTINUED

ITEM 6

Exhibits

Number

Exhibit Description

Computation of ratios of earnings to fixed charges.

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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

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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.

November 7, 2008

BY: s/Keith A. Jensen

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

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