AMERICAN FINANCIAL GROUP INC
Form 10-Q
November 06, 2009

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, 2009 | Commission File

No. 1-13653

AMERICAN FINANCIAL GROUP, INC.

Incorporated under the Laws of Ohio | IRS Employer I.D. No. 31-1544320

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

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

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

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

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

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

As of November 1, 2009, there were 116,225,330 shares of the Registrant's Common Stock outstanding, excluding 14.9 million shares owned by subsidiaries.

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PART I

ITEM I - FINANCIAL STATEMENTS

AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEET (unaudited)

(Dollars In Millions)

	September 30, 2009	December 31, 2008
Assets:		
Cash and cash equivalents	$ 1,434.6	$ 1,264.0
Investments:		
Fixed maturities:		
Available for sale - at fair value		
(amortized cost - $16,499.8 and $15,948.1)	16,421.5	14,079.3
Trading - at fair value	323.5	280.5
Equity securities - at fair value:		
Common stocks (cost - $124.4 and $118.6)	351.9	216.5
Perpetual preferred stocks (cost - $115.1 and $178.4)	105.4	137.1
Mortgage loans	304.4	308.9
Policy loans	277.2	283.6
	409.5	300.6
Real estate and other investments		
Total cash and investments	19,628.0	16,870.5

Recoverables from reinsurers and prepaid reinsurance premiums	3,980.9	4,301.7
Agents' balances and premiums receivable	798.9	629.7
Deferred policy acquisition costs	1,662.8	2,343.1
Other receivables	423.4	414.8
Variable annuity assets (separate accounts)	522.6	415.9
Other assets	629.5	1,241.6
	207.6	210.2
Goodwill		
Total Assets	$27,853.7	$26,427.5
Liabilities and Equity:		
Unpaid losses and loss adjustment expenses	$ 6,252.0	$ 6,764.2
Unearned premiums	1,837.3	1,697.9
Annuity benefits accumulated	11,154.2	10,652.7
Life, accident and health reserves	1,577.8	1,539.8
Payable to reinsurers	646.4	504.1
Long-term debt	877.1	1,029.7
Variable annuity liabilities (separate accounts)	522.6	415.9
Accounts payable, accrued expenses and other liabilities	1,184.2	1,221.6
Total liabilities	24,051.6	23,825.9
Shareholders' Equity:		
Common Stock, no par value - 200,000,000 shares authorized - 116,533,990 and 115,599,169 shares outstanding	116.5	115.6
Capital surplus	1,261.3	1,235.8
Retained earnings	2,169.9	1,841.6
Accumulated other comprehensive income (loss), net of tax	121.9	(703.0
	)	
Total shareholders' equity	3,669.6	2,490.0
Noncontrolling interests	132.5	111.6
Total equity	3,802.1	2,601.6
Total liabilities and equity	$27,853.7	$26,427.5

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AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF EARNINGS (unaudited)

(In Millions, Except Per Share Data)

	Three months ended September 30,		Nine months ended September 30,	
	2009	2008	2009	2008
Income:				
Property and casualty insurance premiums	$ 621.4	$ 850.6	$1,808.8	$2,104.4
Life, accident and health premiums	111.6	109.3	330.5	325.9
Investment income	300.4	283.1	899.6	820.3
Realized gains (losses) on:				
Securities (*)	8.8	(150.1)	(16.9)	(293.5)
Subsidiaries	(5.0)	-	(5.0)	-
Other income	55.5	77.0	177.5	231.8
	1,092.7	1,169.9	3,194.5	3,188.9
Costs and Expenses:				
Property and casualty insurance:				
Losses and loss adjustment expenses	296.1	551.8	845.7	1,185.8
Commissions and other underwriting expenses	217.7	226.0	643.0	659.0
Annuity benefits	111.8	100.9	323.1	287.6
Life, accident and health benefits	86.6	81.1	268.1	253.8
Annuity and supplemental insurance acquisition expenses	38.5	46.1	136.2	140.9
Interest charges on borrowed money	18.5	16.3	47.9	52.3
Other operating and general expenses	120.8	119.7	353.8	355.5

	890.0	1,141.9	2,617.8	2,934.9
Operating earnings before income taxes	202.7	28.0	576.7	254.0
Provision for income taxes	71.6	9.5	203.8	91.4
Net earnings, including noncontrolling interests	131.1	18.5	372.9	162.6
Less: Net (earnings) loss attributable to				
noncontrolling interests	(3.9)	2.4	(14.6)	(5.4)
Net Earnings Attributable to Shareholders	$ 127.2	$ 20.9	$ 358.3	$ 157.2
Earnings Attributable to Shareholders per Common Share:				
Basic	$1.10	$.18	$3.09	$1.38
Diluted	$1.09	$.18	$3.07	$1.34
Average number of Common Shares:				
Basic	116.1	115.2	115.8	114.0
Diluted	117.2	116.9	116.9	117.0
Cash dividends per Common Share	$.13	$.125	$.39	$.375

(*) Consists of the following:

Realized gains (losses) before impairments	$35.3	($ 41.7)	$135.9	($ 27.6)
Losses on securities with impairment	(47.4)	(108.4)	(300.3)	(265.9)

Non-credit portion recognized in other comprehensive income (loss)	20.9	-	147.5	-
Impairment charges recognized in earnings	(26.5)	(108.4)	(152.8)	(265.9)
Total realized gains (losses) on securities	$ 8.8	($150.1)	($ 16.9)	($293.5)

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AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF CHANGES IN EQUITY (unaudited)

(Dollars in Millions)

	Shareholders' Equity					
	Common Shares	Common Stock and Capital Surplus	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total	Noncontrolling Interests
Balance at December 31, 2008	115,599,169	$1,351.4	$1,841.6	($703.0)	$2,490.0	$111.6
Cumulative effect of accounting change	-	-	17.5	(17.5)	-	-
Net earnings	-	-	358.3	-	358.3	14.6
Other comprehensive income, net of tax:						
Change in unrealized gain (loss) on securities	-	-	-	827.3	827.3	6.6
Change in foreign currency translation	-	-	-	14.5	14.5	1.3

Change in unrealized pension and other postretirement benefits	-	-	-	.6	.6	-
Total comprehensive income					1,200.7	22.5
Dividends on Common Stock	-	-	(45.2)	-	(45.2)	-
Shares issued:						
Exercise of stock options	903,133	16.2	-	-	16.2	-
Benefit plans	190,629	2.3	-	-	2.3	-
Dividend reinvestment plan	16,589	.3	-	-	.3	-
Stock-based compensation expense	-	8.1	-	-	8.1	-
Shares exchanged in option exercises	(175,530)	(2.1)	(2.3)	-	(4.4)	-
Other	-	1.6	-	-	1.6	(1.6)
Balance at September 30, 2009	116,533,990	$1,377.8	$2,169.9	$121.9	$3,669.6	$132.5
Balance at December 31, 2007	113,499,080	$1,300.0	$1,733.5	$ 12.6	$3,046.1	$ 99.9
Net earnings	-	-	157.2	-	157.2	5.4
Other comprehensive income (loss), net of tax:						
Change in unrealized gain (loss) on securities	-	-	-	(389.0)	(389.0)	(7.8)
Change in foreign currency translation	-	-	-	(10.2)	(10.2)	(1.7)
Change in unrealized pension and other postretirement benefits	-	-	-	.2	.2	-
Total comprehensive (loss)					(241.8)	(4.1)

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	-
Dividend reinvestment plan	209,297	5.5	-	-	5.5	-
Benefit plans	186,024	5.2	-	-	5.2	-
Other stock-based compensation expense	-	7.7	-	-	7.7	-
Shares acquired and retired	(1,803,000)	(20.7)	(26.7)	-	(47.4)	-
Shares exchanged in option exercises	(247,632)	(2.8)	(3.6)	-	(6.4)	-
Noncontrolling interest of						
acquired subsidiary	-	-	-	-	-	18.7
Other	-	1.1	-	-	1.1	-
Balance at September 30, 2008	115,442,774	$1,345.3	$1,817.7	($386.4)	$2,776.6	$114.5

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AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF CASH FLOWS (UNAUDITED)

(In Millions)

	Nine months ended September 30,	
	2009	2008
Operating Activities:		
Net earnings, including noncontrolling interests	$ 372.9	$ 162.6
Adjustments:		
Depreciation and amortization	155.0	185.8

Annuity benefits	323.1	287.6
Realized losses on investing activities	26.0	287.2
Net (purchases) sales of trading securities	(24.7)	47.5
Deferred annuity and life policy acquisition costs	(128.6)	(143.3)
Decrease (increase) in reinsurance and other receivables	187.5	(657.0)
Decrease (increase) in other assets	85.0	(74.7)
Increase (decrease) in insurance claims and reserves	(334.8)	672.1
Increase in payable to reinsurers	142.3	165.8
Decrease in other liabilities	(43.8)	(71.3)
Other, net	1.2	2.9
Net cash provided by operating activities	761.1	865.2
Investing Activities		
:		
Purchases of and additional investments in:		
Fixed maturity investments	(3,245.5)	(4,998.5)
Equity securities	(19.7)	(138.5)
Subsidiaries	(5.0)	(112.2)
Real estate, property and equipment	(49.0)	(35.9)
Maturities and redemptions of fixed maturity investments	1,387.8	1,534.6
Sales of:		
Fixed maturity investments	1,504.2	2,670.3
Equity securities	41.1	334.6
Real estate, property and equipment	1.2	8.5
Decrease in securities lending collateral	48.1	43.7
Cash and cash equivalents of businesses acquired	-	44.3
Increase in other investments	(68.4	(10.8
)	)	
Net cash used in investing activities	(405.2	(659.9
)	)	
Financing Activities		
:		
Annuity receipts	1,092.3	1,275.9
Annuity surrenders, benefits and withdrawals	(986.2)	(1,049.9)
Net transfers from (to) variable annuity assets	(7.0)	39.6
Additional long-term borrowings	526.4	600.0
Reductions of long-term debt	(682.0)	(584.9)
Decrease in securities lending obligation	(94.6)	(43.7)
Issuances of Common Stock	12.6	20.6
Repurchases of Common Stock	-	(47.4)
Cash dividends paid on Common Stock	(44.9)	(37.2)
Other, net	(1.9	(.6

Net cash provided by (used in) financing activities	(185.3)	172.4
Net Increase in Cash and Cash Equivalents	170.6	377.7
Cash and cash equivalents at beginning of period	1,264.0	815.9
Cash and cash equivalents at end of period	$1,434.6	$1,193.6

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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A. Accounting Policies

Basis of Presentation

The accompanying consolidated financial statements for American Financial Group, Inc. ("AFG") and subsidiaries are unaudited; however, management believes that all adjustments (consisting only of normal recurring accruals unless otherwise disclosed herein) necessary for fair presentation have been made. The results of operations for interim periods are not necessarily indicative of results to be expected for the year. The financial statements have been prepared in accordance with the instructions to Form 10-Q and therefore do not include all information and footnotes necessary to be in conformity with U.S. generally accepted accounting principles.

As a result of a new accounting standard adopted on January 1, 2009, noncontrolling interests in subsidiaries (formerly referred to as minority interest) is reported in the Balance Sheet as a separate component of equity and in the Statement of Earnings as a deduction from net income (instead of as an expense) in deriving net earnings attributable to AFG's shareholders.

Certain reclassifications have been made to prior years to conform to the current year's presentation. All significant intercompany balances and transactions have been eliminated. The results of operations of companies since their formation or acquisition are included in the consolidated financial statements. Events or transactions occurring subsequent to September 30, 2009, and prior to November 6, 2009 (the filing date of this Form 10-Q), have been evaluated for potential recognition or disclosure herein.

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

Fair Value Measurements

Effective January 1, 2008, AFG adopted a new accounting standard on fair value measurements, with the exception of the application of the standard to nonrecurring fair value measurements of nonfinancial assets and liabilities that was adopted pursuant to the standard as of January 1, 2009. The standard 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 or unobservable. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect AFG's assumptions about the assumptions market participants would use in pricing the asset or liability. In the first nine months of 2009, AFG did not have any significant nonrecurring fair value measurements of nonfinancial assets and liabilities. As of January 1, 2009, AFG adopted new accounting guidance on estimating the fair value of an asset or liability when there is no active market and on identifying transactions that are not orderly. The guidance did not change the objective of

fair value measurements. Adoption of these standards did not have a significant impact on AFG's financial condition or results of operations.

In the second quarter of 2009, AFG adopted new accounting guidance regarding interim disclosures about fair value of financial instruments that requires fair value disclosures in interim financial statements for financial instruments, including those that are not reflected in the balance sheet at fair value. Formerly, these disclosures were only required annually. Disclosures required by this guidance are contained in *Note C - "Fair Value Measurements."*

Investments

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

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

Gains or losses on securities are determined on the specific identification basis. When a decline in the value of a specific investment is considered to be other than temporary at the balance sheet date, a provision for impairment is charged to earnings (included in realized gains (losses)) and the cost basis of that investment is reduced.

In April 2009, AFG adopted new accounting guidance relating to the recognition and presentation of other-than-temporary impairments. Under the guidance, if management can assert that it does not intend to sell an impaired fixed maturity security and it is not more likely than not that it will have to sell the security before recovery of its amortized cost basis, then an entity may separate other than temporary impairments into two components: 1) the amount related to credit losses (recorded in earnings) and 2) the amount related to all other factors (recorded in other comprehensive income (loss)). The credit-related portion of an other than temporary impairment is measured by comparing a security's amortized cost to the present value of its current expected cash flows discounted at its effective yield prior to the impairment charge. Both components are required to be shown in the Statement of Earnings. If management intends to sell an impaired security, or it is more likely than not that it will be required to sell the security before recovery, an impairment charge is required to reduce the amortized cost of that security to fair value. AFG adopted this guidance effective January 1, 2009, and recorded a cumulative effect adjustment of $17.5 million to reclassify the non-credit component of previously recognized impairments from retained earnings to accumulated other comprehensive income (loss). Additional disclosures required by this guidance are contained in *Note D - "Investments."*

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.

Derivatives

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

On January 1, 2009, AFG adopted a new accounting standard relating to disclosures about derivative instruments and hedging activities. The standard requires enhanced disclosures about objectives and strategies for using derivatives, how they are accounted for and how the instruments affect the entity's financial statements. See Note E *"Derivatives"* for the related disclosures. Adoption of this standard had no impact on AFG's financial position or results of operations.

Goodwill

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

Reinsurance

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

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

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 is first recognized by charging any

unamortized acquisition costs to expense to the extent required to eliminate the deficiency. If the premium deficiency is greater than unamortized acquisition costs, a liability is accrued for the excess deficiency and reported with unpaid losses and loss adjustment expenses.

DPAC related to annuities and universal life insurance products is deferred to the extent deemed recoverable and amortized, with interest, in relation to the present value of actual and expected gross profits on the policies. To the extent that realized gains and losses result in adjustments to the amortization of DPAC related to annuities, such adjustments are reflected as components of realized gains (losses).

DPAC related to annuities is also adjusted, net of tax, for the change in amortization that would have been recorded if the unrealized gains (losses) from securities had actually been realized. This adjustment is included in unrealized gains (losses) on marketable securities, a component of "Accumulated Other Comprehensive Income (Loss), net of tax" in the Shareholders' Equity section of the Balance Sheet.

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

DPAC includes the present value of future profits on business in force of 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.

Unpaid Losses and Loss Adjustment Expenses

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

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

Annuity Benefits Accumulated

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

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

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 information received from such companies and organizations. For traditional life, accident and health products, premiums are recognized as revenue when legally collectible from policyholders. For interest-sensitive life and universal life products, premiums are recorded in a policyholder account, which is reflected as a liability. Revenue is recognized as amounts are assessed against the policyholder account for mortality coverage and contract expenses.

Noncontrolling Interests

For Balance Sheet purposes, noncontrolling interests represents the interests of shareholders other than AFG in consolidated entities. In the Statement of Earnings, net earnings attributable to noncontrolling interests 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.

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 H - "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 the following adjustments to weighted average common shares (in millions):

	Three months ended September 30,		Nine months ended September 30,	
	2009	2008	2009	2008
Stock-based compensation plans	1.1	1.7	1.1	1.9
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 2009 and 2008 - 4.6 million and 3.9 million; nine months of 2009 and 2008 - 6.0 million and 4.2 million, respectively. Adjustments to net earnings attributable to shareholders in the calculation of diluted earnings per share were nominal in the 2009 and 2008 periods.

Statement of Cash Flows

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

B. **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 liability, umbrella and excess liability and customized programs for small to mid-sized businesses, (iii) Specialty financial, which includes risk management insurance programs for lending and leasing institutions (including collateral and mortgage protection insurance), surety and fidelity products and trade credit insurance, 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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AMERICAN FINANCIAL GROUP, INC. 10-Q

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

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

	Three months ended September 30,		Nine months ended September 30,	
	2009	2008	2009	2008
Revenues				
Property and casualty insurance:				
Premiums earned:				
Specialty				
Property and transportation	$ 239.1	$ 457.6	$ 675.8	$ 915.9
Specialty casualty	195.2	199.1	563.7	611.3
Specialty financial	127.6	123.7	388.4	369.9
California workers' compensation	42.0	51.6	128.6	155.3
Other	17.6	18.5	52.3	51.7
Other lines	(.1)	.1	-	.3
	621.4	850.6	1,808.8	2,104.4
Investment income	102.2	98.1	312.8	296.3
Realized gains (losses)	17.1	(57.7)	41.1	(133.1)
Other	26.6	42.7	87.3	124.7

	767.3	933.7	2,250.0	2,392.3
Annuity and supplemental insurance:				
Investment income	194.4	183.0	584.7	523.7
Life, accident and health premiums	111.6	109.3	330.5	325.9
Realized losses	(13.2)	(93.0)	(63.0)	(157.8)
Other	26.9	29.8	88.8	90.4
	319.7	229.1	941.0	782.2
Other	5.7	7.1	3.5	14.4
	$1,092.7	$1,169.9	$3,194.5	$3,188.9

Operating Earnings Before Income Taxes				
Property and casualty insurance:				
Underwriting:				
Specialty				
Property and transportation	$ 46.3	$ 12.0	$ 120.7	$ 63.6
Specialty casualty	29.6	46.6	108.1	143.1
Specialty financial	29.0	(1.9)	96.4	19.8
California workers' compensation	(2.3)	10.5	(2.4)	33.7
Other	5.8	4.7	2.8	7.3
Other lines	(.8	.9	(5.5	(7.9
	)	)	)	
	107.6	72.8	320.1	259.6
Investment and other operating income	80.4	83.3	253.3	252.4
Realized gains (losses)	17.1	(57.7	41.1	(133.1
	)		)	
	205.1	98.4	614.5	378.9
Annuity and supplemental insurance:				
Operations	46.5	49.2	127.1	120.3
Realized losses	(13.2	(93.0	(63.0	(157.8

	)	)	)	)
	33.3	(43.8)	64.1	(37.5)
Other	(35.7	(26.6	(101.9	(87.4
	)	)	)	)
	$ 202.7	$ 28.0	$ 576.7	$ 254.0

C.

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

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

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

Level 3 - Valuations derived from 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 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, observable market information.

AFG's management is responsible for the valuation process and uses data from outside sources (including nationally recognized pricing services and broker/dealers) in establishing fair value. This data is reviewed by internal investment professionals who ensure the fair value is representative of an exit price and consistent with accounting standards.

Assets and liabilities measured at fair value on September 30, 2009, are summarized below (in millions):

	Level 1	Level 2	Level 3	Total
Assets:				
Fixed maturities:				
Available for sale ("AFS")	$304	$15,461	$657	$16,422
Trading	-	322	1	323
Equity securities:				
Common stocks	98	251	3	352
Perpetual preferred stocks	81	3	21	105
Variable annuity assets (separate accounts) (a)	-	523	-	523
Other investments	-	67	-	67
Total assets accounted for at fair value	$483	$16,627	$682	$17,792
Liabilities:				
Derivatives embedded in annuity benefits accumulated	$ -	$ -	$111	$ 111

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

Approximately 4% of the total assets measured at fair value were Level 3 assets. Approximately 50% of these assets were MBS 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, 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 2009 and 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 and are reflected in the table at fair value as of the date of transfer.

	Fixed Maturities		Equity	Other	Embedded
	AFS	Trading	Securities	Assets	Derivatives
Balance at June 30, 2009	$712	$ 5	$ 26	$ -	($93)
Total realized/unrealized gains (losses):					
Included in net income	5	-	(2)	-	(23)
Included in other comprehensive income (loss)	68	-	-	-	-
Purchases, sales, issuances and settlements	185	-	-	-	5
Transfers into (out of) Level 3	(313)	(4)	-	-	-
Balance at September 30, 2009	$657	$ 1	$ 24	$ -	($111)
Balance at June 30, 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	(26)	(4)	-	3	-
Balance at September 30, 2008	$665	$ 5	$ 59	$ 6	($111)
Balance at December 31, 2008	$706	$ 1	$ 44	$ 5	($96)
Total realized/unrealized gains (losses):					
Included in net income	12	-	(11)	-	(23)
Included in other comprehensive					

income (loss)	71	-	1	-	-
Purchases, sales, issuances and settlements	144	-	(4)	-	8
Transfers into (out of) Level 3	(276)	-	(6)	(5)	-
Balance at September 30, 2009	$657	$ 1	$ 24	$ -	($111)

Balance at December 31, 2007	$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	10	(4)	14	3	-
Balance at September 30, 2008	$665	$ 5	$ 59	$ 6	($111)

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

Fair Value of Financial Instruments

The following table presents (in millions) the carrying value and estimated fair value of AFG's financial instruments at September 30, 2009 and December 31, 2008.

	September 30, 2009		December 31, 2008	
	Carrying Value	Fair Value	Carrying Value	Fair Value

Assets:				
Cash and cash equivalents	$ 1,435	$ 1,435	$ 1,264	$ 1,264
Fixed maturities	16,745	16,745	14,360	14,360
Equity securities	457	457	354	354
Mortgage loans	304	300	309	303
Policy loans	277	277	284	284
Variable annuity assets (separate accounts)	523	523	416	416
Liabilities:				
Annuity benefits accumulated(*)	$10,942	$10,834	$10,436	$ 9,536
Long-term debt	877	876	1,030	916
Variable annuity liabilities (separate accounts)	523	523	416	416

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

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

D. **Investments** Available for sale fixed maturities and equity securities at September 30, 2009, and December 31, 2008, consisted of the following (in millions):

	September 30, 2009				December 31, 2008			
	Amortized	Fair	Gross Unrealized		Amortized	Fair	Gross Unrealized	
	Cost	Value	Gains	Losses	Cost	Value	Gains	Losses
Fixed maturities:								
Direct obligations of the United States Government	$ 286	$ 299	$ 13	$ -	$ 298	$ 323	$ 25	$ -
United States Government agencies and authorities	208	212	4	-	239	246	7	-

States, municipalities and								
political subdivisions	1,563	1,608	53	(8)	967	965	18	(20)
Foreign government	235	239	5	(1)	150	155	5	-
Residential MBS	4,355	4,051	105	(409)	4,899	4,046	34	(887)
Commercial MBS	1,257	1,230	16	(43)	1,089	876	2	(215)
All other corporate	8,596	8,783	397	(210)	8,306	7,468	64	(902)
	$16,500	$16,422	$593	($671)	$15,948	$14,079	$155	($2,024)
Common stocks	$ 124	$ 352	$228	$ -	$ 119	$ 217	$112	($ 14)
Perpetual preferred stocks	$ 115	$ 105	$ 4	($ 14)	$ 178	$ 137	$ 2	($ 43)

The non-credit related portion of other than temporary impairment charges are included in other comprehensive income (loss). Such charges taken for securities still owned at September 30, 2009 were $256 million for residential MBS and $5 million for corporate bonds.

The following tables show gross unrealized losses (in millions) on fixed maturities and equity securities by investment category and length of time that individual securities have been in a continuous unrealized loss position at September 30, 2009 and December 31, 2008.

	Less Than Twelve Months			Twelve Months or More		
	Unrealized Loss	Fair Value	Fair Value as % of Cost	Unrealized Loss	Fair Value	Fair Value as % of Cost
September 30, 2009						
Fixed maturities:						
Direct obligations of the						

United States Government	$ -	$ 25	99%	$ -	$ -	-%
United States Government agencies and authorities	-	11	100%	-	-	-%
States, municipalities and political subdivisions	(2)	107	99%	(6)	67	91%
Foreign government	-	14	100%	(1)	28	98%
Residential MBS	(59)	418	88%	(350)	1,785	84%
Commercial MBS	(1)	53	98%	(42)	605	94%
All other corporate	(12)	276	96%	(198)	1,982	91%
	($ 74)	$ 904	92%	($ 597)	$4,467	88%
Common Stocks	$ -	$ 2	93%	$ -	$ -	-%
Perpetual Preferred Stocks	($ 2)	$ 7	79%	($ 12)	$ 45	79%

December 31, 2008						
Fixed maturities:						
United States Government agencies and authorities	$ -	$ 5	99%	$ -	$ 3	100%
States, municipalities and political subdivisions	(15)	187	93%	(5)	41	89%
Foreign government	-	-	-%	-	-	-%
Residential MBS	(567)	2,262	80%	(320)	914	74%
Commercial MBS	(169)	669	80%	(46)	173	79%
All other corporate	(507)	4,387	90%	(395)	1,284	77%
	($1,258)	$7,510	86%	($ 766)	$2,415	76%
Common Stocks	($ 14)	$ 23	62%	$ -	$ -	-%
Perpetual Preferred Stocks	($ 19)	$ 61	76%	($ 24)	$ 35	59%

At September 30, 2009, the gross unrealized losses on fixed maturities of $671 million relate to approximately 1,100 securities. Investment grade securities (as determined by nationally recognized rating agencies) represented approximately 63% of the gro