

AMERICAN FINANCIAL GROUP INC

Form 10-K

February 28, 2012

Table of Contents

**UNITED STATES SECURITIES AND EXCHANGE COMMISSION**  
**Washington, D.C. 20549**  
**FORM 10-K**  
**Annual Report Pursuant to Section 13 or 15(d) of the**  
**Securities Exchange Act of 1934**  
**For the Fiscal Year Ended December 31, 2011**  
**Commission File No. 1-13653**  
**AMERICAN FINANCIAL GROUP, INC.**

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

**Securities Registered Pursuant to Section 12(b) of the Act:**

Title of Each Class	Name of Each Exchange on Which Registered
Common Stock	New York Stock Exchange and Nasdaq Global Select Market
7-1/8% Senior Debentures due February 3, 2034	New York Stock Exchange
7% Senior Notes due September 30, 2050	New York Stock Exchange

**Securities Registered Pursuant to Section 12(g) of the Act: None**

**Other securities for which reports are submitted pursuant to Section 15(d) of the Act:**

9-7/8% Senior Notes due June 15, 2019

Indicate by check mark whether the Registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  No

Indicate by check mark whether the Registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes  No

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 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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definitions of "accelerated filer" and "large accelerated filer" in Rule 12b-2 of the Exchange Act.

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

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

State the aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was last sold, or the average bid and asked price of such common equity, as of the last business day of the Registrant's most recently completed second fiscal quarter: \$2.8 billion.

Indicate the number of shares outstanding of each of the Registrant's classes of common stock, as of the latest practicable date: 97,895,717 shares (excluding 14.9 million shares owned by subsidiaries) as of February 1, 2012.

**Documents Incorporated by Reference:**

Proxy Statement for 2012 Annual Meeting of Stockholders (portions of which are incorporated by reference into Part III hereof).

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**AMERICAN FINANCIAL GROUP, INC.  
INDEX TO ANNUAL REPORT ON FORM 10-K**

	Page
<b><u>FORWARD-LOOKING STATEMENTS</u></b>	1
<b><u>Part I</u></b>	
<u>Item 1 Business</u>	2
<u>Item 1A Risk Factors</u>	15
<u>Item 1B Unresolved Staff Comments</u>	none
<u>Item 2 Properties</u>	21
<u>Item 3 Legal Proceedings</u>	21
<u>Item 4 Mine Safety Disclosures</u>	none
<b><u>Part II</u></b>	
<u>Item 5 Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities</u>	23
<u>Item 6 Selected Financial Data</u>	24
<u>Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	25
<u>Item 7A Quantitative and Qualitative Disclosures About Market Risk</u>	53
<u>Item 8 Financial Statements and Supplementary Data</u>	56
<u>Item 9 Changes in and Disagreements with Accountants on Accounting and Financial Disclosure</u>	none
<u>Item 9A Controls and Procedures</u>	56
<u>Item 9B Other Information</u>	none
<b><u>Part III</u></b>	
<u>Item 10 Directors, Executive Officers and Corporate Governance</u>	S-1
<u>Item 11 Executive Compensation</u>	S-1
<u>Item 12 Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u>	S-1
<u>Item 13 Certain Relationships and Related Transactions, and Director Independence</u>	S-1

Item 14 Principal Accountant Fees and Services S-1

**Part IV**

Item 15 Exhibits and Financial Statement Schedules S-1

EX-12

EX-21

EX-23

EX-31.A

EX-31.B

EX-31.C

EX-32

EX-101 INSTANCE DOCUMENT

EX-101 SCHEMA DOCUMENT

EX-101 CALCULATION LINKBASE DOCUMENT

EX-101 LABELS LINKBASE DOCUMENT

EX-101 PRESENTATION LINKBASE DOCUMENT

EX-101 DEFINITION LINKBASE DOCUMENT

**Table of Contents**

**FORWARD-LOOKING STATEMENTS**

*The disclosures in this Form 10-K contain certain forward-looking statements that are subject to numerous assumptions, risks or uncertainties. The Private Securities Litigation Reform Act of 1995 provides a safe harbor for forward-looking statements. Some of the forward-looking statements can be identified by the use of words such as anticipates , believes , expects , projects , estimates , intends , plans , seeks , could , may , should , will or the negative version of those words or other comparable terminology. Such forward-looking statements include statements relating to: expectations concerning market and other conditions and their effect on future premiums, revenues, earnings and investment activities; recoverability of asset values; expected losses and the adequacy of reserves for asbestos, environmental pollution and mass tort claims; rate changes; and improved loss experience.*

*Actual results and/or financial condition could differ materially from those contained in or implied by such forward-looking statements for a variety of reasons including but not limited to the following and those discussed in Item 1A Risk Factors.*

*changes in financial, political and economic conditions, including changes in interest and inflation rates, currency fluctuations and extended economic recessions or expansions in the U.S. and abroad; performance of securities markets;*

*AFG s ability to estimate accurately the likelihood, magnitude and timing of any losses in connection with investments in the non-agency residential mortgage market;*

*new legislation or declines in credit quality or credit ratings that could have a material impact on the valuation of securities in AFG s investment portfolio;*

*the availability of capital;*

*regulatory actions (including changes in statutory accounting rules);*

*changes in the legal environment affecting AFG or its customers;*

*tax law and accounting changes;*

*levels of natural catastrophes and severe weather, terrorist activities (including any nuclear, biological, chemical or radiological events), incidents of war or losses resulting from civil unrest and other major losses;*

*development of insurance loss reserves and establishment of other reserves, particularly with respect to amounts associated with asbestos and environmental claims;*

*availability of reinsurance and ability of reinsurers to pay their obligations;*

*the unpredictability of possible future litigation if certain settlements of current litigation do not become effective;*

*trends in persistency, mortality and morbidity;*

*competitive pressures, including those in the annuity bank distribution channels, the ability to obtain adequate rates and policy terms; and*

*changes in AFG s credit ratings or the financial strength ratings assigned by major ratings agencies to AFG s operating subsidiaries.*

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

**Table of Contents**

**PART I**  
**ITEM 1**  
**Business**

**Introduction**

American Financial Group, Inc. ( AFG ) is a holding company that, through subsidiaries, is engaged primarily in property and casualty insurance, focusing on specialized commercial products for businesses, and in the sale of traditional fixed and indexed annuities and a variety of supplemental insurance products, such as Medicare supplement. Its address is 301 East Fourth Street, Cincinnati, Ohio 45202; its phone number is (513) 579-2121. SEC filings, news releases, AFG's Code of Ethics applicable to directors, officers and employees and other information may be accessed free of charge through AFG's Internet site at: [www.AFGinc.com](http://www.AFGinc.com). (Information on AFG's Internet site is not part of this Form 10-K.)

**Property and Casualty Insurance Operations**

**General**

AFG's specialty property and casualty insurance operations consist of approximately 30 niche insurance businesses offering a wide range of commercial coverages. These businesses report to a single senior executive and operate under a business model that allows local decision-making for underwriting, claims and policy servicing in each of the niche operations. These businesses are managed by experienced professionals in particular lines of business or customer groups and operate autonomously but with certain central controls and accountability. The decentralized approach allows each unit the autonomy necessary to respond to local and specialty market conditions while capitalizing on the efficiencies of centralized investment and administrative support functions. AFG's property and casualty insurance operations employed approximately 5,200 persons as of December 31, 2011.

The primary objectives of AFG's property and casualty insurance operations are to achieve solid underwriting profitability and provide excellent service to its policyholders and agents. Underwriting profitability is measured by the combined ratio, which is a sum of the ratios of losses, loss adjustment expenses ( LAE ), underwriting expenses and policyholder dividends to premiums. A combined ratio under 100% indicates an underwriting profit. The combined ratio does not reflect investment income, other income, or federal income taxes.

While many costs included in underwriting are readily determined (commissions, administrative expenses, and many of the losses on claims reported), the process of determining overall underwriting results is highly dependent upon the use of estimates in the case of losses incurred or expected but not yet reported or developed. Actuarial procedures and projections are used to obtain point estimates of ultimate losses. While the process is imprecise and develops amounts which are subject to change over time, management believes that the liabilities for unpaid losses and loss adjustment expenses are adequate.

AFG's statutory combined ratio averaged 87.4% for the period 2009 to 2011 as compared to 102.7% for the property and casualty industry over the same period (Source: A.M. Best's U.S. Property/Casualty Review & Preview February 2012 Edition). AFG believes that its specialty niche focus, product line diversification and underwriting discipline have contributed to the Company's ability to consistently outperform the industry's underwriting results. Management's philosophy is to refrain from writing business that is not expected to produce an underwriting profit even if it is necessary to limit premium growth to do so.

**Table of Contents**

Financial data is reported in accordance with U.S. generally accepted accounting principles ( GAAP ) for shareholder and other investment purposes and reported on a statutory basis for insurance regulatory purposes. Major differences for statutory accounting include charging policy acquisition costs to expense as incurred rather than spreading the costs over the periods covered by the policies; reporting investment grade bonds and redeemable preferred stocks at amortized cost rather than fair value; netting of reinsurance recoverables and prepaid reinsurance premiums against the corresponding liabilities rather than reporting such items separately; and charging to surplus certain GAAP assets, such as furniture and fixtures and agents' balances over 90 days old.

Unless indicated otherwise, the financial information presented for the property and casualty insurance operations herein is presented based on GAAP. Statutory information is provided for industry comparisons or where comparable GAAP information is not readily available.

**Property and Casualty Results**

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* to the financial statements for the reconciliation of AFG's operating profit by significant business segment to the Statement of Earnings.

The following table shows the performance of AFG's property and casualty insurance operations (dollars in millions):

	2011	2010	2009
Gross written premiums	\$ 4,106	\$ 3,589	\$ 3,763
Ceded reinsurance	(1,336)	(1,181)	(1,452)
Net written premiums	\$ 2,770	\$ 2,408	\$ 2,311
Net earned premiums	\$ 2,759	\$ 2,550	\$ 2,412
Loss and LAE	1,694	1,457	1,187
Special asbestos and environmental ( A&E ) charge	50		
Underwriting expenses	835	797	808
Underwriting gain	\$ 180	\$ 296	\$ 417
GAAP ratios:			
Loss and LAE ratio	63.2%	57.2%	49.2%
Underwriting expense ratio	30.2	31.3	33.5
Combined ratio	93.4%	88.5%	82.7%
Statutory ratios:			
Loss and LAE ratio	60.4%	53.5%	46.2%
Underwriting expense ratio	32.3	33.8	36.1
Combined ratio	92.7%	87.3%	82.3%
Industry statutory combined ratio (a)			
All lines	107.5%	101.0%	99.5%



Commercial lines	108.2%	102.7%	103.0%
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(a) Ratios are derived from A.M. Best's U.S. Property/Casualty Review & Preview (February 2012 Edition). As with other property and casualty insurers, AFG's operating results can be adversely affected by unpredictable catastrophe losses. Certain natural disasters (hurricanes, earthquakes, tornadoes, floods, etc.) and other incidents of major loss (explosions, civil disorder, terrorist events, fires, etc.) are classified as catastrophes by industry associations. Losses from these incidents are usually tracked separately from other business of insurers because of their sizable effects on overall operations. Total net losses to AFG's insurance operations from catastrophes, primarily hailstorms, hurricanes and tornadoes, were \$46 million in 2011, \$49 million in 2010 and \$18 million in 2009. AFG generally seeks to reduce its exposure to catastrophes through individual risk selection, including minimizing coastal and known fault-line exposures, and the purchase of reinsurance. AFG's exposure to a catastrophic earthquake or windstorm that industry models indicate could occur once in every 500 years (a 500-year event) is expected to be less than 2.5% of AFG's shareholders' equity.

**Table of Contents**

**Property and Casualty Insurance Products**

AFG is focused on growth opportunities in what it believes to be more profitable specialty businesses where AFG personnel are experts in particular lines of business or customer groups. The following are examples of AFG's specialty businesses:

***Property and Transportation***

*Inland and Ocean Marine*

Provides coverage primarily for builders' risk, contractors' equipment, property, motor truck cargo, marine cargo, boat dealers, marina operators/dealers and excursion vessels.

*Agricultural-related*

Provides federally reinsured multi-peril crop (allied lines) insurance covering most perils as well as crop-hail, equine mortality and other coverages for full-time operating farms/ranches and agribusiness operations on a nationwide basis.

*Commercial Automobile*

Provides coverage for vehicles (such as buses and trucks) in a broad range of businesses including the moving and storage and transportation industries, and a specialized physical damage product for the trucking industry.

***Specialty Casualty***

*Executive and Professional Liability*

Markets coverage for directors and officers of businesses and non-profit organizations; errors and omissions; and provides non-U.S. medical malpractice insurance.

*Umbrella and Excess Liability*

Provides higher layer liability coverage in excess of primary layers.

*Excess and Surplus*

Provides liability, umbrella and excess coverage for unique, volatile or hard to place risks, using rates and forms that generally do not have to be approved by state insurance regulators.

*General Liability*

Provides coverage for contractor-related businesses, energy development and production risks, and environmental liability risks.

*Targeted Programs*

Includes coverage (primarily liability and property) for social service agencies, leisure, entertainment and non-profit organizations, customized solutions for other targeted markets and alternative risk programs using agency captives.

*Workers' Compensation*

Provides coverage for prescribed benefits payable to employees who are injured on the job.

***Specialty Financial***

*Fidelity and Surety*

Provides fidelity and crime coverage for government, mercantile and financial institutions and surety coverage for various types of contractors and public and private corporations.

*Lease and Loan Services*

Provides coverage for insurance risk management programs for lending and leasing institutions, including equipment leasing and collateral and mortgage protection.

**Table of Contents**

Management believes specialization is the key element to the underwriting success of these business units. These specialty businesses are opportunistic and their premium volume will vary based on prevailing market conditions. AFG continually evaluates expansion in existing markets and opportunities in new specialty markets that meet its profitability objectives. For example, in July 2010, a majority-owned subsidiary of AFG acquired Vanliner Group, Inc. ( Vanliner ), a market leader in providing insurance for the moving and storage industry. Likewise, AFG will withdraw from markets that do not meet its profit objectives or business strategy, such as the withdrawal from certain program business in 2010 and 2011.

**Premium Distribution**

The following table shows the net written premiums by sub-segment for AFG's property and casualty insurance operations for 2011 (net written premiums for 2007 are given to show changes over a four-year period)(dollars in millions):

	2011	2007
Property and transportation	\$ 1,436	\$ 1,132
Specialty casualty	867	1,022
Specialty financial	398	488
Other	69	70
	\$ 2,770	\$ 2,712

The geographic distribution of statutory direct written premiums by AFG's U.S.-based insurers in 2011 compared to 2007 is shown below. Amounts exclude business written under special arrangements on behalf of, and fully reinsured to, the purchasers of several divisions sold. Approximately 5% of AFG's direct written premiums in 2011 were derived from non U.S.-based insurers, primarily Marketform, a majority-owned United Kingdom-based Lloyd's insurer acquired in 2008.

	2011	2007
California	12.0%	14.7%
Illinois	8.0	6.1
Texas	6.8	8.0
New York	4.8	4.4
Florida	4.5	7.4
Kansas	4.1	3.2
Iowa	3.8	*
Missouri	3.2	2.1
Indiana	2.9	2.5
South Dakota	2.7	*
Pennsylvania	2.6%	2.4%
Ohio	2.4	2.3
Georgia	2.4	2.3
Nebraska	2.3	2.0
North Carolina	2.2	2.3
North Dakota	2.2	*
New Jersey	2.1	2.1
Minnesota	2.1	*
Oklahoma	2.0	2.7
Other	26.9	35.5

100.0%

100.0%

(\*) less than 2%, included in Other

### Ratings

The following table shows independent ratings and 2011 net written premiums (in millions) of AFG's major property and casualty insurance subsidiaries. Such ratings are generally based on concerns for policyholders and agents and are not directed toward the protection of investors. During 2010, AFG's principal property and casualty insurance companies were upgraded by Standard & Poor's (S&P) to A+. AFG believes that maintaining an S&P rating of at least A- is important to compete successfully in certain lines of business.

Company	Ratings		Net Written Premiums
	AM Best	S&P	
Great American Pool(*)	A	A+	\$ 1,847
National Interstate	A	not rated	442
Marketform Lloyd's Syndicate	A	A+	146
Republic Indemnity	A	A+	135
Mid-Continent	A	A+	127
American Empire Surplus Lines	A+	A+	35
Other			38
			\$ 2,770

(\*) The Great American Pool represents Great American Insurance Company (GAI) and 10 subsidiaries.

**Table of Contents****Reinsurance**

Consistent with standard practice of most insurance companies, AFG reinsures a portion of its business with other insurance companies and assumes a relatively small amount of business from other insurers. AFG uses reinsurance for two primary purposes: (i) to provide higher limits of coverage than it would otherwise be willing to provide (i.e. large line capacity) and (ii) to protect its business by reducing the impact of catastrophes. The availability and cost of reinsurance are subject to prevailing market conditions, which may affect the volume and profitability of business that is written. AFG is subject to credit risk with respect to its reinsurers, as the ceding of risk to reinsurers does not relieve AFG of its liability to its insureds until claims are fully settled.

The commercial marketplace requires large policy limits (\$25 million or more) in several of AFG's lines of business, including certain executive and professional liability, umbrella and excess liability, and fidelity and surety coverages. Since these limits exceed management's desired exposure to an individual risk, AFG generally enters into reinsurance agreements to reduce its net exposure under such policies to an acceptable level. Reinsurance continues to be available for this large line capacity exposure with satisfactory pricing and terms.

AFG has taken steps to limit its exposure to wind and earthquake losses by purchasing catastrophe reinsurance. In addition, AFG purchases catastrophe reinsurance for its workers' compensation businesses. Although the cost of catastrophe reinsurance varies depending on exposure and the level of worldwide loss activity, AFG has been able to obtain reinsurance coverage in adequate amounts at acceptable rates due to management's decision to limit overall exposure to catastrophe losses through individual risk selection (including minimizing coastal and known fault-line exposures) and the Company's limited historical catastrophe losses.

In addition to the large line capacity and catastrophe reinsurance programs discussed above, AFG purchases reinsurance on a product-by-product basis. AFG regularly reviews the financial strength of its current and potential reinsurers. These reviews include consideration of credit ratings, available capital, claims paying history and expertise. This process periodically results in the transfer of risks to more financially secure reinsurers. Substantially all reinsurance is ceded to companies with investment grade or better S&P ratings or is secured by funds withheld or other collateral. Under funds withheld arrangements, AFG retains ceded premiums to fund ceded losses as they become due from the reinsurer. Recoverables from the following companies were individually between 5% and 11% of AFG's total reinsurance recoverable (net of payables to reinsurers) at December 31, 2011: Everest Reinsurance Company, Munich Reinsurance America, Inc. and Swiss Reinsurance America Corporation. In addition, AFG has a reinsurance recoverable from Ohio Casualty Insurance Company of \$212 million related to that company's purchase of AFG's commercial lines business in 1998.

Reinsurance is provided on one of two bases, facultative or treaty. Facultative reinsurance is generally provided on a risk by risk basis. Individual risks are ceded and assumed based on an offer and acceptance of risk by each party to the transaction. AFG purchases facultative reinsurance, both pro rata and excess of loss, depending on the risk and available reinsurance markets. Treaty reinsurance provides for risks meeting prescribed criteria to be automatically ceded and assumed according to contract provisions.

The following table presents (by type of coverage) the amount of each loss above the specified retention maximum generally covered by treaty reinsurance programs (in millions) as of January 1, 2012:

Coverage	Retention Maximum	Reinsurance Coverage(a)
California Workers' Compensation	\$ 3	\$ 147
Other Workers' Compensation	2	48
Commercial Umbrella	4	46
Property - General	3	98
Property - Catastrophe	26	154

(a) Reinsurance covers substantial portions of losses in excess of retention. However, in general, losses resulting from terrorism are not covered.



**Table of Contents**

In addition to the coverage shown above, AFG reinsures a portion of its crop insurance business through the Federal Crop Insurance Corporation ( FCIC ). The FCIC offers both proportional (or quota share ) and non-proportional coverages. The proportional coverage provides that a fixed percentage of risk is assumed by the FCIC. The non-proportional coverage allows AFG to select desired retention of risk on a state-by-state, county, crop or plan basis. AFG typically reinsures 15% to 25% of gross written premium with the FCIC. AFG also purchases quota share reinsurance in the private market. This quota share provides for a ceding commission to AFG and a profit sharing provision. During 2011, AFG reinsured 52.5% of premiums not reinsured by the FCIC in the private market and purchased stop loss protection coverage for the remaining portion of the business. AFG expects to utilize similar levels of reinsurance in 2012. In 2010 and 2009, AFG reinsured approximately 50% and 90%, respectively, of premiums not reinsured by the FCIC.

Included in the Balance Sheet caption recoverables from reinsurers were approximately \$72 million on paid losses and LAE and \$2.2 billion on unpaid losses and LAE at December 31, 2011. These amounts are net of allowances of approximately \$26 million for doubtful collection of reinsurance recoverables. The collectibility of a reinsurance balance is based upon the financial condition of a reinsurer as well as individual claim considerations.

Reinsurance premiums ceded and assumed are presented in the following table (in millions):

	2011	2010	2009
Reinsurance ceded	\$ 1,336	\$ 1,181	\$ 1,452
Reinsurance ceded, excluding crop	652	727	680
Reinsurance assumed including involuntary pools and associations	45	47	32

**Loss and Loss Adjustment Expense Reserves**

The consolidated financial statements include the estimated liability for unpaid losses and LAE of AFG's insurance subsidiaries. This liability represents estimates of the ultimate net cost of all unpaid losses and LAE and is determined by using case-basis evaluations, actuarial projections and management's judgment. These estimates are subject to the effects of changes in claim amounts and frequency and are periodically reviewed and adjusted as additional information becomes known. In accordance with industry practices, such adjustments are reflected in current year operations. Generally, reserves for reinsurance assumed and involuntary pools and associations are reflected in AFG's results at the amounts reported by those entities.



**Table of Contents**

The following table presents the development of AFG's liability for losses and LAE, net of reinsurance, on a GAAP basis for the last ten years. The top line of the table shows the estimated liability (in millions) for unpaid losses and LAE recorded at the balance sheet date for the indicated years. The second line shows the re-estimated liability as of December 31, 2011. The remainder of the table presents intervening development as percentages of the initially estimated liability. The development results from additional information and experience in subsequent years, particularly with regard to A&E charges, settlements and reallocations as detailed below. The middle line shows a cumulative deficiency (redundancy), which represents the aggregate percentage increase (decrease) in the liability initially estimated. The lower portion of the table indicates the cumulative amounts paid as of successive periods as a percentage of the original loss reserve liability. For purposes of this table, reserves of businesses sold are considered paid at the date of sale. See *Note O - Insurance - Property and Casualty Insurance Reserves* to the financial statements for an analysis of changes in AFG's estimated liability for losses and LAE, net and gross of reinsurance, over the past three years on a GAAP basis.

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Liability for unpaid losses and loss adjustment expenses:											
As originally estimated	\$ 3,338	\$ 3,466	\$ 2,901	\$ 3,155	\$ 3,619	\$ 3,791	\$ 3,868	\$ 4,154	\$ 3,899	\$ 4,164	\$ 4,282
As re-estimated at December 31, 2011	\$ 4,306	\$ 4,289	\$ 3,444	\$ 3,310	\$ 3,332	\$ 3,280	\$ 3,268	\$ 3,756	\$ 3,673	\$ 4,095	N/A
Liability re-estimated:											
One year later	104.5%	104.4%	104.9%	106.3%	98.4%	97.4%	93.6%	95.2%	96.0%	98.3%	
Two years later	110.0%	109.7%	114.0%	106.1%	98.8%	92.3%	89.7%	91.6%	94.2%		
Three years later	113.8%	118.0%	114.7%	107.7%	95.2%	89.5%	85.8%	90.4%			
Four years later	121.1%	118.8%	118.0%	106.0%	93.6%	87.0%	84.5%				
Five years later	122.8%	122.1%	118.5%	105.5%	92.1%	86.5%					
Six years later	126.5%	123.0%	118.8%	104.4%	92.1%						
Seven years later	127.7%	123.6%	117.9%	104.9%							
Eight years later	128.6%	123.1%	118.7%								
Nine years later	128.2%	123.7%									
Ten years later	129.0%										
Cumulative deficiency (redundancy)	29.0%	23.7%	18.7%	4.9%	(7.9%)	(13.5%)	(15.5%)	(9.6%)	(5.8%)	(1.7%)	N/A

(a)

Cumulative paid as of:											
One year later	32.7%	42.2%	27.3%	25.4%	23.5%	22.3%	21.0%	24.0%	21.3%	23.3%	
Two years later	61.3%	60.9%	46.4%	40.8%	37.5%	34.8%	32.9%	37.2%	35.9%		
Three years later	74.4%	72.7%	58.8%	52.4%	46.9%	43.6%	41.6%	47.0%			
Four years later	82.8%	80.3%	68.5%	60.1%	53.6%	49.9%	47.5%				
Five years later	88.4%	86.2%	75.2%	65.6%	58.7%	54.2%					
Six years later	93.4%	90.7%	80.1%	70.5%	62.1%						
Seven years later	97.0%	94.2%	84.4%	73.8%							
Eight years later	100.1%	96.9%	87.4%								
Nine years later	102.7%	99.1%									
Ten years later	104.8%										

(a) Cumulative deficiency (redundancy):

Special A&E charges, settlements and reallocations	9.4%	8.2%	9.8%	9.1%	2.9%	2.8%	1.6%	1.2%	1.3%	1.2%	
Other	19.6%	15.5%	8.9%	(4.2%)	(10.8%)	(16.3%)	(17.1%)	(10.8%)	(7.1%)	(2.9%)	
Total	29.0%	23.7%	18.7%	4.9%	(7.9%)	(13.5%)	(15.5%)	(9.6%)	(5.8%)	(1.7%)	N/A

The following is a reconciliation of the net liability to the gross liability for unpaid losses and LAE.

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
As originally estimated:											
Net liability shown above	\$ 3,338	\$ 3,466	\$ 2,901	\$ 3,155	\$ 3,619	\$ 3,791	\$ 3,868	\$ 4,154	\$ 3,899	\$ 4,164	\$ 4,282
Add reinsurance recoverables	1,525	1,804	2,059	2,234	2,243	2,309	2,300	2,610	2,513	2,249	2,238
Gross liability	\$ 4,863	\$ 5,270	\$ 4,960	\$ 5,389	\$ 5,862	\$ 6,100	\$ 6,168	\$ 6,764	\$ 6,412	\$ 6,413	\$ 6,520
As re-estimated at											

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December 31, 2011:												
Net liability shown above	\$ 4,306	\$ 4,289	\$ 3,444	\$ 3,310	\$ 3,332	\$ 3,280	\$ 3,268	\$ 3,756	\$ 3,673	\$ 4,095		
Add reinsurance recoverables	2,516	2,626	2,750	2,544	2,323	2,141	1,933	2,281	1,983	2,007		
Gross liability	\$ 6,822	\$ 6,915	\$ 6,194	\$ 5,854	\$ 5,655	\$ 5,421	\$ 5,201	\$ 6,037	\$ 5,656	\$ 6,102		N/A
Gross cumulative Deficiency (redundancy) (a)	40.3%	31.2%	24.9%	8.6%	(3.5%)	(11.1%)	(15.7%)	(10.7%)	(11.8%)	(4.8%)		N/A

(a) Gross cumulative deficiency (redundancy):

Special A&E charges, settlements and reallocations	7.4%	6.2%	6.7%	6.1%	2.1%	2.1%	1.0%	0.7%	0.7%	0.8%		
Other	32.9%	25.0%	18.2%	2.5%	(5.6%)	(13.2%)	(16.7%)	(11.4%)	(12.5%)	(5.6%)		
Total	40.3%	31.2%	24.9%	8.6%	(3.5%)	(11.1%)	(15.7%)	(10.7%)	(11.8%)	(4.8%)		N/A

**Table of Contents**

In evaluating the re-estimated liability and cumulative deficiency (redundancy), it should be noted that each percentage includes the effects of changes in amounts for prior periods. For example, AFG's \$50 million special A&E charge related to losses recorded in 2011, but incurred before 2001, is included in the re-estimated liability and cumulative deficiency (redundancy) percentage for each of the previous years shown. Conditions and trends that have affected development of the liability in the past may not necessarily exist in the future. Accordingly, it may not be appropriate to extrapolate future redundancies or deficiencies based on this table.

A significant portion of the adverse development in the tables is due to A&E exposures for which AFG has been held liable under general liability policies written prior to 1987, even though such coverage was not intended. Other factors affecting adverse development included changes in the legal environment, including more liberal coverage decisions and higher jury awards, higher legal fees, the general state of the economy and medical cost inflation.

The differences between the liability for losses and LAE reported in the annual statements filed with the state insurance departments in accordance with statutory accounting principles ( SAP ) and that reported in the accompanying consolidated financial statements in accordance with GAAP at December 31, 2011 are as follows (in millions):

Liability reported on a SAP basis, net of \$157 million of retroactive reinsurance	\$	3,749
Reinsurance recoverables, net of allowance		2,238
Other, including reserves of foreign insurers		533
Liability reported on a GAAP basis	\$	6,520

**Asbestos and Environmental ( A&E ) Reserves** AFG's property and casualty group, like many others in the industry, has A&E claims arising in most cases from general liability policies written more than twenty-five years ago. The establishment of reserves for such A&E claims presents unique and difficult challenges and is subject to uncertainties significantly greater than those presented by other types of claims. For a discussion of these uncertainties, see *Item 7 Management's Discussion and Analysis - Uncertainties - Asbestos and Environmental related Insurance Reserves and Note M - Contingencies* to the financial statements.

Management has conducted comprehensive studies of its asbestos and environmental reserves with the aid of outside actuarial and engineering firms and specialty outside counsel every two years with an in-depth internal review during the intervening years. Charges resulting from these studies and reviews are included in Incurred losses and LAE in the table below. The 2011 comprehensive study relied on a ground-up exposure analysis and considered products and non-products exposures, paid claims history, the pattern of new claims, settlements and projected development. As a result of the study, AFG recorded a \$50 million special charge (net of reinsurance) in the second quarter of 2011 to increase the property and casualty group's A&E reserves. During the course of the in-depth internal review in 2010, there were no newly identified emerging trends or issues that management believes significantly impacted the overall adequacy of AFG's A&E reserves. Likewise, the 2009 comprehensive study resulted in only minor adjustments to A&E reserves. For a discussion of the A&E reserve strengthening, see *Management's Discussion and Analysis - Results of Operations - Asbestos and Environmental Reserve Charges*.

The following table (in millions) is a progression of the property and casualty group's A&E reserves.

	2011	2010	2009
Reserves at beginning of year	\$ 342	\$ 378	\$ 399
Incurred losses and LAE	50	8	4
Paid losses and LAE	(30)	(44)	(25)
Reserves at end of year, net of reinsurance recoverable	362	342	378

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Reinsurance recoverable, net of allowance	92	74	79
Gross reserves at end of year	\$ 454	\$ 416	\$ 457

**Table of Contents****Marketing**

The property and casualty insurance group directs its sales efforts primarily through independent property and casualty insurance agents and brokers, although small portions are written through employee agents. Independent agents and brokers generally receive a commission on the sale of each policy. Some agents and brokers are eligible for a bonus commission based on the overall profitability of policies placed with AFG by the broker or agent in a particular year. The property and casualty insurance group writes insurance through several thousand agents and brokers.

**Competition**

AFG's property and casualty insurance businesses compete with other individual insurers, state funds and insurance groups of varying sizes, some of which are mutual insurance companies possessing competitive advantages in that all their profits inure to their policyholders. See *Item 1A - Risk Factors*. They also compete with self-insurance plans, captive programs and risk retention groups. Due to the specialty nature of these coverages, competition is based primarily on service to policyholders and agents, specific characteristics of products offered and reputation for claims handling. Financial strength ratings, price, commissions and profit sharing terms are also important factors.

Management believes that sophisticated data analysis for refinement of risk profiles, extensive specialized knowledge and loss prevention service have helped AFG compete successfully.

**Annuity and Supplemental Insurance Operations****General**

AFG's annuity and supplemental insurance operations are conducted through Great American Financial Resources, Inc. ( GAFRI ). GAFRI's primary insurance subsidiaries include Great American Life Insurance Company ( GALIC ), Annuity Investors Life Insurance Company ( AILIC ), United Teacher Associates Insurance Company ( UTA ) and Loyal American Life Insurance Company ( Loyal ). These companies market retirement products, primarily fixed and indexed annuities, and various forms of supplemental insurance such as Medicare supplement. All of these companies sell their products through independent producers. GAFRI and its subsidiaries employed approximately 800 persons at December 31, 2011.

Following is certain information concerning GAFRI's largest subsidiaries (dollars in millions).

Company	Principal Products	2011			
		Statutory Premiums	Policies In Force	Ratings AM Best	Ratings S&P
GALIC	Fixed and indexed annuities	\$ 2,803	392,000	A	A+
AILIC	Fixed and indexed annuities	301	137,000	A	A+
UTA	Supplemental insurance	206	194,000	B++	not rated
Loyal	Supplemental insurance	103	132,000	A-	not rated

AFG believes that the ratings assigned by independent insurance rating agencies are important because agents, potential policyholders and school districts often use a company's rating as an initial screening device in considering annuity products. AFG believes that (i) a rating in the A category by A.M. Best is necessary to successfully market tax-deferred annuities to public education employees and other non-profit groups and (ii) a rating in the A category by at least one rating agency is necessary to successfully compete in other annuity markets. During 2010, AFG's principal annuity subsidiaries were upgraded by S&P to A+ and its principal supplemental insurance subsidiaries were downgraded one notch by A.M. Best to A- and B++. Ratings are an important competitive factor; AFG believes that these entities can successfully compete in these markets with their respective ratings.

**Table of Contents**

Statutory premiums of AFG's annuity and supplemental insurance companies over the last three years were as follows (in millions):

	2011	Premiums 2010	2009
Non-403(b) indexed annuities	\$ 1,549	\$ 735	\$ 402
Non-403(b) fixed annuities	239	430	294
Bank fixed annuities	971	737	314
403(b) fixed and indexed annuities	257	305	337
Variable annuities	70	73	87
Total annuities	3,086	2,280	1,434
Supplemental insurance	384	402	390
Life insurance	35	39	44
Total	\$ 3,505	\$ 2,721	\$ 1,868

**Annuities**

AFG's principal retirement products are Flexible Premium Deferred Annuities ( FPDAs ) and Single Premium Deferred Annuities ( SPDAs ). Annuities are long-term retirement saving instruments that benefit from income accruing on a tax-deferred basis. The issuer of the annuity collects premiums, credits interest or earnings on the policy and pays out a benefit upon death, surrender or annuitization. FPDAs are characterized by premium payments that are flexible in both amount and timing as determined by the policyholder and are generally made through payroll deductions. SPDAs are generally issued in exchange for a one-time lump-sum premium payment.

Annuity contracts are generally classified as either fixed rate (including indexed) or variable. With a traditional fixed rate annuity, AFG seeks to maintain a desired spread between the yield on its investment portfolio and the rate it credits. AFG accomplishes this by: (i) offering crediting rates that it has the option to change after any initial guarantee period (subject to minimum interest rate guarantees); (ii) designing annuity products that encourage persistency; and (iii) maintaining an appropriate matching of assets and liabilities.

An indexed annuity provides policyholders with the opportunity to receive a crediting rate tied, in part, to the performance of an existing market index (generally the S&P 500) while protecting against the related downside risk through a guarantee of principal (excluding surrender charges). AFG purchases call options designed to substantially offset the effect of the index participation in the liabilities associated with indexed annuities.

As an ancillary product to its traditional fixed rate and indexed annuities, AFG offers variable annuities. With a variable annuity, the earnings credited to the policy vary based on the investment results of the underlying investment options chosen by the policyholder, generally without any guarantee of principal except in the case of death of the insured. Premiums directed to the underlying investment options maintained in separate accounts are invested in funds managed by various independent investment managers. AFG earns a fee on amounts deposited into separate accounts. Subject to contractual provisions, policyholders may also choose to direct all or a portion of their premiums to various fixed rate options, in which case AFG earns a spread on amounts deposited.

**Supplemental and Life Insurance Products**

AFG offers a variety of supplemental insurance products primarily to individuals age 55 and older. Principal products include coverage for Medicare supplement, cancer and accidental injury. These products are sold primarily through independent agents, including a former captive career agency force that was sold by AFG in the fourth quarter of 2010. At December 31, 2011, AFG's reserves related to Medicare supplement, cancer, accidental injury and similar products were \$191 million, net of reinsurance recoverables.

AFG ceased new sales of long-term care insurance beginning in January 2010. Renewal premiums on approximately 60,000 policies will be accepted unless those policies lapse. At December 31, 2011, AFG's long-term care insurance

reserves were \$490 million, net of reinsurance recoverables.



**Table of Contents**

Although AFG no longer actively markets new life insurance products, it continues to service and receive renewal premiums on its in-force block of approximately 211,000 policies and \$21 billion gross (\$5 billion net) of life insurance in force at December 31, 2011. At December 31, 2011, AFG's life insurance reserves were \$492 million, net of reinsurance recoverables.

**Marketing**

The majority of AFG's FPDAs are sold in qualified markets under sections 403(b) and 457 of the Internal Revenue Code. In the 403(b) and 457 markets, schools, government agencies and certain other non-profit organizations may allow employees to save for retirement through contributions made on a before-tax basis. Federal income taxes are not payable on pretax contributions or earnings until amounts are withdrawn.

AFG sells its single premium non-403(b) fixed rate annuities, excluding bank production (discussed below), primarily through a network of approximately 100 national marketing organizations (NMOs) and managing general agents (MGAs) who, in turn, direct over 1,500 actively producing agents.

In 2011, AFG began selling its 403(b) fixed rate annuities directly through writing agents rather than through NMOs and MGAs as it had historically done. AFG believes that, by eliminating the costs associated with NMOs and MGAs in this market segment, it will be able to increase sales by offering higher crediting rates to policyholders and higher commissions to writing agents while still reducing its overall costs.

AFG also sells non-403(b) fixed rate annuities in banks through independent agents and brokers, as well as through direct relationships with certain financial institutions.

Premiums generated through AFG's direct relationship with PNC Bank and through Regions Bank and BB&T by independent brokers were the largest individual sources of annuity premiums in 2011 and accounted for approximately 11%, 11% and 7%, respectively, of AFG's overall annuity premiums in 2011.

AFG is licensed to sell its fixed annuity products in all states except New York; it is licensed to sell its variable products in all states except New York and Vermont. In 2011, the only states that accounted for 5% or more of AFG's annuity premiums were Florida (11%), California (9%), Michigan (6%), Pennsylvania (5%) and Ohio (5%). At December 31, 2011, AFG had approximately 448,000 annuity policies in force.

**Competition**

AFG's annuity and supplemental insurance businesses operate in highly competitive markets. They compete with other insurers and financial institutions based on many factors, including: (i) ratings; (ii) financial strength; (iii) reputation; (iv) service to policyholders and agents; (v) product design (including interest rates credited, index participation and premium rates charged); (vi) commissions; and (vii) number of school districts in which a company has approval to sell. Since most policies are marketed and distributed through independent agents, the insurance companies must also compete for agents.

No single insurer dominates the markets in which AFG's annuity and supplemental insurance businesses compete. See *Item 1A Risk Factors*. Competitors include (i) individual insurers and insurance groups, (ii) mutual funds and (iii) other financial institutions. In a broader sense, AFG's annuity and supplemental insurance businesses compete for retirement savings with a variety of financial institutions offering a full range of financial services. In the bank annuity market, AFG's annuities compete directly against competitors' bank annuities, certificates of deposit and other investment alternatives at the point of sale.

Sales of annuities, including renewal premiums, are affected by many factors, including: (i) competitive annuity products and rates; (ii) the general level and volatility of interest rates, including the slope of the yield curve; (iii) the favorable tax treatment of annuities; (iv) commissions paid to agents; (v) services offered; (vi) ratings from independent insurance rating agencies; (vii) other alternative investments; (viii) performance and volatility of the equity markets; (ix) media coverage of annuities; (x) regulatory developments regarding suitability and the sales process; and (xi) general economic conditions.

**Table of Contents****Other Operations**

Through subsidiaries, AFG is engaged in a variety of other operations, including commercial real estate operations in Cincinnati (office buildings and The Cincinnati Hotel), New Orleans (Le Pavillon Hotel), Whitefield, New Hampshire (Mountain View Grand Resort), Chesapeake Bay (Skipjack Cove Yachting Resort and Bay Bridge Marina), Charleston (Charleston Harbor Resort and Marina), Palm Beach (Sailfish Marina and Resort), Florida City, Florida (retail commercial development) and apartments in Louisville and Pittsburgh. These operations employed approximately 500 full-time employees at December 31, 2011.

**Investment Portfolio****General**

A summary of AFG's fixed maturities and equity securities is shown in Note E to the financial statements. For additional information on AFG's investments, see *Item 7 Management's Discussion and Analysis Investments*. Portfolio yields are shown below.

	2011	2010	2009
Yield on Fixed Maturities (a):			
Excluding realized gains and losses	5.7%	6.2%	6.9%
Including realized gains and losses	5.8%	6.6%	6.8%
Yield on Equity Securities (a):			
Excluding realized gains and losses	4.8%	5.0%	5.0%
Including realized gains and losses	18.5%	15.8%	20.7%

(a) Based on amortized cost; excludes effects of changes in unrealized gains and losses. Realized losses include impairment charges.

The table below compares total returns, which include changes in fair value, on AFG's fixed maturities and equity securities to comparable public indices. While there are no directly comparable indices to AFG's portfolio, the two shown below are widely used benchmarks in the financial services industry. Both AFG's performance and the indices include changes in unrealized gains and losses.

	2011	2010	2009
Total return on AFG's fixed maturities	7.7%	10.9%	21.1%
Barclays Capital U.S. Universal Bond Index	7.4%	7.2%	8.6%
Total return on AFG's equity securities	6.9%	17.4%	48.0%
Standard & Poor's 500 Index	2.1%	15.1%	26.5%

**Fixed Maturity Investments**

AFG's bond portfolio is invested primarily in taxable bonds. The following table shows AFG's available for sale fixed maturities by Standard & Poor's Corporation or comparable rating as of December 31, 2011 (dollars in millions).

S&P or comparable rating	Amortized Cost	Fair Value Amount	%
AAA, AA, A	\$ 13,847	\$ 14,820	68%
BBB	4,422	4,745	22
Total investment grade	18,269	19,565	90

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BB	667	638	3
B	584	547	3
CCC, CC, C	720	723	3
D	322	334	2
Total non-investment grade	2,293	2,242	11
Total	\$ 20,562	\$ 21,807	100%

**Table of Contents**

At December 31, 2011, approximately 77% of AFG's mortgage-backed securities ( MBS ), having a fair value of \$6.8 billion, were rated investment grade (BBB or better) by major rating firms. The National Association of Insurance Commissioners ( NAIC ) has retained third-party investment management firms to assist in the determination of appropriate NAIC designations for MBS based not only on the probability of loss (which is the primary basis of ratings by the major ratings firms), but also on the severity of loss and statutory carrying value. At December 31, 2011, 97% (based on statutory carrying value of \$6.5 billion) of AFG's MBS portfolio held by its insurance companies had an NAIC designation of 1 or 2 (the highest of the six designations).

**Equity Investments**

At December 31, 2011, AFG held common and perpetual preferred stocks with a fair value of \$928 million, the largest of which was a \$130 million common stock investment in Verisk Analytics, Inc. ( Verisk ), a provider of risk information for insurance companies. AFG recorded after-tax gains of \$49 million in 2011, \$17 million in 2010 and \$49 million in 2009 on sales of a portion of its investment in Verisk.

**Regulation**

AFG's insurance company subsidiaries are subject to regulation in the jurisdictions where they do business. In general, the insurance laws of the various states establish regulatory agencies with broad administrative powers governing, among other things, premium rates, solvency standards, licensing of insurers, agents and brokers, trade practices, forms of policies, maintenance of specified reserves and capital for the protection of policyholders, deposits of securities for the benefit of policyholders, investment activities and relationships between insurance subsidiaries and their parents and affiliates. Material transactions between insurance subsidiaries and their parents and affiliates generally must receive prior approval of the applicable insurance regulatory authorities and be disclosed. In addition, while differing from state to state, these regulations typically restrict the maximum amount of dividends that may be paid by an insurer to its shareholders in any twelve-month period without advance regulatory approval. Such limitations are generally based on net earnings or statutory surplus. Under applicable restrictions, the maximum amount of dividends available to AFG in 2012 from its insurance subsidiaries without seeking regulatory clearance is approximately \$546 million.

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ( Dodd-Frank Act ), among other things, established a Federal Insurance Office ( FIO ) within the U.S. Treasury. Under this law, regulations will need to be created for the FIO to carry out its mandate to focus on systemic risk oversight. The FIO is required to gather information regarding the insurance industry and submit to Congress a plan to modernize and improve insurance regulation in the U.S. At this time, it is difficult to predict the extent to which the Dodd-Frank Act, or any resulting regulations, will impact AFG's operations.

Marketform, AFG's UK-based Lloyd's insurer, is subject to regulation by the European Union's executive body, the European Commission. In 2014, Marketform will be required to adopt new capital adequacy and risk management regulations known as Solvency II. Implementation is not expected to be material to AFG.

Most states have created insurance guaranty associations to provide for the payment of claims of insurance companies that become insolvent. Annual guaranty assessments for AFG's insurance companies have not been material.

**Table of Contents**

**ITEM 1A**  
**Risk Factors**

In addition to the other information set forth in this report, the following factors could materially affect AFG's business, financial condition, cash flows or future results. Any one of these factors could cause AFG's actual results to vary materially from recent results or from anticipated future results. The risks described below are not the only risks facing AFG. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect AFG's business, financial condition and/or operating results.

**Adverse developments in the financial markets and deterioration in global economic conditions could have a material adverse effect on AFG's results of operations and financial condition.**

The highly volatile debt and equity markets, lack of liquidity, widening credit spreads and the collapse of several financial institutions during 2008 and early 2009 resulted in significant realized and unrealized losses in AFG's investment portfolio. Although domestic economic conditions and financial markets have improved, financial markets continue to be volatile and there is continued uncertainty with regards to the global economy, particularly in Europe. See *Item 7A Quantitative and Qualitative Disclosures about Market Risk European Debt Exposure*. At December 31, 2011, AFG's net unrealized gain on fixed maturity investments was \$1.2 billion consisting of gross gains of \$1.5 billion and gross losses of \$249 million. Although AFG intends to hold its investments with unrealized losses until they recover in value, its intent may change for a variety of reasons as discussed in *Item 7*

*Management's Discussion and Analysis Investments*. A change in AFG's ability or intent with regard to a security in an unrealized loss position would result in the recognition of a realized loss.

AFG's investment performance could also be adversely impacted by the types of investments, industry groups and/or individual securities in which it invests. As of December 31, 2011, 87% of AFG's investment portfolio was invested in fixed maturity securities. Certain risks are inherent in connection with fixed maturity securities including loss upon default and price volatility in reaction to changes in interest rates and general market factors. AFG's equity securities, which represent 4% of its investment portfolio, are subject to market price volatility.

MBS represented about one-third of AFG's fixed maturity securities at December 31, 2011. AFG's MBS portfolio will continue to be impacted by general economic conditions, including unemployment levels, real estate values and other factors that could negatively affect the creditworthiness of borrowers. MBS in which the underlying collateral is subprime mortgages represented 3% of AFG's total fixed maturity portfolio at December 31, 2011; MBS in which the underlying collateral is Alt-A mortgages (risk profile between prime and subprime) represented approximately 3%.

See *Item 7A Quantitative and Qualitative Disclosures About Market Risk Fixed Maturity Portfolio*.

AFG cannot predict whether and the extent to which industry sectors in which it maintains investments may suffer losses as a result of potential declines in commercial and economic activity, or how any such decline might impact the ability of companies within the affected industry sectors to pay interest or principal on their securities, or how the value of any underlying collateral might be affected.

Investment returns are an important part of AFG's overall profitability. Accordingly, adverse fluctuations in the fixed income or equity markets could adversely impact AFG's profitability, financial condition or cash flows.

In addition, should economic conditions deteriorate or remain weak, it could have a material adverse effect on AFG's insureds and reinsurers. However, the impact that this would have on AFG's business cannot be predicted.

**Table of Contents****Intense competition could adversely affect AFG's profitability.**

The property and casualty group operates in a highly competitive industry that is affected by many factors that can cause significant fluctuations in its results of operations. The industry has historically been subject to pricing cycles characterized by periods of intense competition and lower premium rates (a downcycle) followed by periods of reduced competition, reduced underwriting capacity due to lower policyholders' surplus and higher premium rates (an upcycle). The trend of AFG's underwriting results typically follows that of the industry and a prolonged downcycle could adversely affect AFG's results of operations.

AFG's specialty insurance businesses compete with other individual insurers, state funds and insurance groups of varying sizes, some of which are mutual insurance companies possessing competitive advantages in that all their profits inure to their policyholders. In addition, certain foreign insurers can write business in the U.S. on a tax-advantaged basis and therefore hold a competitive advantage over AFG. AFG also competes with self-insurance plans, captive programs and risk retention groups. Peer companies and major competitors in some or all of AFG's specialty lines include the following companies and/or their subsidiaries: ACE Ltd., American International Group Inc. (Chartis and Lexington Insurance), Arch Capital Group Ltd., Chubb Corp., Cincinnati Financial Corp., CNA Financial Corp., Liberty Mutual, Markel Corp., Munich Re Group (Midland), Hartford Financial Services Group, HCC Insurance Holdings, Inc., Ironshore Insurance Ltd., RLI Corp., The Travelers Companies Inc., Tokio Marine Holdings, Inc. (Philadelphia Consolidated), W.R. Berkley Corp., Wells Fargo Corp. (Rural Community Insurance), XL Group Plc, Fairfax Financial Holdings Limited (Zenith National) and Zurich Financial Services Group.

AFG's annuity and supplemental insurance businesses compete with individual insurers and insurance groups, mutual funds and other financial institutions. Competitors include the following companies and/or their subsidiaries: ING Life Insurance and Annuity Company, Metropolitan Life Insurance Company, American International Group Inc., Western National Life Insurance Company, Life Insurance Company of the Southwest, Midland National Life Insurance Company, Allianz Life Insurance Company of North America, Aviva Life and Annuity Company, Mutual of Omaha Insurance Company and Bankers Life and Casualty Company. Bank annuity premiums represented approximately one-third of AFG's annuity premiums in 2011 and have been a key driver in the growth of AFG's annuity business over the last three years. Approximately 89% of AFG's bank annuity premiums in 2011 were generated through three large banks. Although AFG has been able to add several new banks in 2010 and 2011, the failure to replace these banks if they significantly reduce sales of AFG annuities could adversely impact AFG's future profitability. In the bank annuity market, AFG competes directly against competitors' bank annuities, certificates of deposit and other investment alternatives at the point of sale.

Competition is based on many factors, including service to policyholders and agents, product design, reputation for claims handling, ratings and financial strength. Price, commissions, fees, profit sharing terms, interest crediting rates, technology and distribution channels are also important factors. Some of AFG's competitors have more capital and greater resources than AFG, and may offer a broader range of products and lower prices than AFG offers. If competition limits AFG's ability to write new or renewal business at adequate rates, its results of operations will be adversely affected.

**AFG's revenues could be negatively affected if it is not able to attract and retain independent agents.**

AFG's reliance on the independent agency market makes it vulnerable to a reduction in the amount of business written by agents. Many of AFG's competitors also rely significantly on the independent agency market. Accordingly, AFG must compete with other insurance carriers for independent agents' business. Some of its competitors offer a wider variety of products, lower price for insurance coverage or higher commissions. Loss of a substantial portion of the business that AFG writes through independent agents could adversely affect AFG's revenues and profitability.

**Table of Contents****The inability to obtain reinsurance or to collect on ceded reinsurance could adversely impact AFG's results.**

AFG relies on the use of reinsurance to limit the amount of risk it retains. The following amounts of gross property and casualty premiums have been ceded to other insurers: 2011 \$1.3 billion (33%); 2010 \$1.2 billion (33%) and 2009 \$1.5 billion (39%). The availability and cost of reinsurance are subject to prevailing market conditions, which are beyond AFG's control and which may affect AFG's level of business and profitability. AFG also reinsures the death benefits above certain retained amounts on its run-off life insurance business. AFG is also subject to credit risk with respect to its reinsurers, as AFG will remain liable to its insureds if any reinsurer is unable to meet its obligations under agreements covering the reinsurance ceded.

**AFG is subject to comprehensive regulation, and its ability to earn profits may be restricted by these regulations.**

As previously discussed under *Item 1 Business Regulation*, AFG is subject to comprehensive regulation by government agencies in the states and countries where its insurance company subsidiaries are domiciled and where these subsidiaries issue policies and handle claims. AFG must obtain prior approval for certain corporate actions. The regulations may limit AFG's ability to obtain rate increases or take other actions designed to increase AFG's profitability. Such regulation is primarily intended for the protection of policyholders rather than securityholders.

In July 2010, the Dodd-Frank Act was signed into law. Among other things, this law established the Federal Insurance Office within the U.S. Treasury and authorizes it to gather information regarding the insurance industry and submit to Congress a plan to modernize and improve insurance regulation in the U.S.

Existing insurance-related laws and regulations may become more restrictive in the future or new restrictive laws may be enacted; it is not possible to predict the potential effects of these laws and regulations. The costs of compliance or the failure to comply with existing or future regulations could harm AFG's financial results and its reputation with customers.

**The failure of AFG's insurance subsidiaries to maintain a commercially acceptable financial strength rating would have a significant negative effect on their ability to compete successfully.**

As discussed under *Item 1 Business Property and Casualty Insurance Operations* and *Item 1 - Business Annuity and Supplemental Insurance Operations General*, financial strength ratings are an important factor in establishing the competitive position of insurance companies and may be expected to have an effect on an insurance company's sales. A downgrade out of the A category in AFG's insurers' claims-paying and financial strength ratings could significantly reduce AFG's business volumes in certain lines of business, adversely impact AFG's ability to access the capital markets and increase AFG's borrowing costs.

**The continued threat of terrorism and ongoing military and other actions, as well as civil unrest, may adversely affect AFG's financial results.**

The continued threat of terrorism, both within the United States and abroad, and the ongoing military and other actions and heightened security measures in response to these types of threats, as well as civil unrest, may cause significant volatility and declines in the equity markets in the United States, Europe and elsewhere, loss of life, property damage, additional disruptions to commerce and reduced economic activity. Actual terrorist attacks could cause losses from insurance claims related to AFG's property and casualty and life insurance operations with adverse financial consequences. In addition, some of the assets in AFG's investment portfolios may be adversely affected by declines in the capital markets and economic activity caused by the continued threat of terrorism, ongoing military and other action, heightened security measures and civil unrest.

**Table of Contents**

**AFG may experience difficulties with technology or data security, which could have an adverse effect on its business or reputation.**

AFG uses computer systems to store, retrieve, evaluate and utilize company and customer data and information. Systems failures or outages could compromise AFG's ability to perform business functions in a timely manner, which could harm its ability to conduct business and hurt its relationships with business partners and customers. In the event of a disaster such as a natural catastrophe, an industrial accident, a blackout, a computer virus, a terrorist attack or war, AFG's systems may be inaccessible to employees, customers or business partners for an extended period of time. Even if AFG's employees are able to report to work, they may be unable to perform their duties for an extended period of time if the Company's data or systems are disabled or destroyed.

Despite the implementation of security measures, these systems may also be vulnerable to physical break-ins, computer viruses, programming errors, attacks by third parties or similar disruptive problems. Any compromise of security could have a material adverse effect on AFG's business or reputation and could subject AFG to liability if confidential customer information is misappropriated from its computer systems.

**AFG's property and casualty reserves may be inadequate, which could significantly affect AFG's financial results.**

AFG's property and casualty insurance subsidiaries record reserve liabilities for the estimated payment of losses and loss adjustment expenses for both reported and unreported claims. Due to the inherent uncertainty of estimating reserves, it has been necessary in the past, and will continue to be necessary in the future, to revise estimated liabilities as reflected in AFG's reserves for claims and related expenses. The historic development of reserves for losses and loss adjustment expense may not necessarily reflect future trends in the development of these amounts. Accordingly, it is not appropriate to extrapolate future redundancies or deficiencies based on historical information. To the extent that reserves are inadequate and are strengthened, the amount of such increase is treated as a charge to earnings in the period in which the deficiency is recognized.

**AFG's results could be negatively impacted by severe weather conditions or other catastrophes.**

AFG recorded catastrophe losses of \$46 million in 2011 (primarily from tornadoes), \$49 million in 2010 (primarily from hailstorms) and \$18 million in 2009 (primarily from tornadoes). Catastrophes (some of which are seasonal) can be caused by natural events such as hurricanes, windstorms, tornadoes, floods, hailstorms, severe winter weather, earthquakes, explosions and fire, and by man-made events, such as terrorist attacks and riots. While not considered a catastrophe by industry standards, droughts could also have a significant adverse impact on AFG's crop insurance results. The extent of losses from a catastrophe is a function of the amount of insured exposure in the area affected by the event and the severity of the event. In addition, certain catastrophes could result in both property and non-property claims from the same event. A severe catastrophe or a series of catastrophes could result in losses exceeding AFG's reinsurance protection and may have a material adverse impact on its results of operations or financial condition.

**Climate change and related regulation could adversely affect AFG's property and casualty insurance operations.**

While AFG does not believe that its operations are likely to be impacted by existing laws and regulations regarding climate change, it is possible that future regulation in this area could result in additional compliance costs and demands on management time.

To the extent that global climate change meaningfully alters weather and tidal patterns, or sea levels, it is possible that the AFG's property and casualty insurance operations could experience an increase in claims, primarily in coastal areas and in AFG's crop and agricultural businesses.



**Table of Contents**

**Volatility in crop prices could negatively impact AFG's financial results.**

Weather conditions and the level of crop prices in the commodities market heavily impact AFG's crop insurance business. These factors are inherently unpredictable and could result in significant volatility in the results of the crop insurance business from one year to the next. AFG's crop results could also be negatively impacted by pests and disease.

**Exposure to asbestos or environmental claims could materially adversely affect AFG's results of operations and financial condition.**

AFG has asbestos and environmental ( A&E ) exposures arising from its insurance operations and former railroad and manufacturing operations. A&E liabilities are especially difficult to estimate for many reasons, including the long delays between exposure and manifestation of any bodily injury or property damage, difficulty in identifying the source of the asbestos or environmental contamination, long reporting delays and difficulty in properly allocating liability for the asbestos or environmental damage. Claimants continue to assert new theories of recovery, and from time to time, there is proposed state and federal legislation regarding A&E liability, which would also affect AFG's exposure. If AFG has not established adequate reserves to cover future claims, AFG's results of operations and financial condition could be materially adversely affected.

**Changes in interest rates could adversely impact the spread AFG earns on its annuity products.**

The profitability of AFG's annuity business is largely dependent on spread (the difference between what it earns on its investments and the crediting rate it pays on its annuity contracts). Most of AFG's annuity products have guaranteed minimum crediting rates (ranging from 4% down to currently 1% on new business). During periods of falling interest rates, AFG may not be able to fully offset the decline in investment earnings with lower crediting rates. During periods of rising rates, there may be competitive pressure to increase crediting rates to avoid a decline in sales or increased surrenders, thus resulting in lower spreads. In addition, an increase in surrenders could require the sale of investments at a time when the prices of those assets are lower due to the increase in market rates, which may result in realized investment losses.

**Variations from the actuarial assumptions used to establish certain assets and liabilities in AFG's annuity and supplemental insurance business could negatively impact AFG's reported financial results.**

The earnings on certain products sold by AFG's annuity and supplemental insurance business depend significantly upon the extent to which actual experience is consistent with the assumptions used in setting reserves and establishing and amortizing deferred policy acquisition costs ( DPAC ). These assumptions relate to investment yields (and spreads over fixed annuity crediting rates), mortality, surrenders, annuitizations, morbidity (frequency and severity of sickness), policy persistency (percentage of policies remaining in force), and, on some policies, the ability to obtain price increases. Developing such assumptions is complex and involves information obtained from company-specific and industry-wide data, as well as general economic information. These assumptions, and therefore AFG's results of operations, could be negatively impacted by changes in any of the factors listed above. Although charges related to changes in these assumptions were immaterial in 2011, AFG recorded a \$25 million pretax charge in 2010 due primarily to the impact of changes in assumptions related to future investment yields and annuitization and death benefits partially offset by the impact of lower expected expenses and crediting rates in the fixed annuity business.

**Table of Contents**

**AFG's ability to get price increases and appropriate investment yields on its closed block of long-term care policies may adversely affect AFG's profitability.**

AFG ceased writing new long-term care insurance policies in January 2010. Previous policies written are guaranteed renewable, but can be re-priced to reflect adverse experience, subject to regulatory approval. Inability to get needed regulatory approval may adversely impact AFG's results of operations.

In addition, given the duration of the long-term care product, AFG may be unable to purchase appropriate assets with cash flows and durations necessary to match those of future claims in that business.

**As a holding company, AFG is dependent on the operations of its insurance company subsidiaries to meet its obligations and pay future dividends.**

AFG is a holding company and a legal entity separate and distinct from its insurance company subsidiaries. As a holding company without significant operations of its own, AFG's principal sources of funds are dividends and other distributions from its insurance company subsidiaries. As discussed under *Regulation*, state insurance laws limit the ability of insurance companies to pay dividends or other distributions and require insurance companies to maintain specified levels of statutory capital and surplus. AFG's rights to participate in any distribution of assets of its insurance company subsidiaries are subject to prior claims of policyholders and creditors (except to the extent that its rights, if any, as a creditor are recognized). Consequently, AFG's ability to pay debts, expenses and cash dividends to its shareholders may be limited.

**Adverse developments in the financial markets may limit AFG's access to capital.**

Financial markets in the U.S. and elsewhere experienced extreme volatility during the latter part of 2008 and early 2009. These circumstances exerted downward pressure on stock prices and limited access to the equity and debt markets for certain issuers, including AFG.

The three-year revolving credit facility under which AFG can borrow up to \$500 million expires in August 2013. There is no assurance that this facility will be renewed. In addition, AFG's access to funds through this facility is dependent on the ability of its banks to meet their funding commitments. There were no borrowings outstanding under this agreement during 2011.

If AFG cannot obtain adequate capital or sources of credit on favorable terms, or at all, its business, operating results and financial condition would be adversely affected.

**AFG may be adversely impacted by a downgrade in the ratings of its debt securities.**

AFG's debt securities are rated by Standard & Poor's and Moody's independent corporate credit rating agencies. AFG's senior indebtedness is currently rated BBB+ by Standard & Poor's and Baa2 by Moody's. Securities ratings are subject to revision or withdrawal at any time by the assigning rating organization. A security rating is not a recommendation to buy, sell or hold securities. An unfavorable change in either of these ratings could make it more expensive to access the capital markets and may increase the interest rate charged under AFG's current multi-bank credit line.

**AFG is a party to litigation which, if decided adversely, could impact its financial results.**

AFG and its subsidiaries are named as defendants in a number of lawsuits. See *Item 1 Business Property and Casualty Insurance Operations Asbestos and Environmental (A&E) Reserves*, *Item 3 Legal Proceedings*, and *Item 7 Management's Discussion and Analysis Uncertainties*. Litigation, by its very nature, is unpredictable and the outcome of these cases is uncertain and could result in liabilities that may vary from amounts AFG has currently recorded and a material variance could have a material effect on AFG's business, operations, profitability or financial condition.

**Table of Contents**

**Certain shareholders exercise substantial control over AFG's affairs, which may impede a change of control transaction.**

Carl H. Lindner III and S. Craig Lindner are each Co-Chief Executive Officers and Directors of AFG. Carl H. Lindner III and S. Craig Lindner beneficially own 8.7% and 6.6%, respectively, of AFG's outstanding Common Stock as of February 1, 2012. As a result, certain members of the Lindner family have the ability to exercise significant influence over AFG's management, including over matters requiring shareholder approval.

**The price of AFG Common Stock may fluctuate significantly, which may make it difficult for holders to resell common stock when they want or at a price they find attractive.**

The price of AFG's Common Stock, listed on the NYSE and Nasdaq Global Select Market, constantly changes. During 2011, AFG's Common Stock traded at prices ranging between \$29.45 and \$37.50. AFG's Common Stock price can fluctuate as a result of a variety of factors, many of which are beyond its control. These factors include but are not limited to:

- actual or anticipated variations in quarterly operating results;
- actual or anticipated changes in the dividends paid on AFG Common Stock;
- rating agency actions;
- recommendations by securities analysts;
- significant acquisitions or business combinations, strategic partnerships, joint ventures or capital commitments by or involving AFG or its competitors;
- operating and stock price performance of other companies that investors deem comparable to AFG;
- news reports relating to trends, concerns and other issues in AFG's lines of business;
- general economic conditions, including volatility in the financial markets; and
- geopolitical conditions such as acts or threats of terrorism or military conflicts.

**ITEM 2**

**Properties**

Subsidiaries of AFG own several buildings in downtown Cincinnati. AFG and its affiliates occupy about half of the aggregate 680,000 square feet of commercial and office space in these buildings.

AFG's insurance subsidiaries lease the majority of their office and storage facilities in numerous cities throughout the United States, including Great American's and GAFRI's home offices in Cincinnati. In 2011, AFG consolidated operations from several leased and owned locations in downtown Cincinnati into a new office tower in that city subject to a 15-year lease. National Interstate occupies approximately 90% of the 177,000 square feet of office space on 17.5 acres of land that it owns in Richfield, Ohio. See *Item 1 Business Other Operations* for a discussion of AFG's other commercial real estate operations.

**ITEM 3**

**Legal Proceedings**

AFG and its subsidiaries are involved in various litigation, most of which arose in the ordinary course of business, including litigation alleging bad faith in dealing with policyholders and challenging certain business practices of insurance subsidiaries. Except for the following, management believes that none of the litigation meets the threshold for disclosure under this Item.

AFG's insurance company subsidiaries and its 100%-owned subsidiary, American Premier Underwriters (including its subsidiaries, American Premier), are parties to litigation and receive claims alleging injuries and damages from asbestos, environmental and other substances and workplace hazards and have established loss accruals for such potential liabilities; other than the A.P. Green Industries proceedings discussed below, none of such litigation or claims is individually material to AFG. The ultimate loss for these claims may vary materially from amounts currently recorded as the conditions surrounding resolution of these claims continue to change.

**Table of Contents**

American Premier is a party or named as a potentially responsible party in a number of proceedings and claims by regulatory agencies and private parties under various environmental protection laws, including the Comprehensive Environmental Response, Compensation and Liability Act ( CERCLA ), seeking to impose responsibility on American Premier for hazardous waste or discharge remediation costs at certain railroad sites formerly owned by its predecessor, Penn Central Transportation Company ( PCTC ), and at certain other sites where hazardous waste or discharge allegedly generated by PCTC's railroad operations and American Premier's former manufacturing operations is present. It is difficult to estimate American Premier's liability for remediation costs at these sites for a number of reasons, including the number and financial resources of other potentially responsible parties involved at a given site, the varying availability of evidence by which to allocate responsibility among such parties, the wide range of costs for possible remediation alternatives, changing technology and the period of time over which these matters develop. Nevertheless, American Premier believes that its accruals for potential environmental liabilities are adequate to cover the probable amount of such liabilities, based on American Premier's estimates of remediation costs and related expenses and its estimates of the portions of such costs that will be borne by other parties. Such estimates are based on information currently available to American Premier and are subject to future change as additional information becomes available.

As previously reported, Great American Insurance Company and certain other insurers were parties to declaratory judgment coverage litigation brought in 2001 in the United States District Court for the Southern District of Ohio (arising from claims alleging asbestos exposure resulted in bodily injury) under insurance policies issued during the 1970's and 1980's to Bigelow-Liptak Corporation and related companies, subsequently known as A.P. Green Industries, Inc. ( A.P. Green ).

A.P. Green sought to recover defense and indemnity expenses related to those claims from a number of insurers, including Great American.

In February 2002, A.P. Green filed petitions for bankruptcy under Chapter 11 of the Bankruptcy Code in the United States Bankruptcy Court for the Western District of Pennsylvania (In Re Global Industrial Technologies, Inc., et al, filed February 14, 2002) and subsequently (in 2002) commenced adversary proceedings in that Court against Great American Insurance Company and other companies to obtain an adjudication of the insured's rights under the above-referenced insurance policies.

In 2003, Great American Insurance Company entered into an agreement, which was approved by the Bankruptcy Court, for the settlement of coverage litigation related to A.P. Green asbestos claims. The settlement of \$123.5 million (Great American has the option to pay in cash or over time with 5.25% interest) has been fully accrued and allows up to 10% of the settlement to be paid in AFG Common Stock. The settlement agreement is conditioned upon confirmation of a plan of reorganization that includes an injunction prohibiting the assertion against Great American of any present or future asbestos personal injury claims under policies issued to A.P. Green and related companies.

During 2007, the Bankruptcy Court confirmed the A. P. Green Plan of Reorganization which includes the injunction required by Great American's settlement agreement. Certain parties subsequently appealed the confirmation.

On May 3, 2011, in connection with the appeal of the 2007 bankruptcy court confirmation, the Third Circuit Court of Appeals issued an opinion holding that two non-settling insurers had standing to challenge the trust established to administer silica claims which had been approved as part of the plan of bankruptcy along with the trust established to administer asbestos claims. The court also vacated the order confirming the Plan of Reorganization and remanded the Plan to the bankruptcy court for further proceedings on this limited issue. While the bankruptcy court had previously concluded that the trust to administer silica claims was a valid and legitimate trust, the Third Circuit held that a fuller evidentiary hearing is required on remand. Management believes that resolution of this issue ultimately will not impact the Great American settlement.

**Table of Contents****PART II  
ITEM 5****Market for Registrant's Common Equity, Related Stockholder Matters  
and Issuer Purchases of Equity Securities**

AFG Common Stock is listed and traded on the New York Stock Exchange and the Nasdaq Global Select Market under the symbol AFG. The information presented in the table below represents the high and low sales prices per share reported on the NYSE Composite Tape.

	2011		2010	
	High	Low	High	Low
First Quarter	\$ 35.21	\$ 32.19	\$ 28.64	\$ 23.90
Second Quarter	36.19	33.94	30.25	25.40
Third Quarter	36.05	29.45	30.88	26.69
Fourth Quarter	37.50	29.66	32.75	30.04

There were approximately 7,200 shareholders of record of AFG Common Stock at February 1, 2012. AFG declared and paid quarterly dividends of \$.1625 per share in January, April and July 2011. In August 2011, AFG increased its quarterly dividend to \$.175 and declared and paid its first dividend at that rate in October 2011. In 2010, AFG declared and paid quarterly dividends of \$.1375 per share in January, April and July and \$.1625 per share in October. The ability of AFG to pay dividends will be dependent upon, among other things, the availability of dividends and payments under intercompany tax allocation agreements from its insurance company subsidiaries.

**Issuer Purchases of Equity Securities** AFG repurchased shares of its common stock during 2011 as follows:

	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares that May Yet be Purchased Under the Plans or Programs (a)
First Quarter	2,457,721	\$ 34.04	2,457,721	10,250,706
Second Quarter	2,710,121	\$ 34.79	2,710,121	7,540,585
Third Quarter	2,635,444	\$ 32.25	2,635,444	4,905,141
October	152,700	\$ 31.09	152,700	4,752,441
November	727,000	\$ 35.17	727,000	4,025,441
December	598,400	\$ 36.20	598,400	3,427,041

(a) Represents the remaining shares that may be repurchased under the Plans authorized by AFG's Board of Directors in August 2010 and February 2011. In February 2012, AFG's Board of Directors authorized the repurchase of five million additional shares.

In addition, AFG acquired 2,467 shares of its common stock (at \$36.48 per share) in October 2011, 1,900 shares (at \$35.73 per share) in November 2011, and 16,384 shares (at an average of \$36.62 per share) in December 2011 in

connection with its stock incentive plans.

**Table of Contents****ITEM 6**  
**Selected Financial Data**

The following table sets forth certain data for the periods indicated (dollars in millions, except per share data).

	2011	2010	2009	2008	2007
Earnings Statement Data (a):					
Total Revenues	\$ 4,750	\$ 4,497	\$ 4,320	\$ 4,293	\$ 4,379
Operating Earnings Before Income Taxes	560	689	812	316	639
Earnings from Continuing Operations	320	423	530	200	413
Discontinued Operations					2
Less: Net Earnings (Loss) Attributable to Noncontrolling Interests	(23)	(56)	11	4	32
Net Earnings Attributable to Shareholders	343	479	519	196	383
Basic Earnings Per Common Share:					
Earnings from Continuing Operations	\$ 3.39	\$ 4.38	\$ 4.49	\$ 1.71	\$ 3.24
Discontinued Operations					.01
Net Earnings Attributable to Shareholders	3.39	4.38	4.49	1.71	3.25
Diluted Earnings Per Common Share:					
Earnings from Continuing Operations	\$ 3.33	\$ 4.33	\$ 4.45	\$ 1.67	\$ 3.09
Discontinued Operations					.01
Net Earnings Attributable to Shareholders	3.33	4.33	4.45	1.67	3.10
Cash Dividends Paid Per Share of Common Stock					
	\$ .6625	\$ .575	\$ .52	\$ .50	\$ .40
Ratio of Earnings to Fixed Charges Including Annuity Benefits (b)					
	1.95	2.41	2.58	1.63	2.40
Balance Sheet Data (a):					
Total Assets	\$ 36,042	\$ 32,454	\$ 27,683	\$ 26,428	\$ 25,808
Long-term Debt	934	952	828	1,030	937
Shareholders Equity	4,545	4,470	3,781	2,490	3,046

- (a) New accounting guidance issued by the Financial Accounting Standards Board limits the types of costs incurred in issuing or renewing insurance contracts that can be deferred. AFG will adopt this guidance retrospectively on January 1, 2012. See Note A Accounting Policies Recent Accounting Standards to the financial statements for disclosures of the impact of adopting the guidance.
- (b) Fixed charges are computed on a total enterprise basis. For purposes of calculating the ratios, earnings have been computed by adding to pretax earnings the fixed charges and the noncontrolling interests in earnings of subsidiaries having fixed charges and the undistributed equity in losses of investees. Fixed charges include interest (including annuity benefits as indicated), amortization of debt premium/discount and expense, preferred dividend and distribution requirements of subsidiaries and a portion of rental expense deemed to be representative of the interest factor.

The ratio of earnings to fixed charges *excluding* annuity benefits was 6.61, 9.09, 11.06, 4.75 and 8.49 for 2011, 2010, 2009, 2008 and 2007, respectively. Although the ratio of earnings to fixed charges *excluding* annuity

benefits is not required or encouraged to be disclosed under Securities and Exchange Commission rules, some investors and lenders may not consider interest credited to annuity policyholders accounts a borrowing cost for an insurance company, and accordingly, believe this ratio is meaningful.



**Table of Contents**

**ITEM 7**  
**Management's Discussion and Analysis**  
**of Financial Condition and Results of Operations**  
**INDEX TO MD&A**

	<b>Page</b>
<b><u>General</u></b>	<b>25</b>
<b><u>Overview</u></b>	<b>25</b>
<b><u>Critical Accounting Policies</u></b>	<b>26</b>
<b><u>Liquidity and Capital Resources</u></b>	<b>27</b>
<b><u>Ratios</u></b>	<b>27</b>
<b><u>Parent and Subsidiary Liquidity</u></b>	<b>27</b>
<b><u>Contractual Obligations</u></b>	<b>29</b>
<b><u>Off-Balance Sheet Arrangements</u></b>	<b>29</b>
<b><u>Investments</u></b>	<b>29</b>
<b><u>Uncertainties</u></b>	<b>34</b>
<b><u>Managed Investment Entities</u></b>	<b>44</b>
<b><u>Results of Operations</u></b>	<b>46</b>
<b><u>General</u></b>	<b>46</b>
<b><u>Income Items</u></b>	<b>46</b>
<b><u>Expense Items</u></b>	<b>52</b>
<b><u>New Accounting Standards</u></b>	<b>53</b>

**GENERAL**

Following is a discussion and analysis of the financial statements and other statistical data that management believes will enhance the understanding of AFG's financial condition and results of operations. This discussion should be read in conjunction with the financial statements beginning on page F-1.

*As discussed in Note A Accounting Policies Recent Accounting Standards, certain historical amounts presented herein will be retrospectively restated in 2012 to reflect the adoption of new accounting guidance related to deferred policy acquisition costs ( DPAC ).*

**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.

At December 31, 2011, AFG (parent) held approximately \$456 million in cash and securities and had \$500 million available under a bank line of credit expiring in August 2013.

**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 and indexed annuities and a variety of supplemental insurance products such as Medicare supplement.

The property and casualty business is cyclical in nature with periods of high competition resulting in low premium rates, sometimes referred to as a soft market or downcycle followed by periods of reduced competition and higher premium rates, referred to as a hard market or upcycle. For the past several years, AFG's property and casualty insurance operations have experienced soft market conditions.

AFG reported net earnings attributable to shareholders of \$343 million (\$3.33 per share diluted) in 2011 compared to \$479 million (\$4.33 per share diluted) in 2010.

**Table of Contents**

Improved operating results in the annuity and supplemental insurance group were more than offset by a second quarter 2011 special charge to strengthen reserves for asbestos and other environmental exposures, primarily within the property and casualty run-off operations, lower underwriting profit and lower investment income in the on-going property and casualty operations and a fourth quarter charge for a valuation allowance against deferred tax assets.

**CRITICAL ACCOUNTING POLICIES**

Significant accounting policies are summarized in Note A to the financial statements. The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that can have a significant effect on amounts reported in the financial statements. As more information becomes known, these estimates and assumptions change and thus impact amounts reported in the future. The areas where management believes the degree of judgment required to determine amounts recorded in the financial statements make accounting policies critical are as follows:

- the establishment of insurance reserves, especially asbestos and environmental-related reserves,
- the recoverability of reinsurance,
- the recoverability of deferred acquisition costs,
- the establishment of asbestos and environmental reserves of former railroad and manufacturing operations,
- and
- the valuation of investments, including the determination of other-than-temporary impairments.

See *Liquidity and Capital Resources – Uncertainties* for a discussion of insurance reserves, recoverables from reinsurers, and contingencies related to American Premier's former operations and *Liquidity and Capital Resources – Investments* for a discussion of impairments on investments. Deferred policy acquisition costs ( DPAC ) and certain liabilities related to annuities and universal life insurance products are amortized in relation to the present value of expected gross profits on the policies. Assumptions considered in determining expected gross profits involve significant judgment and include management's estimates of assumed interest rates and investment spreads, surrenders, annuitizations, renewal premiums and mortality. Should actual experience require management to change its assumptions (commonly referred to as "unlocking"), a charge or credit would be recorded to adjust DPAC or annuity liabilities to the levels they would have been if the new assumptions had been used from the inception date of each policy.

Reserves for future policy benefits related to AFG's closed block of long-term care business are established (and related acquisition costs are amortized) over the life of the policies based on policy benefit assumptions as of the date of issuance, including investment yields, mortality, morbidity, persistency, and expenses. Once these assumptions are established for a given policy or group of policies, they are not changed over the life of the policy unless a loss recognition event (premium deficiency) occurs. Loss recognition occurs when, based on current expectations as of the measurement date, existing contract liabilities plus the present value of future premiums, including reasonably expected rate increases, are not expected to cover the present value of future claims payments and related settlement and maintenance costs as well as unamortized acquisition costs. Adverse changes in any of the reserve assumptions in future periods could result in loss recognition and charges to earnings for AFG's long-term care business.

**Table of Contents****LIQUIDITY AND CAPITAL RESOURCES**

**Ratios** AFG's debt to total capital ratio on a consolidated basis is shown below (dollars in millions). Management intends to maintain the ratio of debt to capital at or below 25% and intends to maintain the capital of its significant insurance subsidiaries at or above levels currently indicated by rating agencies as appropriate for the current ratings.

	December 31,	
	2011	2010
Long-term debt	\$ 934	\$ 952
Total capital	5,017	5,050
Ratio of debt to total capital:		
Including debt secured by real estate	18.6%	18.9%
Excluding debt secured by real estate	17.6%	17.8%

The ratio of debt to total capital is a non-GAAP measure that management believes is useful for investors, analysts and independent ratings agencies to evaluate AFG's financial strength and liquidity and to provide insight into how AFG finances its operations. It is calculated by dividing AFG's long-term debt by its total capital, which includes long-term debt, noncontrolling interests and shareholders' equity (excluding unrealized gains (losses) related to fixed maturity investments and appropriated retained earnings related to managed investment entities).

AFG's ratio of earnings to fixed charges, including annuity benefits as a fixed charge, was 1.95 for the year ended December 31, 2011. Excluding annuity benefits, this ratio was 6.61 for 2011. Although the ratio excluding annuity benefits is not required or encouraged to be disclosed under Securities and Exchange Commission rules, it is presented because interest credited to annuity policyholder accounts is not always considered a borrowing cost for an insurance company.

The NAIC's model law for risk based capital (RBC) applies to both life and property and casualty companies. RBC formulas determine the amount of capital that an insurance company needs so that it has an acceptable expectation of not becoming financially impaired. At December 31, 2011, the capital ratios of all AFG insurance companies substantially exceeded the RBC requirements.

**Parent and Subsidiary Liquidity**

**Parent Holding Company Liquidity** Management believes AFG has sufficient resources to meet its liquidity requirements. If funds generated from operations, including dividends, tax payments and borrowings from subsidiaries, are insufficient to meet fixed charges in any period, AFG would be required to utilize parent company cash and marketable securities or to generate cash through borrowings, sales of other assets, or similar transactions. AFG can borrow up to \$500 million under its revolving credit facility which expires in August 2013. There were no borrowings under this agreement, or any other parent company short-term borrowing arrangements, during 2011. During 2011, AFG repurchased 9.3 million shares of its Common Stock for \$315 million. During 2010, AFG issued \$132 million of 7% Senior Notes due 2050 and repurchased 10.3 million shares of its Common Stock for \$292 million. During 2009, AFG retired \$136 million of 7-1/8% Senior Debentures at maturity, issued \$350 million of 9-7/8% Senior Notes due 2019 and repurchased 3.3 million shares of its Common Stock for \$81 million. All debentures and notes issued by AFG (and AAG Holding Company, a GAFRI subsidiary) are rated investment grade by two nationally recognized rating agencies. Under a currently effective shelf registration statement, AFG can offer additional equity or debt securities. The shelf registration provides AFG with flexibility to access the capital markets from time to time as market and other conditions permit.

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.

**Table of Contents**

**Subsidiary Liquidity** Great American Life Insurance Company ( GALIC ), a wholly-owned annuity and supplemental insurance subsidiary, is a member of the Federal Home Loan Bank of Cincinnati ( FHLB ). The FHLB makes advances and provides other banking services to member institutions, which provides the annuity and supplemental insurance operations with a substantial additional source of liquidity. In the fourth quarter of 2011, the FHLB advanced GALIC \$240 million at interest rates ranging from .02% to .03% over LIBOR (average rate of .31% at December 31, 2011). These advances must be repaid within 5 to 7 years, but GALIC has the option to prepay all or a portion of the advances on a monthly basis. GALIC has invested the proceeds from the advances in fixed maturity securities for the purpose of earning a spread over the interest payments due to the FHLB.

National Interstate Corporation ( NATL ), a 52%-owned property and casualty insurance subsidiary, can borrow up to \$75 million, subject to certain conditions, under an unsecured credit agreement expiring in December 2012. Amounts borrowed bear interest at rates ranging from .45% to .9% (currently .65%) over LIBOR based on NATL 's credit rating. There was \$22 million outstanding under this agreement at December 31, 2011. The maximum outstanding balance under this agreement during 2011 was \$22 million.

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 generally 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. 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. With declining rates, AFG receives some protection (from spread compression) due to the ability to lower crediting rates, subject to contractually guaranteed minimum interest rates ( GMIRs ). AFG began selling new policies with GMIRs below 2% in 2003; almost all new business since late 2010 has been issued with a 1% GMIR. At December 31, 2011, the average crediting rate on AFG 's annuities was approximately 3.1%, while the average GMIR was approximately 2.5%. This margin provides AFG the flexibility to lower its crediting rates by up to 60 basis points on average in the future should market interest rates continue to remain low for a long period of time.

For statutory accounting purposes, equity securities of non-affiliates are generally carried at fair value. At December 31, 2011, AFG 's insurance companies owned publicly traded equity securities with a fair value of \$895 million. In addition, GAI 's investment in NATL common stock had a fair value of \$252 million and a statutory carrying value of \$199 million at December 31, 2011. Decreases in market prices could adversely affect the insurance group 's capital, potentially impacting the amount of dividends available or necessitating a capital contribution. Conversely, increases in market prices could have a favorable impact on the group 's dividend-paying capability. AFG believes its insurance subsidiaries maintain sufficient liquidity to pay claims and benefits and operating expenses. In addition, these subsidiaries have sufficient capital to meet commitments in the event of unforeseen events such as reserve deficiencies, inadequate premium rates or reinsurer insolvencies. Nonetheless, changes in statutory accounting rules, significant declines in the fair value of the insurance subsidiaries ' investment portfolios or significant ratings downgrades on these investments, could create a need for additional capital.

**Table of Contents**

**Contractual Obligations** The following table shows an estimate (based on historical patterns and expected trends) of payments to be made for insurance reserve liabilities, as well as scheduled payments for major contractual obligations (in millions).

	Total	Within One Year	2-3 Years	4-5 Years	More than 5 Years
Annuity, life, accident and health liabilities (a)	\$ 17,147	\$ 1,618	\$ 3,230	\$ 3,905	\$ 8,394
Property and casualty unpaid losses and loss adjustment expenses (b)	6,520	1,700	1,800	1,100	1,920
Long-term debt, including interest	2,096	107	165	200	1,624
Operating leases	412	52	93	70	197
Total (c)	\$ 26,175	\$ 3,477	\$ 5,288	\$ 5,275	\$ 12,135

- (a) Reserve projections include anticipated cash benefit payments only. Projections do not include any impact for future earnings or additional premiums.
- (b) Dollar amounts and time periods are estimates based on historical net payment patterns applied to the gross reserves and do not represent actual contractual obligations. Based on the same assumptions, AFG projects reinsurance recoveries related to these reserves totaling \$2.2 billion as follows: Within 1 year \$600 million; 2-3 years - \$600 million; 4-5 years \$400 million; and thereafter \$638 million. Actual payments and their timing could differ significantly from these estimates.
- (c) AFG's \$74 million liability for unrecognized tax benefits (including \$15 million in interest) as of December 31, 2011, is not included because the period of payment cannot be reliably estimated.

AFG has no material contractual purchase obligations or other long-term liabilities at December 31, 2011.

**Off-Balance Sheet Arrangements** See *Note P Additional Information Financial Instruments with Off-Balance Sheet Risk* to the financial statements.

**Investments** AFG attempts to optimize investment income while building the value of its portfolio, placing emphasis upon total long-term performance.

AFG's investment portfolio at December 31, 2011, contained \$21.8 billion in Fixed maturities classified as available for sale and \$928 million in Equity securities, all carried at fair value with unrealized gains and losses included in a separate component of shareholders' equity on an after-tax basis. In addition, \$440 million in fixed maturities were classified as trading with changes in unrealized holding gains or losses included in investment income.

As detailed under *Net Unrealized Gain on Marketable Securities* in Note E to the financial statements, unrealized gains and losses on AFG's fixed maturity and equity securities are included in Shareholders' Equity after adjustments for related changes in DPAC and certain liabilities related to annuities, noncontrolling interests and deferred income taxes. DPAC applicable to annuity products is adjusted for the impact of unrealized gains or losses on investments as if these gains or losses had been realized, with corresponding increases or decreases (net of tax) included in accumulated other comprehensive income in AFG's Balance Sheet.

Fixed income investment funds are generally invested in securities with intermediate-term maturities with an objective of optimizing total return while allowing flexibility to react to changes in market conditions. At December 31, 2011, the average life of AFG's fixed maturities was about six years.

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

approximately 30% of AFG's fixed maturities, prices for each security are generally obtained from both pricing services and broker quotes. For the remainder of AFG's fixed maturity portfolio, approximately 93% are priced using pricing services and the balance is priced primarily using non-binding broker quotes. When prices obtained for the same security vary, AFG's internal investment professionals select the price they believe is most indicative of an exit price.

**Table of Contents**

The pricing services use a variety of observable inputs to estimate fair value of fixed maturities that do not trade on a daily basis. Based upon information provided by the pricing services, these inputs include, but are not limited to, recent reported trades, benchmark yields, issuer spreads, bids or offers, reference data, and measures of volatility. Included in the pricing of MBS are estimates of the rate of future prepayments and defaults of principal over the remaining life of the underlying collateral. Due to the lack of transparency in the process that brokers use to develop prices, valuations that are based on brokers' prices are classified as Level 3 in the GAAP hierarchy unless the price can be corroborated, for example, by comparison to similar securities priced using observable inputs.

Valuation techniques utilized by pricing services and prices obtained from external sources are reviewed by AFG's internal investment professionals who are familiar with the securities being priced and the markets in which they trade to ensure the fair value determination is representative of an exit price. To validate the appropriateness of the prices obtained, these investment managers consider widely published indices (as benchmarks), recent trades, changes in interest rates, general economic conditions and the credit quality of the specific issuers. In addition, the Company communicates directly with the pricing service regarding the methods and assumptions used in pricing, including verifying, on a test basis, the inputs used by the service to value specific securities. Prices obtained from a broker or pricing service are adjusted only in cases where they are deemed not to be representative of an appropriate exit price (fewer than 1% of the securities).

In general, the fair value of AFG's fixed maturity investments is inversely correlated to changes in interest rates. The following table demonstrates the sensitivity of such fair values to reasonably likely changes in interest rates by illustrating the estimated effect on AFG's fixed maturity portfolio that an immediate increase of 100 basis points in the interest rate yield curve would have at December 31, 2011 (dollars in millions). Increases or decreases from the 100 basis points illustrated would be approximately proportional.

Fair value of fixed maturity portfolio	\$ 22,247
Pretax impact on fair value of 100 bps increase in interest rates	\$ (1,046)
Pretax impact as % of total fixed maturity portfolio	(4.7%)

Approximately 90% of the fixed maturities held by AFG at December 31, 2011, 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 non-investment grade. Management believes that the high quality investment portfolio should generate a stable and predictable investment return.

MBS are subject to significant prepayment risk due to the fact that, in periods of declining interest rates, mortgages may be repaid more rapidly than scheduled as borrowers refinance higher rate mortgages to take advantage of lower rates. Although interest rates have been low for the last few years, a weak housing market and uncertain economic conditions have led to tighter lending standards, which have resulted in fewer buyers being able to refinance the mortgages underlying much of AFG's non-agency RMBS portfolio.



**Table of Contents**

Summarized information for AFG's MBS (including those classified as trading) at December 31, 2011, is shown (in millions) in the table below. Agency-backed securities are those issued by a U.S. government-backed agency; Alt-A mortgages are those with risk profiles between prime and subprime. The majority of the Alt-A securities and substantially all of the subprime securities are backed by fixed rate mortgages. The average life of the residential and commercial MBS is approximately 4 and 5 years, respectively.

Collateral type	Amortized		Fair Value	Unrealized Gain (Loss)	% Rated
	Cost	Fair Value	as % of Cost		Investment Grade
Residential:					
Agency-backed	\$ 340	\$ 354	104%	\$ 14	100%
Non-agency prime	2,058	2,112	103	54	68
Alt-A	787	739	94	(48)	44
Subprime	686	653	95	(33)	29
Commercial	2,665	2,877	108	212	100
Other	22	25	114	3	48
	\$ 6,558	\$ 6,760	103%	\$ 202	77%

The National Association of Insurance Commissioners ( NAIC ) assigns creditworthiness designations on a scale of 1 to 6 with 1 being the highest quality and 6 being the lowest quality. The NAIC retained a third-party investment management firm to assist in the determination of appropriate NAIC designations for mortgage-backed securities based not only on the probability of loss (which is the primary basis of ratings by the major ratings firms), but also on the severity of loss and statutory carrying value. At December 31, 2011, 97% (based on statutory carrying value of \$6.5 billion) of AFG's MBS securities had an NAIC designation of 1 or 2.

Municipal bonds represented approximately 18% of AFG's fixed maturity portfolio at December 31, 2011. AFG's municipal bond portfolio is high quality, with 99% of the securities rated investment grade at that date. The portfolio is well diversified across the states of issuance and individual issuers. At December 31, 2011, approximately 80% of the municipal bond portfolio was held in revenue bonds, with the remaining 20% held in general obligation bonds. State general obligation securities of California, Illinois, New Jersey and New York collectively represented only 2% of this portfolio.

**Table of Contents**

Summarized information for the unrealized gains and losses recorded in AFG's Balance Sheet at December 31, 2011, is shown in the following table (dollars in millions). Approximately \$133 million of available for sale Fixed maturities and \$36 million of Equity securities had no unrealized gains or losses at December 31, 2011.

	Securities With Unrealized Gains	Securities With Unrealized Losses
<b>Available for Sale Fixed Maturities</b>		
Fair value of securities	\$ 18,623	\$ 3,051
Amortized cost of securities	\$ 17,129	\$ 3,300
Gross unrealized gain (loss)	\$ 1,494	\$ (249)
Fair value as % of amortized cost	109%	92%
Number of security positions	3,763	846
Number individually exceeding \$2 million gain or loss	146	11
Concentration of gains (losses) by type or industry (exceeding 5% of unrealized):		
Mortgage-backed securities	\$ 388	\$ (186)
Banks, savings and credit institutions	85	(33)
Gas and electric services	172	(2)
States and municipalities	267	(3)
Percentage rated investment grade	94%	62%
<b>Equity Securities</b>		
Fair value of securities	\$ 665	\$ 227
Cost of securities	\$ 453	\$ 255
Gross unrealized gain (loss)	\$ 212(*)	\$ (28)
Fair value as % of cost	147%	89%
Number of security positions	131	83
Number individually exceeding \$2 million gain or loss	12	4

(\*) Includes \$121 million on AFG's investment in Verisk Analytics, Inc.

The table below sets forth the scheduled maturities of AFG's available for sale fixed maturity securities at December 31, 2011, 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 Gains	Securities with Unrealized Losses
<b>Maturity</b>		
One year or less	3%	1%
After one year through five years	26	19
After five years through ten years	35	15
After ten years	10	5
	74	40
Mortgage-backed securities (average life of approximately four years)	26	60
	100%	100%



**Table of Contents**

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

Fixed Maturities at December 31, 2011	Aggregate Fair Value	Aggregate Unrealized Gain (Loss)	Fair Value as % of Cost Basis
<b>Securities with unrealized gains:</b>			
Exceeding \$500,000 (841 issues)	\$ 10,121	\$ 1,093	112%
\$500,000 or less (2,922 issues)	8,502	401	105
	\$ 18,623	\$ 1,494	109%
<b>Securities with unrealized losses:</b>			
Exceeding \$500,000 (151 issues)	\$ 982	\$ (164)	86%
\$500,000 or less (695 issues)	2,069	(85)	96
	\$ 3,051	\$ (249)	92%

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.

Securities with Unrealized Losses at December 31, 2011	Aggregate Fair Value	Aggregate Unrealized Loss	Fair Value as % of Cost Basis
<b>Investment grade fixed maturities with losses for:</b>			
Less than one year (292 issues)	\$ 1,528	\$ (52)	97%
One year or longer (129 issues)	367	(41)	90
	\$ 1,895	\$ (93)	95%
<b>Non-investment grade fixed maturities with losses for:</b>			
Less than one year (250 issues)	\$ 859	\$ (58)	94%
One year or longer (175 issues)	297	(98)	75
	\$ 1,156	\$ (156)	88%
<b>Common equity securities with losses for:</b>			
Less than one year (61 issues)	\$ 169	\$ (19)	90%
One year or longer (4 issues)	4	(1)	80
	\$ 173	\$ (20)	90%

**Perpetual preferred equity securities with losses for:**

Less than one year (9 issues)	\$	23	\$	(1)	96%
One year or longer (9 issues)		31		(7)	82
	\$	54	\$	(8)	87%

When a decline in the value of a specific investment is considered to be other-than-temporary, a provision for impairment is charged to earnings (accounted for as a realized loss) and the cost basis of that investment is reduced by the amount of the charge. The determination of whether unrealized losses are other-than-temporary requires judgment based on subjective as well as objective factors. Factors considered and resources used by management include:

- a) whether the unrealized loss is credit-driven or a result of changes in market interest rates,
- b) the extent to which fair value is less than cost basis,
- c) historical operating, balance sheet and cash flow data contained in issuer SEC filings and news releases,
- d) near-term prospects for improvement in the issuer and/or its industry,
- e) third party research and communications with industry specialists,
- f) financial models and forecasts,
- g) the continuity of dividend payments, maintenance of investment grade ratings and hybrid nature of certain investments,
- h) discussions with issuer management, and
- i) ability and intent to hold the investment for a period of time sufficient to allow for anticipated recovery in fair value.

**Table of Contents**

Based on its analysis of the factors listed above, management believes (i) AFG will recover its cost basis in the securities with unrealized losses and (ii) that AFG has the ability to hold the securities until they recover in value and had no intent to sell them at December 31, 2011. 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. Significant declines in the fair value of AFG's investment portfolio could have a significant adverse effect on AFG's liquidity. For information on AFG's realized gains (losses) on securities, including charges for other-than-temporary impairment, see *Management's Discussion and Analysis - Results of Operations - Realized Gains (Losses) on Securities*.

**Uncertainties** As more fully explained in the following paragraphs, 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.

**Property and Casualty Insurance Reserves** Estimating the liability for unpaid losses and loss adjustment expenses (LAE) is inherently judgmental and is influenced by factors that are subject to significant variation. Determining the liability is a complex process incorporating input from many areas of the Company including actuarial, underwriting, pricing, claims and operations management.

The estimates of liabilities 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 periods on direct business written (case reserves); (b) estimates received from ceding reinsurers and insurance pools and associations; (c) estimates of claims incurred but not reported or IBNR (including possible development on known claims); (d) estimates (based on experience) of expense for investigating and adjusting claims; and (e) the current state of law and coverage litigation.

The process used to determine the total reserve for liabilities involves estimating the ultimate incurred losses and LAE, adjusted for amounts already paid on the claims. The IBNR reserve is derived by first estimating the ultimate unpaid reserve liability and subtracting case reserves and LAE.

In determining management's best estimate of the ultimate liability, management (including Company actuaries) considers items such as the effect of inflation on medical, hospitalization, material, repair and replacement costs, the nature and maturity of lines of insurance, general economic trends and the legal environment. In addition, historical trends adjusted for changes in underwriting standards, policy provisions, product mix and other factors are analyzed using actuarial reserve development techniques. Weighing all of the factors, the management team determines a single or point estimate that it records as its best estimate of the ultimate liabilities. Ranges of loss reserves are not developed by Company actuaries. This reserve analysis and review is completed each quarter and for every line of business. Each quarterly review includes in-depth analysis of over 500 subdivisions of the business, employing multiple actuarial techniques. For each particular subdivision, actuaries use informed, professional judgment to adjust these techniques as necessary to respond to specific conditions in the data or within the business.

Some of the standard actuarial methods employed for the quarterly reserve analysis may include (but may not be limited to):

- Case Incurred Development Method
- Paid Development Method
- Projected Claim Count Times Projected Claim Severity
- Bornhuetter-Ferguson Method
- Incremental Paid LAE to Paid Loss Methods

**Table of Contents**

Management believes that each method has particular strengths and weaknesses and that no single estimation method is most accurate in all situations. When applied to a particular group of claims, the relative strengths and weaknesses of each method can change over time based on the facts and circumstances. Ultimately, the estimation methods chosen are those which management believes produce the most reliable indication for the particular liabilities under review. The period of time from the occurrence of a loss through the settlement of the liability is referred to as the tail. Generally, the same actuarial methods are considered for both short-tail and long-tail lines of business because most of them work properly for both. The methods are designed to incorporate the effects of the differing length of time to settle particular claims. For short-tail lines, management tends to give more weight to the Case Incurred and Paid Development methods, although the various methods tend to produce similar results. For long-tail lines, more judgment is involved, and more weight may be given to the Bornhuetter-Ferguson method and the Projected Claim Count times Projected Claim Severity method. Liability claims for long-tail lines are more susceptible to litigation and can be significantly affected by changing contract interpretation and the legal environment. Therefore, the estimation of loss reserves for these classes is more complex and subject to a higher degree of variability.

The level of detail in which data is analyzed varies among the different lines of business. Data is generally analyzed by major product or by coverage within product, using countrywide data; however, in some situations, data may be reviewed by state for a few large volume states. Appropriate segmentation of the data is determined based on data volume, data credibility, mix of business, and other actuarial considerations.

Supplementary statistical information is also reviewed to determine which methods are most appropriate to use or if adjustments are needed to particular methods. Such information includes:

- Open and closed claim counts
- Average case reserves and average incurred on open claims
- Closure rates and statistics related to closed and open claim percentages
- Average closed claim severity
- Ultimate claim severity
- Reported loss ratios
- Projected ultimate loss ratios
- Loss payment patterns

Within each line, results of individual methods are reviewed, supplementary statistical information is analyzed, and all data from underwriting, operating and claim management are considered in deriving management's best estimate of the ultimate liability. This estimate may be the result of one method, or a weighted average of several methods, or a judgmental selection as the management team determines is appropriate.

**Table of Contents**

The following table shows (in millions) the breakdown of AFG's property and casualty reserves between case reserves, IBNR reserves and LAE reserves (estimated amounts required to adjust, record and settle claims, other than the claim payments themselves).

## Gross Loss Reserves at December 31, 2011

	Case	IBNR	LAE	Total Reserve
<b>Statutory Line of Business</b>				
Other liability – occurrence	\$ 507	\$ 1,268	\$ 265	\$ 2,040
Workers' compensation	744	348	130	1,222
Special property (fire, allied lines, inland marine, earthquake)	527	30	25	582
Other liability – claims made	210	272	61	543
Commercial auto/truck liability/medical	162	253	87	502
Commercial multi-peril	142	92	88	322
Other lines	191	337	167	695
<b>Total Statutory Reserves</b>	<b>2,483</b>	<b>2,600</b>	<b>823</b>	<b>5,906</b>
<b>Adjustments for GAAP:</b>				
Reserves of foreign operations	285	270	7	562
Deferred gains on retroactive reinsurance		74		74
Loss reserve discounting	(20)			(20)
Other	(1)	(1)		(2)
<b>Total Adjustments for GAAP</b>	<b>264</b>	<b>343</b>	<b>7</b>	<b>614</b>
<b>Total GAAP Reserves</b>	<b>\$ 2,747</b>	<b>\$ 2,943</b>	<b>\$ 830</b>	<b>\$ 6,520</b>

While current factors and reasonably likely changes in variable factors are considered in estimating the liability for unpaid losses, there is no method or system that can eliminate the risk of actual ultimate results differing from such estimates. As shown in footnote (a) to the reserve development table (loss triangle) on page 8, the original estimates of AFG's liability for losses and loss adjustment expenses, net of reinsurance, over the past 10 years have developed through December 31, 2011, to be deficient (for three years) by as much as 19.6% and redundant (for seven years) by as much as 17.1% (excluding the effect of special charges for asbestos and environmental exposures). This development illustrates the historical impact caused by variability in factors considered in estimating insurance reserves.

Following is a discussion of certain critical variables affecting the estimation of loss reserves of the more significant long-tail lines of business (asbestos and environmental liabilities are separately discussed below). Many other variables may also impact ultimate claim costs.

An important assumption underlying reserve estimates is that the cost trends implicitly built into development patterns will continue into the future. However, future results could vary due to an unexpected change in the underlying cost trends. This unexpected change could arise from a variety of sources including a general increase in economic inflation, inflation from social programs, new medical technologies, or other factors such as those listed below in connection with AFG's largest lines of business. It is not possible to isolate and measure the potential impact of just one of these variables, and future cost trends could be partially impacted by several such variables. However, it is reasonable to address the sensitivity of the reserves to potential impact from changes in these variables by measuring



the effect of a possible overall 1% change in future cost trends that may be caused by one or more variables. Utilizing the effect of a 1% change in overall cost trends enables changes greater than 1% to be estimated by extrapolation. Each additional 1% change in the cost trend would increase the effect on net earnings by an amount slightly (about 4%) greater than the effect of the previous 1%. For example, if a 1% change in cost trends in a line of business would change net earnings by \$20 million, a 2% change would change net earnings by approximately \$41 million.

**Table of Contents**

The estimated cumulative impact that a 1% change in cost trends would have on net earnings is shown below (in millions).

Line of business	Effect of 1% Change in Cost Trends
Other liability – occurrence	\$ 17
Workers’ compensation	23
Other liability – claims made	9
Commercial auto/truck liability/medical	6
Commercial multi-peril	4

The judgments and uncertainties surrounding management’s reserve estimation process and the potential for reasonably possible variability in management’s most recent reserve estimates may also be viewed by looking at how recent historical estimates of reserves have developed. The following table shows (in millions) what the impact on AFG’s net earnings would be on the more significant lines of business if the December 31, 2011, reserves (net of reinsurance) developed at the same rate as the average development of the most recent five years.

	5-yr. Average Development(*)	Net Reserves(**) December 31, 2011	Effect on Net Earnings(**)
Other liability – occurrence	(5.5%)	\$ 742	\$ 41
Workers’ compensation	(.8%)	838	7
Other liability – claims made	(5.9%)	398	23
Commercial auto/truck liability/ medical	(2.6%)	361	9
Commercial multi-peril	.9%	192	(2)

(\*) Unfavorable (favorable), net of tax effect.

(\*\*) Excludes asbestos and environmental liabilities.

The following discussion describes key assumptions and important variables that affect the estimate of the reserve for loss and loss adjustment expenses of the more significant lines of business and explains what caused them to change from assumptions used in the preceding period.

*Other Liability – Occurrence*

This long-tail line of business consists of coverages protecting the insured against legal liability resulting from negligence, carelessness, or a failure to act causing property damage or personal injury to others. Some of the important variables affecting estimation of loss reserves for other liability – occurrence include:

- Litigious climate
- Unpredictability of judicial decisions regarding coverage issues
- Magnitude of jury awards
- Outside counsel costs
- Timing of claims reporting

AFG recorded favorable development of \$50 million in 2011, \$108 million in 2010 and \$55 million in 2009 related to its other liability-occurrence coverage where both the frequency and severity of claims were lower than previously projected.

While management applies the actuarial methods mentioned above, more judgment is involved in arriving at the final reserve to be held. For recent accident years, more weight is given to the Bornhuetter-Ferguson method.

Uncertainty has emerged regarding AFG's potential exposure for claims arising from the use of Chinese drywall. The potential exposure arises from insured policyholders who may have been associated with the installation of Chinese drywall in residential construction. AFG continues to monitor judicial decisions and settlements in this evolving area and is evaluating the possible implications of recent events on its potential exposure. While the ultimate liability is uncertain, management believes that AFG's reserves for claims arising from the use of Chinese drywall are adequate.

**Table of Contents**

*Workers Compensation*

This long-tail line of business provides coverage to employees who may be injured in the course of employment. Some of the important variables affecting estimation of loss reserves for workers compensation include:

- Legislative actions and regulatory interpretations
- Future medical cost inflation
- Economic conditions
- Timing of claims reporting

Approximately one-half of AFG's workers compensation business is currently written in California. Major reforms passed by the California state legislature in 2003 and in 2004 reduced employer premiums and set treatment standards for injured workers in that state. AFG's subsidiary that writes workers compensation business in California recorded favorable prior year loss development of \$5 million in 2011, \$11 million in 2010 and \$20 million in 2009 due primarily to the business written in California prior to 2008.

For several years after the reforms, the impact on claim settlements was more favorable than originally anticipated for claims incurred in 2003 to 2007, resulting in favorable development through 2011. However, this trend has subsided and the favorable development has flattened for more recent years. In both California and countrywide, economic conditions over the last couple years have led to longer duration of claims resulting in higher claim severity.

Several methods (including development methods and those based on claim count and severity) are weighted together to produce indications of reserve need. Management continues to review the frequency, severity and loss and LAE ratios implied by the indications from the standard tests and considers the uncertainties of future costs in determining the appropriate reserve level.

*Other Liability Claims Made*

This long-tail line of business consists mostly of directors and officers liability. Some of the important variables affecting estimation of loss reserves for other liability claims made include:

- Litigious climate
- Economic conditions
- Variability of stock prices
- Magnitude of jury awards

The general state of the economy and the variability of the stock price of the insured can affect the frequency and severity of shareholder class action suits that trigger coverage under directors and officers liability policies. Recent economic conditions have led to increased claims for small account business and not-for-profit organizations.

AFG recorded favorable prior year loss development of \$66 million in 2011, \$40 million in 2010 and \$26 million in 2009 on its directors and officers liability business as claim severity was significantly less than expected for claims incurred prior to 2010. Claims incurred in 2010 have developed adversely as economic conditions have driven severity higher than originally anticipated. The legal professional liability business, which has been in run-off since 2008, had favorable development of \$17 million in 2011, \$18 million in 2010 and \$14 million in 2009 after several years of modest adverse development; as this run-off liability has matured, the claim severity trends have stabilized. While management applies the actuarial methods mentioned above, more judgment is involved in arriving at the final reserve to be held. The selection of methods vary by subdivision of the data within this line. Some businesses within this line use the Paid Development method while others use the Case Incurred Development method and the Bornhuetter-Ferguson method.

**Table of Contents**

*Commercial Auto/Truck Liability/Medical*

This line of business is a mix of coverage protecting the insured against legal liability for property damage or personal injury to others arising from the operation of commercial motor vehicles. The property damage liability exposure is usually short-tail with relatively quick reporting and settlement of claims. The bodily injury and medical payments exposures are longer-tailed; although the claim reporting is relatively quick, the final settlement can take longer to achieve.

Some of the important variables affecting estimation of loss reserves for commercial auto/truck liability/medical are similar to other liability occurrence and include:

- Magnitude of jury awards
- Unpredictability of judicial decisions regarding coverage issues
- Litigious climate and trends
- Change in frequency of severe accidents
- Health care costs and utilization of medical services by injured parties

AFG recorded favorable prior year loss development of \$8 million in 2011, \$26 million in 2010 and \$6 million in 2009 for this line of business as claim severity was lower than in prior assumptions.

*Commercial Multi-Peril*

This long-tail line of business consists of two or more coverages protecting the insured from various property and liability risk exposures. The commercial multi-peril line of business includes coverage similar to other liability occurrence, so in general, variables affecting estimation of loss reserves for commercial multi-peril include those mentioned above for other liability occurrence. In addition, this line includes reserves for a run-off book of homebuilders business covering contractors liability for construction defects. Variables important to estimating the liabilities for this coverage include:

- Changing legal/regulatory interpretations of coverage
- Statutes of limitations and statutes of repose in filing claims
- Changes in policy forms and endorsements

AFG recorded adverse prior year loss development of \$13 million in 2011 and \$19 million in 2010 after having favorable development of \$2 million in 2009. The adverse development resulted from higher claim frequency and severity in a block of program business related to motel/hotel, apartments, restaurants, taverns and recreation. This adverse development more than offset favorable development in coverage for non-profit organizations of \$6 million in 2011, \$13 million in 2010 and \$11 million in 2009 as claim severity was less than anticipated.

*Reserves of Foreign Operations*

Reserves of foreign operations relate primarily to the operations of Marketform Group, Limited, AFG's 72%-owned United Kingdom-based Lloyd's insurer. Historically, the largest line of business written by Marketform has been non-U.S. medical malpractice, which provides coverage for injuries and damages caused by medical care providers, including but not limited to, hospitals and their physicians. Although Marketform offers this product in approximately 30 countries, the majority of the business has been written in the United Kingdom, Australia and Italy.

Significant variables in estimating the loss reserves for the medical malpractice business include:

- Litigious environment
- Magnitude of court awards
- A slow moving judicial system including varying approaches to medical malpractice claims among courts in different regions of Italy
- Third party claims administration in Italy
- Trends in claim costs, including medical cost inflation and, in Italy, escalating tables used to establish damages for personal injury

**Table of Contents**

Marketform recorded adverse prior year reserve development of \$44 million in 2011, \$55 million in 2010 and \$56 million in 2009 related primarily to its Italian public hospital medical malpractice business, which it ceased writing in 2008. The development resulted from significant issues related to third party administration of claims and a challenging legal environment in Italy. Management believes that current reserves, which represent its best estimate of future liabilities, are adequate. Nonetheless, it concluded that sufficient uncertainty exists with respect to Italian public hospital medical malpractice reserves to leave open the 2007 year of account, in accordance with Lloyd's provisions until a larger percentage of claims have been paid and the ultimate liabilities can be estimated with greater certainty. Included in AFG's liability for unpaid losses and loss adjustment expenses at December 31, 2011, are reserves of \$126 million related to this business.

Traditional actuarial techniques are not applicable to the Italian public hospital medical malpractice business due to the significant changes in this account over time. Accordingly, more detailed methods are used, including claim count development times average severity, and uplifting case reserves to historical severity levels.

**Recoverables from Reinsurers and Availability of Reinsurance** AFG is subject to credit risk with respect to its reinsurers, as reinsurance contracts do not relieve AFG of its liability to policyholders. To mitigate this risk, substantially all reinsurance is ceded to companies with investment grade or better S&P ratings or is secured by funds withheld or other collateral.

The availability and cost of reinsurance are subject to prevailing market conditions, which are beyond AFG's control and which may affect AFG's level of business and profitability. Although the cost of certain reinsurance programs may increase, management believes that AFG will be able to maintain adequate reinsurance coverage at acceptable rates without a material adverse effect on AFG's results of operations. AFG's gross and net combined ratios are shown in the table below.

See *Item 1 Business Property and Casualty Operations Reinsurance* for more information on AFG's reinsurance programs. For additional information on the effect of reinsurance on AFG's historical results of operations see *Note O Insurance Reinsurance* and the gross loss development table under *Item 1 Business Property and Casualty Operations Loss and Loss Adjustment Expense Reserves*.

The following table illustrates the effect that purchasing reinsurance has had on AFG's combined ratio over the last three years.

	2011	2010	2009
Before reinsurance (gross)	88.5%	85.2%	86.0%
Effect of reinsurance	4.9	3.3	(3.3)
Actual (net of reinsurance)	93.4%	88.5%	82.7%

**Asbestos and Environmental-related ( A&E ) Insurance Reserves** Asbestos and environmental reserves of the property and casualty group consisted of the following (in millions):

	December 31,	
	2011	2010
Asbestos	\$ 292	\$ 276
Environmental	70	66
A&E reserves, net of reinsurance recoverable	362	342
Reinsurance recoverable, net of allowance	92	74
Gross A&E reserves	\$ 454	\$ 416

Asbestos reserves include claims asserting alleged injuries and damages from exposure to asbestos. Environmental reserves include claims relating to polluted waste sites.



**Table of Contents**

Asbestos claims against manufacturers, distributors or installers of asbestos products were presented under the products liability section of their policies which typically had aggregate limits that capped an insurer's liability. In recent years, a number of asbestos claims are being presented as non-products claims, such as those by installers of asbestos products and by property owners or operators who allegedly had asbestos on their property, under the premises or operations section of their policies. Unlike products exposures, these non-products exposures typically had no aggregate limits, creating potentially greater exposure for insurers. Further, in an effort to seek additional insurance coverage, some insureds with installation activities who have substantially eroded their products coverage are presenting new asbestos claims as non-products operations claims or attempting to reclassify previously settled products claims as non-products claims to restore a portion of previously exhausted products aggregate limits. AFG, along with other insurers, is and will be subject to such non-products claims. It is difficult to predict whether insureds will be successful in asserting claims under non-products coverage or whether AFG and other insurers will be successful in asserting additional defenses. Therefore, the future impact of such efforts is uncertain.

Approximately 59% of AFG's net asbestos reserves relate to policies written directly by AFG subsidiaries. Claims from these policies generally are product oriented claims with only a limited amount of non-product exposures, and are dominated by small to mid-sized commercial entities that are mostly regional policyholders with few national target defendants. The remainder is assumed reinsurance business that includes exposures for the periods 1954 to 1983. The asbestos and environmental assumed claims are ceded by various insurance companies under reinsurance treaties. A majority of the individual assumed claims have exposures of less than \$100,000 to AFG. Asbestos losses assumed include some of the industry known manufacturers, distributors and installers. Pollution losses include industry known insured names and sites.

Establishing reserves for A&E claims relating to policies and participations in reinsurance treaties and former operations is subject to uncertainties that are significantly greater than those presented by other types of claims. For this group of claims, traditional actuarial techniques that rely on historical loss development trends cannot be used and a range of reasonably possible losses cannot be estimated. Case reserves and expense reserves are established by the claims department as specific policies are identified. In addition to the case reserves established for known claims, management establishes additional reserves for claims not yet known or reported and for possible development on known claims. These additional reserves are management's best estimate based on periodic comprehensive studies and internal reviews adjusted for payments and identifiable changes, supplemented by management's review of industry information about such claims, with due consideration to individual claim situations.

Management believes that estimating the ultimate liability for asbestos claims presents a unique and difficult challenge to the insurance industry 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. The casualty insurance industry is engaged in extensive litigation over these coverage and liability issues as the volume and severity of claims against asbestos defendants continue to increase. 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. Emerging trends, such as those named below, could impact AFG's reserves and payments:

There is a growing interest at the state level to attempt to legislatively address asbestos liabilities and the manner in which asbestos claims are resolved. These developments are fluid and could result in piecemeal state-by-state solutions.

The manner by which bankruptcy courts are addressing asbestos liabilities is in flux. AFG's insureds may make claims alleging significant non-products exposures.



**Table of Contents**

While management believes that AFG's reserves for A&E claims are a reasonable estimate of ultimate liability for such claims, actual results may vary materially from the amounts currently recorded due to the difficulty in predicting the number of future claims, the impact of recent bankruptcy filings, and unresolved issues such as whether coverage exists, whether policies are subject to aggregate limits on coverage, how claims are to be allocated among triggered policies and implicated years, and whether claimants who exhibit no signs of illness will be successful in pursuing their claims. A 1% variation in loss cost trends, caused by any of the factors previously described, would change net income by approximately \$17 million.

AFG tracks its A&E claims by policyholder. The following table shows, by type of claim, the number of policyholders that did not receive any payments in the calendar year separate from policyholders that did receive a payment. Policyholder counts represent policies written by AFG subsidiaries and do not include assumed reinsurance.

	2011	2010	2009
Number of policyholders with no payments:			
Asbestos	113	122	71
Environmental	98	132	156
	211	254	227
Number of policyholders with payments:			
Asbestos	58	54	110
Environmental	26	20	22
	84	74	132
Total	295	328	359

Amounts paid (net of amounts received from reinsurers) for asbestos and environmental claims, including loss adjustment expenses, were as follows (in millions):

	2011	2010	2009
Asbestos	\$ 13	\$ 27	\$ 11
Environmental	17	17	14
Total	\$ 30	\$ 44	\$ 25

The survival ratio is a measure often used by industry analysts to compare A&E reserves strength among companies. This ratio is typically calculated by dividing reserves for A&E exposures by the three year average of paid losses, and therefore measures the number of years that it would take to pay off current reserves based on recent average payments. Because this ratio can be significantly impacted by a number of factors such as loss payout variability, caution should be exercised in attempting to determine reserve adequacy based simply on the survival ratio. At December 31, 2011, AFG's three year survival ratios were 17.4 times paid losses for the asbestos reserves and 11.0 times paid losses for the total A&E reserves. Excluding amounts associated with the settlements of asbestos-related coverage litigation for A.P. Green Industries (see *Item 3 Legal Proceedings*) and another large claim, AFG's three year survival ratios were 10.9 and 7.6 times paid losses for the asbestos reserves and total A&E reserves, respectively. Data published by Conning Research & Consulting in June 2012 indicate that industry survival ratios were 8.5 for asbestos reserves and 7.8 for total A&E reserves at December 31, 2010.

AFG has conducted comprehensive studies of its asbestos and environmental reserves with the aid of outside actuarial and engineering firms and specialty outside counsel every two years with an in-depth internal review during the

intervening years.

In the second quarter of 2011, AFG completed a comprehensive study of its asbestos and environmental exposures relating to the run-off operations of its property and casualty group and its exposures related to former railroad and manufacturing operations and sites. The study relied on a ground-up exposure analysis. With respect to asbestos, it considered products and non-products exposures, paid claims history, the pattern of new claims, settlements and projected development. As a result of the study, AFG recorded a \$50 million special charge (net of reinsurance) to increase the property and casualty group's asbestos reserves by \$28 million and its environmental reserves by \$22 million. The property and casualty group's asbestos reserves increase related primarily to exposures on business assumed from other insurers resulting from an increase in anticipated aggregate exposures in several large settlements involving several insurers in which AFG has a small proportional share. Some insurers have settled long-standing asbestos exposures with their insureds and are seeking payment from reinsurers. Asbestos reserves related to the property and casualty group's direct

**Table of Contents**

asbestos exposures were increased to reflect higher frequency and severity of mesothelioma and other cancer claims as well as increased defense costs on many of these claims. These trends were partially offset by a decline in the number of claims without serious injury and fewer new claims that required payment being reported to AFG. The increase in the property and casualty group's environmental reserves was attributed primarily to a small number of increases on specific environmental claims at several sites. During the second quarter of 2010, an in-depth internal review of AFG's A&E exposures was completed by AFG's internal A&E claims specialists and actuaries in consultation with external actuaries and specialty outside counsel. During the second quarter of 2009, AFG completed a comprehensive study of its A&E exposures with the assistance of outside actuarial and engineering firms and specialty outside counsel. The 2010 in-depth internal review and the 2009 comprehensive study resulted in only minor adjustments to the A&E reserves. See *Management's Discussion and Analysis - Results of Operations - Asbestos and Environmental Reserve Charges* for the amount of A&E reserve strengthening recorded in 2011, 2010 and 2009.

**Supplemental Insurance Reserves - Long-term Care** AFG, as well as other companies selling long-term care products have relatively limited claims, lapse, and mortality experience over extended periods, making it difficult to predict future claims. Long-term care claims tend to be much higher in dollar amount and longer in duration than other health care products such as Medicare supplement. In addition, long-term care claims are incurred much later in the life of a policy than most other supplemental health products. These factors make it difficult to appropriately price this product and were instrumental in AFG's decision to stop writing new policies beginning in January 2010. AFG's long-term care products have level premiums and are guaranteed renewable. Premium rates can potentially be increased in reaction to adverse experience. However, any rate increases would require regulatory approval. Reserves for future policy benefits under long-term care policies are established (and related acquisition costs are amortized) over the life of the policies based on policy benefit assumptions as of the date of issuance, including investment yields, mortality, morbidity, persistency, and expenses. Once these assumptions are established for a given policy or group of policies, they are not changed over the life of the policy unless a loss recognition event (premium deficiency) occurs. Loss recognition occurs when, based on current expectations as of the measurement date, existing contract liabilities plus the present value of future premiums, including reasonably expected rate increases, are not expected to cover the present value of future claims payments and related settlement and maintenance costs as well as unamortized acquisition costs. Based on loss recognition testing at December 31, 2011, AFG's long-term care reserves plus the present value of future premiums exceeded claims costs and unamortized acquisition expenses by approximately \$25 million. Adverse changes in any of the reserve assumptions in future periods could result in loss recognition for AFG's long-term care business. For example, a 1% change in claims costs or a 0.1% change in investment yields in all future periods, excluding their effect on the Company's ability to achieve future rate increases, would each impact the December 31, 2011, excess described above by approximately \$10 million. Once the excess is reduced to zero, the impact of adverse changes in assumptions is recorded as a charge to earnings as either a reduction in unamortized acquisition costs or an increase to contract reserves, net of any reinsurance recoverable.

**Contingencies related to Subsidiaries - Former Operations** The A&E studies and reviews discussed above encompassed reserves 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 and certain manufacturing operations disposed of by American Premier and its subsidiaries and by GAFRI. Charges resulting from the A&E studies and review were less than \$10 million in 2011, 2010 and 2009. Liabilities for claims and contingencies arising from these former operations totaled \$92 million at December 31, 2011. For a discussion of the uncertainties in determining the ultimate liability, see *Note M - Contingencies* to the financial statements.

**Table of Contents****MANAGED INVESTMENT ENTITIES**

Beginning in 2010, accounting standards require AFG to consolidate its investments in collateralized loan obligation ( CLO ) entities that it manages and owns an interest in (in the form of debt). See *Note A Accounting Policies Managed Investment Entities* and *Note H Managed Investment Entities*. The effect of consolidating these entities is shown in the tables below (in millions). The Before CLO Consolidation columns include AFG's investment and earnings in the CLOs on an unconsolidated basis.

**CONDENSED CONSOLIDATING BALANCE SHEET**

	Before CLO Consolidation	Managed Investment Entities	Consol. Entries	Consolidated As Reported
December 31, 2011				
Assets:				
Cash and other investments	\$ 25,675	\$	\$ (98)(a)	\$ 25,577
Assets of managed investment entities		3,058		3,058
Other assets	7,407			7,407
<b>Total assets</b>	<b>\$ 33,082</b>	<b>\$ 3,058</b>	<b>\$ (98)</b>	<b>\$ 36,042</b>
Liabilities:				
Unpaid losses, loss adjustment expenses and unearned premiums	\$ 8,004	\$	\$	\$ 8,004
Annuity, life, accident and health benefits and reserves	17,147			17,147
Liabilities of managed investment entities		2,885	(98)(a)	2,787
Long-term debt and other liabilities	3,413			3,413
<b>Total liabilities</b>	<b>28,564</b>	<b>2,885</b>	<b>(98)</b>	<b>31,351</b>
Shareholders' Equity:				
Common Stock and Capital surplus	1,219			1,219
Retained earnings:				
Appropriated managed investment entities		173		173
Unappropriated	2,596			2,596
Accumulated other comprehensive income	557			557
<b>Total shareholders' equity</b>	<b>4,372</b>	<b>173</b>		<b>4,545</b>
Noncontrolling interests	146			146
<b>Total equity</b>	<b>4,518</b>	<b>173</b>		<b>4,691</b>
<b>Total liabilities and equity</b>	<b>\$ 33,082</b>	<b>\$ 3,058</b>	<b>\$ (98)</b>	<b>\$ 36,042</b>
December 31, 2010				
Assets:				
Cash and other investments	\$ 22,687	\$	\$ (17)(a)	\$ 22,670
Assets of managed investment entities		2,537		2,537

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Other assets		7,247				7,247		
Total assets	\$	29,934	\$	2,537	\$	(17)	\$	32,454
Liabilities:								
Unpaid losses, loss adjustment expenses and unearned premiums	\$	7,947	\$		\$		\$	7,947
Annuity, life, accident and health benefits and reserves		14,555						14,555
Liabilities of managed investment entities				2,340		(17)(a)		2,323
Long-term debt and other liabilities		3,009						3,009
Total liabilities		25,511		2,340		(17)		27,834
Shareholders' Equity:								
Common Stock and Capital surplus		1,271						1,271
Retained earnings:								
Appropriated - managed investment entities				197				197
Unappropriated		2,523						2,523
Accumulated other comprehensive income		479						479
Total shareholders' equity		4,273		197				4,470
Noncontrolling interests		150						150
Total equity		4,423		197				4,620
Total liabilities and equity	\$	29,934	\$	2,537	\$	(17)	\$	32,454

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

**Table of Contents****CONDENSED CONSOLIDATING STATEMENT OF EARNINGS**

	Before CLO Consolidation(a)	Managed Investment Entities	Consol. Entries	Consolidated As Reported
Year ended December 31, 2011				
Revenues:				
Insurance premiums	\$ 3,189	\$	\$	\$ 3,189
Investment income	1,247		(6)(b)	1,241
Realized gains (losses) on securities	76			76
Realized gains (losses) on subsidiaries	(3)			(3)
Income (loss) of managed investment entities:				
Investment income		105		105
Loss on change in fair value of assets/liabilities		(29)	(4)(b)	(33)
Other income	194		(19)(c)	175
<b>Total revenues</b>	<b>4,703</b>	<b>76</b>	<b>(29)</b>	<b>4,750</b>
Costs and Expenses:				
Insurance benefits and expenses	3,671			3,671
Expenses of managed investment entities		100	(29)(b)(c)	71
Interest on borrowed money and other expenses	448			448
<b>Total costs and expenses</b>	<b>4,119</b>	<b>100</b>	<b>(29)</b>	<b>4,190</b>
Operating earnings before income taxes	584	(24)		560
Provision for income taxes	240			240
Net earnings, including noncontrolling interests	344	(24)		320
Less: Net earnings (loss) attributable to noncontrolling interests	1		(24)(d)	(23)
<b>Net Earnings Attributable to Shareholders</b>	<b>\$ 343</b>	<b>\$ (24)</b>	<b>\$ 24</b>	<b>\$ 343</b>
Year ended December 31, 2010				
Revenues:				
Insurance premiums	\$ 3,001	\$	\$	\$ 3,001
Investment income	1,208		(17)(b)	1,191
Realized gains (losses) on securities	101			101
Realized gains(losses) on subsidiaries	(13)			(13)
Income (loss) of managed investment entities:				
Investment income		93		93
		(80)	10(b)	(70)

Loss on change in fair value of assets/liabilities				
Other income	209		(15)(c)	194
Total revenues	4,506	13	(22)	4,497
Costs and Expenses:				
Insurance benefits and expenses	3,297			3,297
Expenses of managed investment entities		77	(22)(b)(c)	55
Interest on borrowed money and other expenses	456			456
Total costs and expenses	3,753	77	(22)	3,808
Operating earnings before income taxes	753	(64)		689
Provision for income taxes	266			266
Net earnings, including noncontrolling interests	487	(64)		423
Less: Net earnings (loss) attributable to noncontrolling interests	8		(64)(d)	(56)
Net Earnings Attributable to Shareholders	\$ 479	\$ (64)	\$ 64	\$ 479

- (a) Includes \$6 million and \$17 million in 2011 and 2010, respectively, in investment income representing the change in fair value of AFG's CLO investments plus \$19 million and \$15 million in 2011 and 2010, respectively, in CLO management fees earned.
- (b) Elimination of the change in fair value of AFG's investments in the CLOs, including \$10 million and \$7 million 2011 and 2010, respectively, in distributions recorded as interest expense by the CLOs.
- (c) Elimination of management fees earned by AFG.
- (d) Allocate losses of CLOs attributable to other debt holders to noncontrolling interests.

**Table of Contents****RESULTS OF OPERATIONS THREE YEARS ENDED DECEMBER 31, 2011**

**General** AFG's net earnings attributable to shareholders, determined in accordance with GAAP, include certain items that may not be indicative of its ongoing core operations. The following table identifies such items and reconciles net earnings attributable to shareholders to core net operating earnings, a non-GAAP financial measure that AFG believes is a useful tool for investors and analysts in analyzing ongoing operating trends (in millions, except per share amounts):

	2011	2010	2009
Core net operating earnings	\$ 364	\$ 433	\$ 493
Realized gains (a)	45	46	26
Special asbestos and environmental ( A&E ) charge(a)	(38)		
Valuation allowance against deferred tax assets(b)	(28)		
<b>Net earnings attributable to shareholders</b>	<b>\$ 343</b>	<b>\$ 479</b>	<b>\$ 519</b>
Diluted per share amounts:			
Core net operating earnings	\$ 3.53	\$ 3.92	\$ 4.23
Realized gains	.45	.41	.22
Special asbestos and environmental charge	(.37)		
Valuation allowance against deferred tax assets	(.28)		
<b>Net earnings attributable to shareholders</b>	<b>\$ 3.33</b>	<b>\$ 4.33</b>	<b>\$ 4.45</b>

(a) The tax effects of reconciling items are shown below (in millions):

	2011	2010	2009
Realized gains	\$ (27)	\$ (36)	\$ (8)
Special A&E charge	21		

In addition, realized gains are shown net of noncontrolling interests of (\$1 million) in 2011, (\$6 million) in 2010 and (\$4 million) in 2009.

(b) The valuation allowance is net of \$6 million in noncontrolling interest.

Net earnings attributable to shareholders and core net earnings decreased in 2011 compared to 2010 due primarily to lower underwriting profit and lower investment income in the property and casualty insurance operations partially offset by increased earnings in the annuity and supplemental operations. Net earnings attributable to shareholders were also impacted by a second quarter 2011 special A&E charge and a fourth quarter 2011 charge for a valuation allowance against deferred tax assets.

Net earnings attributable to shareholders and core net operating earnings decreased in 2010 compared to 2009 due primarily to lower underwriting profit and lower investment income in the property and casualty insurance operations, partially offset by improved results in the annuity and supplemental insurance operations. Net earnings attributable to shareholders also benefited from higher realized gains in 2010 than in 2009.

**Property and Casualty Insurance Underwriting** AFG reports its property and casualty insurance business in the following sub-segments: (i) Property and transportation, (ii) Specialty casualty and (iii) Specialty financial.

To understand the overall profitability of particular lines, the timing of claims payments and the related impact of investment income must be considered. Certain short-tail lines of business (primarily property coverages) generally have quick loss payouts, which reduce the time funds are held, thereby limiting investment income earned thereon. On the other hand, long-tail lines of business (primarily liability coverages and workers compensation) generally have



payouts that are either structured over many years or take many years to settle, thereby significantly increasing investment income earned on related premiums received.

Underwriting profitability is measured by the combined ratio, which is a sum of the ratios of losses, loss adjustment expenses, underwriting expenses and policyholder dividends to premiums. A combined ratio under 100% indicates an underwriting profit. The combined ratio does not reflect investment income, other income or federal income taxes.

**Table of Contents**

While AFG desires and seeks to earn an underwriting profit on all of its business, it is not always possible to do so. As a result, AFG attempts to expand in the most profitable areas and control growth or even reduce its involvement in the least profitable ones.

AFG's combined ratio has been better than the industry average for twenty-four of the last twenty-six years.

Management believes that AFG's insurance operations have performed better than the industry as a result of its specialty niche focus, product line diversification, stringent underwriting discipline and alignment of compensation incentives.

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

	2011	2010	2009
Gross Written Premiums			
Property and transportation	\$ 2,273	\$ 1,778	\$ 1,816
Specialty casualty	1,302	1,295	1,394
Specialty financial	529	514	557
Other	2	2	(4)
	\$ 4,106	\$ 3,589	\$ 3,763
Net Written Premiums			
Property and transportation	\$ 1,436	\$ 1,159	\$ 872
Specialty casualty	867	864	923
Specialty financial	398	323	448
Other	69	62	68
	\$ 2,770	\$ 2,408	\$ 2,311
Combined Ratios			
Property and transportation	92.0%	88.0%	74.1%
Specialty casualty	95.5	94.6	93.2
Specialty financial	85.1	74.8	74.1
Total Specialty	91.6	88.0	82.4
Aggregate (including discontinued lines)	93.4%	88.5%	82.7%

Gross and net written premiums increased in 2011 compared to 2010 due primarily to higher premiums in the Property and transportation segment, particularly the crop and transportation businesses. In addition, higher net written premiums in 2011 reflect the impact of a third quarter 2010 reinsurance transaction in the Specialty financial group. Overall renewal rate momentum in the Specialty insurance operations was positive during the fourth quarter of 2011.

The Specialty insurance operations generated an underwriting profit of \$231 million in 2011, \$77 million lower than in 2010. Lower favorable reserve development, poor results in a block of program business and lower profitability in the crop operations were partially offset by improved results in the excess and surplus businesses. Results for 2011 include \$120 million (4.3 points on the combined ratio) of favorable reserve development compared to \$170 million (6.7 points) in 2010. Catastrophe losses totaled \$46 million (1.7 points) in 2011 compared to \$49 million (1.9 points) in 2010.

Gross written premiums decreased 5% in 2010 compared to 2009 due primarily to competitive pressures and lower spring agricultural commodity prices. Premiums resulting from National Interstate's third quarter acquisition of Vanliner, premium growth from Marketform and higher fall agricultural commodity prices partially offset these declines. The increase in net written premiums in 2010 compared to 2009 is a result of decreased cessions under the crop reinsurance agreement, partially offset by the decline in premiums resulting from the reinsurance transaction in

the Specialty financial group. Excluding crop operations, gross and net written premiums decreased 2% and 5%, respectively, in 2010 compared to 2009. Average renewal rates in the Specialty insurance operations during 2010 were flat compared to the prior year.

The Specialty insurance operations generated an underwriting profit of \$308 million in 2010, \$116 million lower than in 2009. In addition to soft market conditions, the reduced profit in 2010 compared to 2009 reflects a \$35 million decrease in favorable prior year reserve development and a \$31 million increase in catastrophe losses. Results for 2010 include 6.7 points of favorable reserve development compared to 8.5 points in 2009 and 1.9 points of catastrophe losses compared to .7 points in 2009.

**Table of Contents**

**Property and transportation** gross and net written premiums increased in 2011 when compared to 2010 as a result of higher crop premiums resulting from higher spring agricultural commodity prices as well as additional premiums related to National Interstate's acquisition of Vanliner in July 2010. This group reported an underwriting profit of \$113 million, \$27 million lower than in 2010. Lower underwriting profits in the crop, property and inland marine and transportation businesses were partially offset by lower catastrophe losses. Catastrophe losses for this group were \$32 million (2.3 points) in 2011 compared to \$39 million (3.3 points) in 2010.

Gross written premiums for 2010 declined from 2009 primarily as a result of lower spring commodity prices that had the effect of lowering AFG's crop premium volume. These declines were partially offset by additional premiums from the Vanliner acquisition. AFG returned to historical levels of 50% cessions under its crop reinsurance agreement in 2010, compared to 90% in 2009, contributing to a substantial increase in this group's net written premiums. Excluding crop, this group's net written premiums for 2010 increased 9% from 2009, primarily as a result of the Vanliner acquisition. This group reported an underwriting profit of \$140 million in 2010, \$96 million lower than in 2009 due primarily to lower favorable reserve development and higher catastrophe losses. Results for 2010 include 2.3 points of favorable reserve development compared to 5.7 points in 2009 and 3.3 points of catastrophe losses in 2010 compared to minimal catastrophe losses in 2009.

**Specialty casualty** gross and net written premiums for 2011 were up slightly when compared to the 2010 period. Growth in the international operations and higher premiums in the excess and surplus and targeted markets operations more than offset the non-renewal of two major programs that did not meet return thresholds and a decision to exit the excess workers' compensation business. This group reported an underwriting profit of \$39 million in 2011, \$8 million lower than the prior year. Improved results in the excess and surplus businesses were more than offset by underwriting losses in a block of program business and an \$18 million decrease in favorable reserve development.

Gross and net written premiums decreased in 2010 compared to 2009 due primarily to competitive market conditions in the excess and surplus markets and California workers' compensation businesses, as well as volume reductions resulting from decreased demand for general liability coverages in the homebuilders' market. Growth in gross written premiums in the Marketform and environmental operations partially offset these declines. Increased retentions in the executive liability operations helped to offset decreases in net written premiums. This group reported an underwriting profit of \$47 million in 2010, \$16 million lower than in 2009. The decrease was primarily due to lower underwriting profits in the California workers' compensation business and the general liability operations (primarily those that serve the homebuilders' industry). These decreases were partially offset by improved results in the executive liability and excess and surplus operations.

Underwriting results for 2011, 2010 and 2009 include \$44 million, \$55 million and \$56 million, respectively, in adverse reserve development related to Marketform, primarily its run-off Italian public hospital medical malpractice business.

**Specialty financial** net written premiums in 2011 were higher when compared to 2010 due primarily to the impact of a third quarter 2010 reinsurance transaction that involved the sale of unearned premiums related to the automotive lines of business. This group reported an underwriting profit of \$61 million in 2011, \$51 million lower than in 2010. Lower favorable reserve development, primarily in the run-off automobile residual value insurance ( RVI ) business, contributed to this decline.

**Table of Contents**

Gross written premiums decreased in 2010 compared to 2009, reflecting the decision to exit certain automotive lines of business in 2009. During the third quarter of 2010, AFG ceded the unearned premium related to these businesses in a reinsurance transaction, which resulted in a reduction of approximately \$100 million in net written premiums. Specialty financial underwriting profit was \$112 million in 2010 compared to \$134 million in 2009. The lower underwriting profit in 2010 reflects \$51 million less of favorable prior year reserve development in the RVI operations than was recorded in 2009.

**Asbestos and Environmental Reserve Charges** As previously discussed under *Uncertainties Asbestos and Environmental-related ( A&E ) Insurance Reserves*, AFG has established property and casualty insurance reserves for claims related to environmental exposures and asbestos claims. AFG also has recorded liabilities for various environmental and occupational injury and disease claims arising out of former railroad and manufacturing operations. Total charges recorded to increase reserves (net of reinsurance recoverable) for A&E exposures of AFG's property and casualty group (included in loss and loss adjustment expenses) and its former railroad and manufacturing operations (included in other operating and general expenses) were as follows (in millions):

	2011	2010	2009
Property and casualty group	\$ 50	\$ 9	\$ 4
Former operations	9	19	15

**Loss development** As shown in *Note O Insurance Property and Casualty Insurance Reserves*, AFG's property and casualty operations recorded favorable loss development of \$69 million in 2011, \$158 million in 2010 and \$198 million in 2009 related to prior accident years. Major areas of favorable (adverse) development were as follows (in millions):

	2011	2010	2009
Property and transportation	\$ 26	\$ 27	\$ 52
Specialty casualty	71	89	59
Specialty financial	10	48	105
Other specialty	13	6	(11)
Total Specialty	120	170	205
Other, primarily asbestos and environmental charges	(51)	(12)	(7)
Aggregate (including discontinued lines)	\$ 69	\$ 158	\$ 198

Favorable reserve development in the Property and transportation group in 2011, 2010 and 2009 reflects lower than expected loss frequency in crop products. The favorable reserve development in this group also reflects lower severity in auto liability products in 2010 and lower than expected loss frequency in ocean marine products and lower severity in farm and crop losses in 2009.

Favorable reserve development in the Specialty casualty group in 2011 is due primarily to lower than expected claim severity in directors and officers liability, excess and surplus lines and the run-off legal professional liability business, partially offset by adverse development due to higher frequency and severity on run-off Italian public hospital medical malpractice liability products written by Marketform and a block of U.S.-based program (motel/hotel, restaurants, taverns and recreational) business. Favorable reserve development in the Specialty casualty group in 2010 is due to lower than expected severity on claims in general liability, directors and officers liability and the run-off legal professional liability business, partially offset by adverse development on run-off Italian medical malpractice liability products in Marketform. Favorable reserve development in the Specialty casualty group in 2009 reflects lower severity on claims in general liability and directors and officers liability as well as lower than expected frequency in a block of program (leisure camps, fairs and festivals, and sports and leisure) business, partially offset by adverse development on Marketform's run-off Italian medical malpractice reserves.

Favorable reserve development in the Specialty financial group in 2011 is due to lower than expected frequency and severity in the surety, fidelity, crime and foreign credit businesses as economic conditions did not affect these lines as adversely as had been anticipated. Favorable reserve development in Specialty financial in 2010 and 2009 related to lower than expected frequency and severity in the run-off RVI operations due to favorable trends in used car sale prices and lower loss severity in AFG's surety, fidelity and crime products.

**Table of Contents**

The development in Other specialty reflects adjustments to the deferred gain on the retroactive insurance transaction entered into in connection with the sale of a business in 1998, net of related amortization.

**Annuity and Supplemental Insurance Operations** Operating earnings before income taxes (excluding realized gains (losses)) of the annuity and supplemental insurance segment increased \$22 million (11%) to \$224 million in 2011 due primarily to higher earnings in the fixed annuity and Medicare supplement businesses, partially offset by higher mortality in the run-off life operations, the impact of a decrease in the stock market on the variable annuity business and the impact of lower interest rates on the indexed annuity business. The 2010 results were \$40 million (25%) higher than 2009 as expense savings and higher earnings in the fixed annuity and supplemental insurance operations were partially offset by lower earnings in the variable annuity operations.

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

	2011	2010	2009
403(b) Fixed and Indexed Annuities:			
First Year	\$ 18	\$ 34	\$ 66
Renewal	164	168	144
Single Sum	75	103	127
Subtotal	257	305	337
Non-403(b) Indexed Annuities	1,549	735	402
Non-403(b) Fixed Annuities	239	430	294
Bank Annuities	971	737	314
Variable Annuities	70	73	87
Total Annuity Premiums	\$ 3,086	\$ 2,280	\$ 1,434

Bank annuities represent annuity premiums generated through banks by independent agents and brokers, as well as through direct relationships with certain financial institutions.

The increase in annuity premiums in 2011 and 2010 is attributable to increased sales of indexed annuities in the non-403(b) single premium market and higher sales through banks.

Increased sales of indexed annuities reflects the industry trend towards indexed annuities and away from traditional fixed annuities, as well as AFG's introduction of new indexed products and features. The increase in Bank Annuities premiums in 2011 reflects the addition of several new banks.

**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):

	2011	2010	2009
Premiums			
Supplemental insurance operations			
First Year	\$ 38	\$ 63	\$ 85
Renewal	367	361	330
Life operations (in run-off)	25	27	29
	\$ 430	\$ 451	\$ 444
Benefits			
Supplemental insurance operations	\$ 326	\$ 330	\$ 317
Life operations (in run-off)	43	38	44

\$ 369 \$ 368 \$ 361

In January 2010, AFG ceased new sales of long-term care insurance. Renewal premiums will be accepted unless those policies lapse.



**Table of Contents**

**Investment Income** Over the past couple of years, yields available in the financial markets on fixed maturity securities have generally declined, placing downward pressure on AFG's investment portfolio yield. The \$50 million increase in investment income in 2011 compared to 2010 reflects higher average invested assets, primarily related to growth in the annuity business, partially offset by lower yields on fixed maturity investments. The \$9 million decrease in investment income in 2010 compared to 2009 reflects lower yields on fixed maturity investments partially offset by higher average invested assets. Investment income includes \$27 million in 2011, \$66 million in 2010 and \$130 million in 2009 of interest income earned on interest-only and similar MBS, primarily non-agency interest-only securities with interest rates that float inversely with short-term rates.

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

	2011	2010	2009
Realized gains (losses) before impairments:			
Disposals	\$ 156	\$ 134	\$ 115
Change in the fair value of derivatives	(24)	43	154
Adjustments to annuity deferred policy acquisition costs and related items	(4)	(14)	(23)
	128	163	246
Impairment charges:			
Securities	(68)	(86)	(271)
Adjustments to annuity deferred policy acquisition costs and related items	16	24	68
	(52)	(62)	(203)
	\$ 76	\$ 101	\$ 43

Realized gains on disposals include gains of approximately \$76 million in 2011, \$26 million in 2010 and \$76 million in 2009 on sales of shares of Verisk Analytics, Inc.

The change in fair value of derivatives includes net losses of less than \$1 million in 2011, net gains of \$50 million in 2010 and \$157 million in 2009 from the mark-to-market of MBS, primarily interest-only securities with interest rates that float inversely with short-term rates. See *Note F Derivatives*.

Approximately \$57 million, \$79 million and \$221 million of the impairment charges in 2011, 2010 and 2009, respectively, related to fixed maturity investments, primarily corporate bonds and MBS.

**Realized Losses on Subsidiaries** In the third quarter of 2010, AFG recorded an impairment charge of \$22 million resulting from management's decision to de-emphasize the sale of supplemental health insurance products through career agents, including the sale of a marketing subsidiary. Partially offsetting this loss was National Interstate's \$7 million gain on the acquisition of Vanliner in 2010. See *Note I Goodwill and Other Intangibles* and *Note B Acquisition*.

**Other Income** The \$19 million decrease in other income in 2011 compared to 2010 reflects \$16 million in income recorded in the third quarter of 2010 from the sale of real estate and the termination of leases by a tenant. When comparing other income for 2010 to 2009, this income was more than offset by a decline in income from AFG's warranty business and lower fee income in certain other businesses.



**Table of Contents**

**Annuity Benefits** Annuity benefits reflect amounts accrued on annuity policyholders' funds accumulated. On deferred annuities (annuities in the accumulation phase), interest is generally credited to policyholders' accounts at their current stated interest rates. Furthermore, for two-tier deferred annuities (annuities under which a higher interest amount can be earned if a policy is annuitized rather than surrendered), additional reserves are accrued for (i) persistency and premium bonuses and (ii) excess benefits expected to be paid for future deaths and annuitizations. Changes in investment yields, crediting rates, actual surrender, death and annuitization experience or modifications in actuarial assumptions can affect these additional reserves and could result in charges (or credits) to earnings in the period the projections are modified.

In the fourth quarters of 2011, 2010 and 2009, AFG conducted its detailed review of actual results and future assumptions underlying its annuity operations. As a result of the reviews, AFG recorded expense reductions of \$10 million in 2011 and \$3 million in 2010 and a charge of \$5 million in 2009 to annuity benefits related to changes in these assumptions. Excluding these items, annuity benefits increased \$73 million in 2011 compared to 2010 and \$17 million in 2010 compared to 2009 reflecting growth in the annuity business partially offset by lower average crediting rates. The impact of changes in interest rates and stock market performance on the fair value of derivatives related to the indexed annuity business also impacted the 2011 and 2010 results.

**Annuity and Supplemental Insurance Acquisition Expenses** Annuity and supplemental insurance acquisition expenses include amortization of annuity, supplemental insurance and life business 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 ).

As a result of the 2011 and 2010 reviews of actual results and future assumptions discussed above in Annuity Benefits, AFG recorded write-offs of DPAC of \$10 million in 2011 and \$28 million in 2010 due primarily to the impact of changes in assumptions related to future investment yields, surrenders and annuitization and death benefits partially offset by the impact of lower expected expenses and crediting rates in the fixed annuity business. As a result of the 2009 review, AFG recorded an \$8 million write-off of DPAC due primarily to the impact of changes in assumptions related to future investment yields on the fixed annuity business. Excluding these charges, insurance acquisition expenses remained unchanged in 2011 compared to 2010 and increased \$24 million in 2010 compared to 2009 reflecting additional amortization due to growth in the annuity business.

The vast majority of this group's DPAC asset relates to its annuity and life insurance lines of business. Unanticipated spread compression, decreases in the stock market, adverse mortality experience, and higher than expected lapse rates could lead to further write-offs of DPAC or PVFP in the future.

**Interest Charges on Borrowed Money** Interest expense increased \$7 million (9%) in 2011 compared to 2010 and \$11 million (16%) in 2010 compared to 2009 reflecting AFG's issuance of \$132 million of 7% Senior Notes in September 2010.

**Other Operating and General Expenses** The \$85 million decrease in 2010 compared to 2009 reflects the 2009 sale of a small subsidiary, lower expenses in AFG's warranty business due to the run-off of certain products, and lower expenses in the annuity and supplemental insurance operations.

**Income Taxes** See *Note L Income Taxes* to the financial statements for an analysis of items affecting AFG's effective tax rate.

**Table of Contents**

**Noncontrolling Interests** The following table details net earnings (loss) in consolidated subsidiaries attributable to holders other than AFG (in millions):

	2011	2010	2009
National Interstate	\$ 15	\$ 19	\$ 21
Marketform	(15)	(11)	(10)
Managed Investment Entities	(24)	(64)	
Other	1		
	\$ (23)	\$ (56)	\$ 11

Marketform's losses reflect adverse reserve development in its run-off Italian public hospital medical malpractice business. As discussed in Notes A and H to the financial statements, the losses of Managed Investment Entities in 2011 and 2010 represent CLO losses that ultimately inure to holders of CLO debt other than AFG.

**NEW ACCOUNTING STANDARDS**

See Note A - Recent Accounting Standards for a discussion of new accounting standards to be adopted by AFG in 2012.

**ITEM 7A****Quantitative and Qualitative Disclosures About Market Risk**

Market risk represents the potential economic loss arising from adverse changes in the fair value of financial instruments. AFG's exposures to market risk relate primarily to its investment portfolio and annuity contracts, which are exposed to interest rate risk and, to a lesser extent, equity price risk. To a much lesser extent, AFG's long-term debt is also exposed to interest rate risk.

**Fixed Maturity Portfolio** The fair value of AFG's fixed maturity portfolio is directly impacted by changes in market interest rates. AFG's fixed maturity portfolio is comprised of primarily fixed rate investments with intermediate-term maturities. This practice is designed to allow flexibility in reacting to fluctuations of interest rates. The portfolios of AFG's insurance operations are managed with an attempt to achieve an adequate risk-adjusted return while maintaining sufficient liquidity to meet policyholder obligations. AFG's annuity and run-off life operations attempt to align the duration of their invested assets to the projected cash flows of policyholder liabilities.

Consistent with the discussion in *Item 7 - Management's Discussion and Analysis - Investments*, the following table demonstrates the sensitivity of the fair value of AFG's fixed maturity portfolio to reasonably likely changes in interest rates by illustrating the estimated effect on AFG's fixed maturity portfolio that an immediate increase of 100 basis points in the interest rate yield curve would have at December 31 (based on the duration of the portfolio, dollars in millions). Increases or decreases from the 100 basis points illustrated would be approximately proportional.

	2011	2010
Fair value of fixed maturity portfolio	\$ 22,247	\$ 19,721
Pretax impact on fair value of 100 bps increase in interest rates	\$ (1,046)	\$ (868)
Pretax impact as % of total fixed maturity portfolio	(4.7%)	(4.4%)

**Table of Contents**

**European Debt Exposure** Certain European countries, including the so-called peripheral countries (Greece, Portugal, Ireland, Italy and Spain) have been experiencing varying degrees of financial stress over the past couple of years. There remains considerable uncertainty as to future developments in the European debt crisis and the impact on global financial markets. Market concerns over the direct and indirect exposure of European financial institutions to the peripheral countries have resulted in widening of credit spreads and increased costs of funding for some European financial institutions.

At December 31, 2011, AFG owned no sovereign debt issued by the peripheral countries. The total exposure of AFG's fixed maturity portfolio to sovereign and non-sovereign (corporate industrial and financial institution) debt at December 31, 2011, is shown in the table below (in millions):

	Carrying Value	Fair Value	Unrealized Gain (Loss)
<b>European Industrials</b>			
Eurozone (17 countries with euro as common currency)	\$ 293	\$ 308	\$ 15
Non-Eurozone (primarily U.K., Switzerland and Sweden)	404	445	41
<b>Total European Industrials</b>	<b>\$ 697</b>	<b>\$ 753</b>	<b>\$ 56</b>
<b>European Financials</b>			
Eurozone (17 countries with euro as common currency)	\$ 135	\$ 132	\$ (3)
Non-Eurozone (primarily U.K., Switzerland and Sweden)	285	273	(12)
<b>Total European Financials</b>	<b>\$ 420</b>	<b>\$ 405</b>	<b>\$ (15)</b>
<b>European Sovereign Debt</b>			
Eurozone (primarily France, Germany and Netherlands)	\$ 18	\$ 18	\$
Non-Eurozone (primarily U.K. and Sweden)	13	13	
<b>Total European Sovereign Debt</b>	<b>\$ 31</b>	<b>\$ 31</b>	<b>\$</b>
<b>Total European Exposure</b>			
Eurozone	\$ 446	\$ 458	\$ 12
Non-Eurozone	702	731	29
<b>Total European Exposure</b>	<b>\$ 1,148</b>	<b>\$ 1,189</b>	<b>\$ 41</b>

**Annuity Contracts** Substantially all of AFG's fixed rate annuity contracts permit AFG to change crediting rates (subject to minimum interest rate guarantees as determined by applicable law) enabling management to react to changes in market interest rates. In late 2003, AFG began issuing products with guaranteed minimum crediting rates of less than 2% in states where required approvals have been received. The guaranteed minimum crediting rate on virtually all new product sales since 2010 is 1%. At December 31, 2011, approximately half of AFG's annuity contracts were at, or within ten basis points of the guaranteed minimum crediting rate.

At December 31, 2011, the weighted-average stated crediting rate on the in-force block of AFG's principal fixed annuity products was approximately 3.1%, and management estimates that the crediting rate on this in-force business will remain approximately 3.1% over the next five years. This rate reflects actuarial assumptions as to (i) expected

investment spreads, (ii) deaths, (iii) annuitizations, (iv) surrenders and (v) renewal premiums. Actual experience and changes in actuarial assumptions may result in different effective crediting rates than those above. The current stated crediting rates (excluding bonus interest) on new sales of AFG's fixed annuity products generally range from 1.0% to 2.0%.

Actuarial assumptions used to estimate DPAC and certain annuity liabilities, as well as AFG's ability to maintain spread, could be impacted if a low interest rate environment continues for an extended period, or if increases in interest rates cause policyholder behavior to differ significantly from current expectations.

**Table of Contents**

Projected payments (in millions) in each of the subsequent five years and for all years thereafter on AFG's fixed annuity liabilities at December 31 were as follows.

	First	Second	Third	Fourth	Fifth	Thereafter	Total	Fair Value(*)
2011	\$ 1,373	\$ 1,500	\$ 1,495	\$ 1,772	\$ 1,941	\$ 7,339	\$ 15,420	\$ 15,314
2010	1,248	1,309	1,418	1,381	1,602	5,947	12,905	12,233

(\*) Fair value excludes life contingent annuities in the payout phase (carrying value of \$201 million and \$208 million at December 31, 2011 and 2010, respectively).

AFG's indexed annuities represented approximately one-third of annuity benefits accumulated at December 31, 2011. These annuities provide policyholders with a crediting rate tied, in part, to the performance of an existing stock market index. AFG attempts to mitigate the risk in the index-based component of these products through the purchase of call options on the appropriate index. AFG's strategy is designed so that an increase in the liabilities, due to an increase in the market index, will be generally offset by unrealized and realized gains on the call options purchased by AFG. Both the index-based component of the annuities and the related call options are considered derivatives and adjusted to fair value through current earnings as annuity benefits. Adjusting these derivatives to fair value increased (decreased) annuity benefits expense by \$42 million in 2011, (\$21 million) in 2010 and \$3 million in 2009.

**Long-Term Debt** The following table shows scheduled principal payments (in millions) on fixed-rate long-term debt of AFG and its subsidiaries and related weighted average interest rates for each of the subsequent five years and for all years thereafter.

	December 31, 2011			December 31, 2010		
	Scheduled Principal Payments	Rate		Scheduled Principal Payments	Rate	
2012	\$ 1	5.9%	2011	\$ 9	10.2%	
2013	2	5.9	2012	1	5.9	
2014	2	5.9	2013	2	5.9	
2015	14	5.7	2014	2	5.9	
2016	45	6.1	2015	14	5.7	
Thereafter	799	8.4	Thereafter	844	8.3	
Total	\$ 863	7.9%	Total	\$ 872	8.2%	
Fair Value	\$ 940		Fair Value	\$ 941		

No amounts were outstanding under AFG's bank credit facility at December 31, 2011 or 2010.

**Table of Contents**

**ITEM 8**  
**Financial Statements and Supplementary Data**

	Page
<u>Report of Independent Registered Public Accounting Firm</u>	F-1
<u>Consolidated Balance Sheet:</u> <u>December 31, 2011 and 2010</u>	F-2
<u>Consolidated Statement of Earnings:</u> <u>Years ended December 31, 2011, 2010, and 2009</u>	F-3
<u>Consolidated Statement of Changes in Equity:</u> <u>Years ended December 31, 2011, 2010, and 2009</u>	F-4
<u>Consolidated Statement of Cash Flows:</u> <u>Years ended December 31, 2011, 2010, and 2009</u>	F-5
<u>Notes to Consolidated Financial Statements</u>	F-6

Selected Quarterly Financial Data has been included in Note N to the Consolidated Financial Statements.

**ITEM 9A**

**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 these controls and procedures are effective. There have been no changes in AFG's internal control over financial reporting during the fourth fiscal quarter of 2011 that materially affected, or are reasonably likely to materially affect, AFG's internal control over financial reporting. There have been no significant changes in AFG's internal controls or in other factors that could significantly affect these controls subsequent to the date of their evaluation.

**MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING**

AFG's management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Securities Exchange Act Rules 13a-15(f). Under the supervision and with the participation of management, including AFG's principal executive officers and principal financial officer, AFG conducted an evaluation of the effectiveness of internal control over financial reporting as of December 31, 2011, based on the criteria set forth in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission.

There are inherent limitations to the effectiveness of any system of internal controls and procedures, including the possibility of human error and the circumvention or overriding of the controls and procedures. Accordingly, even effective internal controls and procedures can only provide reasonable assurance of achieving their control objectives. Based on AFG's evaluation, management concluded that internal control over financial reporting was effective as of December 31, 2011. The attestation report of AFG's independent registered public accounting firm on AFG's internal control over financial reporting as of December 31, 2011, is set forth below.



**Table of Contents**

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM  
ON INTERNAL CONTROL OVER FINANCIAL REPORTING**

**Board of Directors and Shareholders**

**American Financial Group, Inc.**

We have audited American Financial Group, Inc. and subsidiaries (the Company's) internal control over financial reporting as of December 31, 2011, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). The Company's management is responsible for maintaining effective internal control over financial reporting, and for its assessment of internal control over financial reporting included in the accompanying Management's Report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, American Financial Group, Inc. and subsidiaries maintained, in all material respects, effective internal control over financial reporting as of December 31, 2011, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of American Financial Group, Inc. and subsidiaries as of December 31, 2011 and 2010, and the related consolidated statements of earnings, changes in equity and cash flows for each of the three years in the period ended December 31, 2011, and our report dated February 28, 2012, expressed an unqualified opinion thereon.

**/s/ ERNST & YOUNG LLP**

Cincinnati, Ohio

February 28, 2012

**Table of Contents**

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

**Board of Directors and Shareholders**

**American Financial Group, Inc.**

We have audited the accompanying consolidated balance sheets of American Financial Group, Inc. and subsidiaries (the Company) as of December 31, 2011 and 2010, and the related consolidated statements of earnings, changes in equity and cash flows for each of the three years in the period ended December 31, 2011. Our audits also included the financial statement schedules listed in the Index at Item 15(a). These financial statements and schedules are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedules based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of American Financial Group, Inc. and subsidiaries at December 31, 2011 and 2010, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2011, in conformity with U.S. generally accepted accounting principles. Also, in our opinion, the related financial statement schedules, when considered in relation to the basic financial statements taken as a whole, present fairly in all material respects the information set forth therein.

As discussed in Note A to the consolidated financial statements, in connection with implementing a new accounting standard, the Company changed its method of accounting for certain variable interest entities in 2010.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), American Financial Group, Inc. and subsidiaries' internal control over financial reporting as of December 31, 2011, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated February 28, 2012, expressed an unqualified opinion thereon.

**/s/ ERNST & YOUNG LLP**

Cincinnati, Ohio

February 28, 2012

**Table of Contents**

**AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEET**  
(Dollars In Millions)

	December 31,	
	2011	2010
<b>Assets:</b>		
Cash and cash equivalents	\$ 1,324	\$ 1,099
Investments:		
Fixed maturities, available for sale at fair value (amortized cost \$20,562 and \$18,490)	21,807	19,328
Fixed maturities, trading at fair value	440	393
Equity securities, at fair value (cost \$744 and \$458)	928	690
Mortgage loans	401	468
Policy loans	252	264
Real estate and other investments	425	428
 Total cash and investments	 25,577	 22,670
 Recoverables from reinsurers	 2,942	 2,964
Prepaid reinsurance premiums	409	422
Agents' balances and premiums receivable	565	535
Deferred policy acquisition costs	1,105	1,244
Assets of managed investment entities	3,058	2,537
Other receivables	895	674
Variable annuity assets (separate accounts)	548	616
Other assets	757	606
Goodwill	186	186
 Total assets	 \$ 36,042	 \$ 32,454
 <b>Liabilities and Equity:</b>		
Unpaid losses and loss adjustment expenses	\$ 6,520	\$ 6,413
Unearned premiums	1,484	1,534
Annuity benefits accumulated	15,420	12,905
Life, accident and health reserves	1,727	1,650
Payable to reinsurers	475	320
Liabilities of managed investment entities	2,787	2,323
Long-term debt	934	952
Variable annuity liabilities (separate accounts)	548	616
Other liabilities	1,456	1,121
 Total liabilities	 31,351	 27,834
 Shareholders' equity:		
Common Stock, no par value		
200,000,000 shares authorized		

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97,846,402 and 105,168,366 shares outstanding	98	105
Capital surplus	1,121	1,166
Retained earnings:		
Appropriated managed investment entities	173	197
Unappropriated	2,596	2,523
Accumulated other comprehensive income, net of tax	557	479
Total shareholders equity	4,545	4,470
Noncontrolling interests	146	150
Total equity	4,691	4,620
Total liabilities and equity	\$ 36,042	\$ 32,454

See notes to consolidated financial statements.

F-2

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**Table of Contents**

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

	Year ended December 31,		
	2011	2010	2009
<b>Revenues:</b>			
Property and casualty insurance premiums	\$ 2,759	\$ 2,550	\$ 2,412
Life, accident and health premiums	430	451	444
Investment income	1,241	1,191	1,200
Realized gains (losses) on:			
Securities (*)	76	101	43
Subsidiaries	(3)	(13)	(5)
Income (loss) of managed investment entities:			
Investment income	105	93	
Loss on change in fair value of assets/liabilities	(33)	(70)	
Other income	175	194	226
<b>Total revenues</b>	<b>4,750</b>	<b>4,497</b>	<b>4,320</b>
<b>Costs and Expenses:</b>			
Property and casualty insurance:			
Losses and loss adjustment expenses	1,744	1,457	1,187
Commissions and other underwriting expenses	835	797	808
Annuity benefits	510	444	435
Life, accident and health benefits	369	368	361
Annuity and supplemental insurance acquisition expenses	213	231	187
Interest charges on borrowed money	85	78	67
Expenses of managed investment entities	71	55	
Other operating and general expenses	363	378	463
<b>Total costs and expenses</b>	<b>4,190</b>	<b>3,808</b>	<b>3,508</b>
Operating earnings before income taxes	560	689	812
Provision for income taxes	240	266	282
Net earnings, including noncontrolling interests	320	423	530
Less: Net earnings (loss) attributable to noncontrolling interests	(23)	(56)	11
<b>Net Earnings Attributable to Shareholders</b>	<b>\$ 343</b>	<b>\$ 479</b>	<b>\$ 519</b>
<b>Earnings Attributable to Shareholders per Common Share:</b>			
Basic	\$ 3.39	\$ 4.38	\$ 4.49
Diluted	\$ 3.33	\$ 4.33	\$ 4.45

Average number of Common Shares:				
Basic		101.3	109.2	115.7
Diluted		102.9	110.5	116.8
Cash dividends per Common Share	\$	.6625	\$ .575	\$ .52
(*) Consists of the following:				
Realized gains before impairments	\$	128	\$ 163	\$ 246
Losses on securities with impairment		(31)	(50)	(373)
Non-credit portion recognized in other comprehensive income (loss)		(21)	(12)	170
Impairment charges recognized in earnings		(52)	(62)	(203)
Total realized gains on securities	\$	76	\$ 101	\$ 43

See notes to consolidated financial statements.

**Table of Contents**

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

	Common		Shareholders		Equity		Noncon- trolling Interests	Total Equity
	Common	Stock and Capital	Retained Earnings		Accum. Other Comp Inc.	Total		
	Shares	Surplus	Appro.	Unappro.	(Loss)	Total		
<b>Balance at December 31, 2008</b>	115,599,169	\$ 1,351	\$	\$ 1,842	\$ (703)	\$ 2,490	\$ 112	\$ 2,602
Cumulative effect of accounting change				17	(17)			
Net earnings				519		519	11	530
Other comprehensive income (loss), net of tax:								
Change in unrealized gain (loss) on securities					866	866	6	872
Change in foreign currency translation					18	18	1	19
Change in unrealized pension and other postretirement benefits					(1)	(1)		(1)
Total comprehensive income (loss)						1,402	18	1,420
Dividends on Common Stock				(60)		(60)		(60)
Shares issued:								
Exercise of stock options	1,026,891	18				18		18
Other benefit plans	207,601	3				3		3
Dividend reinvestment plan	20,847							
Stock-based compensation expense		11				11		11
Shares acquired and retired	(3,291,835)	(39)		(42)		(81)		(81)

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Shares exchanged benefit plans	(176,330)	(2)		(2)		(4)		(4)
Noncontrolling interest of acquired business							10	10
Other		2				2	(2)	
<b>Balance at December 31, 2009</b>	113,386,343	1,344		2,274	163	3,781	138	3,919
Cumulative effect of accounting change			261	4	(4)	261		261
Net earnings				479		479	(56)	423
Other comprehensive income (loss), net of tax:								
Change in unrealized gain (loss) on securities					313	313	2	315
Change in foreign currency translation					8	8		8
Total comprehensive income (loss)						800	(54)	746
Allocation of losses of managed investment entities			(64)			(64)	64	
Dividends on Common Stock				(64)		(64)		(64)
Shares issued:								
Exercise of stock options	1,547,526	31				31		31
Other benefit plans	479,514	6				6		6
Dividend reinvestment plan	17,028							
Stock-based compensation expense		12				12		12
Shares acquired and retired	(10,261,045)	(122)		(170)		(292)		(292)
Shares exchanged benefit plans	(1,000)							
Other					(1)	(1)	2	1
<b>Balance at December 31, 2010</b>	105,168,366	1,271	197	2,523	479	4,470	150	4,620



Net earnings			343			343	(23)	320
Other comprehensive income (loss), net of tax:								
Change in unrealized gain (loss) on securities					80	80	5	85
Change in foreign currency translation					(3)	(3)	1	(2)
Change in unrealized pension and other postretirement benefits					1	1		1
Total comprehensive income (loss)						421	(17)	404
Allocation of losses of managed investment entities			(24)			(24)	24	
Dividends on Common Stock					(68)	(68)		(68)
Shares issued:								
Exercise of stock options	1,576,664	38				38		38
Other benefit plans	387,746	9				9		9
Dividend reinvestment plan	15,763	1				1		1
Stock-based compensation expense		14				14		14
Shares acquired and retired	(9,281,386)	(113)	(202)			(315)		(315)
Shares exchanged benefit plans	(20,751)	(1)				(1)		(1)
Other							(11)	(11)
<b>Balance at December 31, 2011</b>	97,846,402	\$ 1,219	\$ 173	\$ 2,596	\$ 557	\$ 4,545	\$ 146	\$ 4,691

See notes to consolidated financial statements.

**Table of Contents**

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

	Year ended December 31,		
	2011	2010	2009
<b>Operating Activities:</b>			
Net earnings, including noncontrolling interests	\$ 320	\$ 423	\$ 530
Adjustments:			
Depreciation and amortization	192	214	198
Annuity benefits	510	444	435
Realized gains on investing activities	(74)	(92)	(34)
Net purchases of trading securities	(45)	(11)	(51)
Deferred annuity and life policy acquisition costs	(253)	(211)	(172)
Change in:			
Reinsurance and other receivables	(228)	555	352
Other assets	(101)	8	145
Insurance claims and reserves	134	(413)	(421)
Payable to reinsurers	155	(150)	(41)
Other liabilities	246	2	(17)
Managed investment entities assets/liabilities	(212)	89	
Other operating activities, net	23	6	(9)
Net cash provided by operating activities	667	864	915
<b>Investing Activities:</b>			
Purchases of:			
Fixed maturities	(5,321)	(4,979)	(4,855)
Equity securities	(397)	(223)	(21)
Mortgage loans	(190)	(159)	(82)
Real estate, property and equipment	(86)	(74)	(62)
Subsidiaries		(128)	(5)
Proceeds from:			
Maturities and redemptions of fixed maturities	1,974	2,081	1,934
Repayments of mortgage loans	269	71	11
Sales of fixed maturities	1,293	1,540	2,207
Sales of equity securities	198	49	127
Sales of real estate, property and equipment	3	4	1
Sale of subsidiary	9		
Managed investment entities:			
Purchases of investments	(1,563)	(1,008)	
Proceeds from sales and redemptions of investments	1,391	1,018	
Cash and cash equivalents of businesses acquired or sold, net	(5)	95	(23)
Other investing activities, net	(14)	8	(15)
Net cash used in investing activities	(2,439)	(1,705)	(783)

**Financing Activities:**

Annuity receipts	3,326	2,282	1,434
Annuity surrenders, benefits and withdrawals	(1,321)	(1,221)	(1,273)
Net transfers from (to) variable annuity assets	39	7	(10)
Additional long-term borrowings	2	159	581
Reductions of long-term debt	(20)	(39)	(785)
Issuances of managed investment entities' liabilities	394		
Retirement of managed investment entities' liabilities	(66)	(45)	
Issuances of Common Stock	39	32	15
Repurchases of Common Stock	(315)	(292)	(81)
Cash dividends paid on Common Stock	(67)	(63)	(60)
Other financing activities, net	(14)		(97)
Net cash provided by (used in) financing activities	1,997	820	(276)
<b>Net Change in Cash and Cash Equivalents</b>	<b>225</b>	<b>(21)</b>	<b>(144)</b>
Cash and cash equivalents at beginning of year	1,099	1,120	1,264
Cash and cash equivalents at end of year	\$ 1,324	\$ 1,099	\$ 1,120

See notes to consolidated financial statements.

**Table of Contents**

**AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
INDEX TO NOTES**

**A. Accounting Policies**

**B. Acquisition**

**C. Segments of Operations**

**D. Fair Value Measurements**

**E. Investments**

**F. Derivatives**

**G. Deferred Policy Acquisition Costs**

**H. Managed Investment Entities**

**I. Goodwill and Other Intangibles**

**J. Long-Term Debt**

**K. Shareholders' Equity**

**L. Income Taxes**

**M. Contingencies**

**N. Quarterly Operating Results (Unaudited)**

**O. Insurance**

**P. Additional Information**

**Q. Condensed Consolidating Information**

**A. Accounting Policies**

**Basis of Presentation** The consolidated financial statements include the accounts of American Financial Group, Inc. ( AFG ) and its subsidiaries. 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 December 31, 2011, and prior to the filing of this Form 10-K, have been evaluated for potential recognition or disclosure herein.

The preparation of the financial statements in conformity with U.S. generally accepted accounting principles ( GAAP ) 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.

**Recent Accounting Standards** In October 2010, the FASB issued Accounting Standards Update ( ASU ) 2010-26 to address diversity in practice regarding which costs related to issuing or renewing insurance contracts qualify for deferral. To qualify for deferral, the guidance specifies that a cost must be directly related to the successful acquisition of an insurance contract. The guidance is effective on January 1, 2012, with retrospective application permitted, but not required. AFG will adopt the new standard retrospectively on that date. The impact of adoption on amounts reported herein is shown in the table below (in millions, except per share data):

	December 31,	
	2011	2010
Deferred policy acquisition costs		
As reported	\$ 1,105	\$ 1,244
As adjusted	901	1,031
Net deferred tax liability (included in other liabilities)		
As reported	\$ 203	\$ 116
As adjusted	132	41
Shareholders' equity		
As reported	\$ 4,545	\$ 4,470
As adjusted	4,412	4,332

Table of Contents

**AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED**

	2011	December 31, 2010	2009
Net earnings attributable to shareholders			
As reported	\$ 343	\$ 479	\$ 519
As adjusted	342	482	521
Diluted earnings per Common Share			
As reported	\$ 3.33	\$ 4.33	\$ 4.45
As adjusted	3.32	4.36	4.46

In May 2011, the FASB issued ASU 2011-04 which clarifies the application of existing fair value measurement and amends certain disclosure requirements. The guidance is to be applied prospectively for reporting periods beginning after December 15, 2011. Early adoption is not permitted. The impact of adoption is not expected to be material to AFG's results of operations or financial position.

In June 2011, the FASB issued ASU 2011-05, which eliminates the option to report other comprehensive income in the statement of changes in equity. Instead, the guidance requires that all other comprehensive income (non-owner changes in shareholders' equity) be presented either in a single continuous statement of comprehensive income, which would contain net income and other comprehensive income sections and replace the statement of earnings, or in a separate statement of other comprehensive income immediately following the statement of earnings. AFG intends to present other comprehensive income in a separate statement. The guidance is effective January 1, 2012, with retrospective application required. The guidance relates solely to the presentation of other comprehensive income and therefore does not change the measurement of net income, other comprehensive income or earnings per share.

Accordingly, the adoption of this guidance will have no impact on AFG's results of operations or financial position.

**Fair Value Measurements** Accounting standards define fair value as the price that would be received to sell an asset or paid to transfer a liability (an exit price) in an orderly transaction between market participants on the measurement date. The standards establish a hierarchy of valuation techniques based on whether the assumptions that market participants would use in pricing the asset or liability (inputs) are observable or unobservable. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect AFG's assumptions about the assumptions market participants would use in pricing the asset or liability. Except for the acquisition discussed in *Note B Acquisition* and the impairment of goodwill discussed in *Note I Goodwill and Other Intangibles*, AFG did not have any significant nonrecurring fair value measurements of nonfinancial assets and liabilities in 2011 or 2010.

New accounting guidance adopted by AFG on January 1, 2010, requires additional disclosures about transfers between levels in the hierarchy of fair value measurements. The guidance also clarifies existing disclosure requirements related to the level of disaggregation presented and inputs used in determining fair values. Additional detail relating to the roll-forward of Level 3 fair values was required in 2011.

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

**Table of Contents**

**AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED**

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

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

In 2009, AFG adopted new accounting guidance relating to the recognition and presentation of other-than-temporary impairments. Under the guidance, if management can assert that it does not intend to sell an impaired fixed maturity security and it is not more likely than not that it will have to sell the security before recovery of its amortized cost basis, then the other-than-temporary impairment is separated into two components: 1) the amount related to credit losses (recorded in earnings) and 2) the amount related to all other factors (recorded in other comprehensive income (loss)). The credit-related portion of an other-than-temporary impairment is measured by comparing a security's amortized cost to the present value of its current expected cash flows discounted at its effective yield prior to the impairment charge. Both components are shown in the Statement of Earnings. If management intends to sell an impaired security, or it is more likely than not that it will be required to sell the security before recovery, an impairment charge to earnings is recorded to reduce the amortized cost of that security to fair value. AFG adopted this guidance effective January 1, 2009, and recorded a cumulative effect adjustment of \$17 million to reclassify the non-credit component of previously recognized impairments from retained earnings to accumulated other comprehensive income (loss). Additional disclosures required by this guidance are contained in *Note E*

*Investments.*

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

**Goodwill** Goodwill represents the excess of cost of subsidiaries over AFG's equity in their underlying net assets. Goodwill is not amortized, but is subject to an impairment test at least annually. On October 1, 2011, AFG adopted ASU 2011-08, *Intangibles - Goodwill and Other*, which simplifies the annual goodwill impairment test by only requiring an entity to complete the test on a reporting unit if the entity determines that it is more likely than not that the reporting unit's fair value is less than its carrying amount. The adoption of this guidance did not impact AFG's results of operations or financial position.

**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.

**Table of Contents**

**AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED**

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

**Deferred Policy Acquisition Costs ( DPAC )** Policy acquisition costs (principally commissions, premium taxes and other marketing and underwriting expenses) related to the production of new business are deferred. DPAC also includes capitalized costs associated with sales inducements offered to fixed annuity policyholders such as enhanced interest rates and premium and persistency bonuses. As discussed above under Recent Accounting Standards, AFG's current accounting for DPAC will change effective in 2012 and amounts included herein will be adjusted retrospectively.

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

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

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

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



**Table of Contents**

**AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED**

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

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

Because AFG has no right to use the CLO assets and no obligation to pay the CLO liabilities, the assets and liabilities of the CLOs are shown separately in AFG s Balance Sheet (at fair value). Prior to adoption of guidance requiring the consolidation of VIEs beginning in 2010, the CLOs were not consolidated. Upon adoption of the guidance, the \$261 million excess of fair value of the CLOs assets over the fair value of the liabilities was recorded in AFG s Balance Sheet as appropriated retained earnings managed investment entities, representing the cumulative effect of adopting the new guidance that ultimately will inure to the benefit of the CLO debt holders.

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

**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.

**Table of Contents**

**AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED**

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

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

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

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

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

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

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

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

**Table of Contents**

**AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED**

**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. A valuation allowance is established to reduce total deferred tax assets to an amount that will more likely than not be realized.

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

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

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

**Earnings Per Share** Basic earnings per share is calculated using the weighted average number of shares of common stock outstanding during the period. The calculation of diluted earnings per share includes the following adjustments to weighted average common shares related to stock-based compensation plans: 2011 1.6 million, 2010 1.3 million and 2009 1.1 million.

AFG's weighted average diluted shares outstanding excludes the following anti-dilutive potential common shares related to stock compensation plans: 2011 2.3 million, 2010 3.5 million and 2009 5.7 million. Adjustments to net earnings attributable to shareholders in the calculation of diluted earnings per share were nominal in the 2011, 2010 and 2009 periods.

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

**Table of Contents**

**AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED**

**B. Acquisition**

**Vanliner Group, Inc. ( Vanliner )** In July 2010, National Interstate ( NATL ), a 52%-owned subsidiary of AFG, completed the acquisition of Vanliner, a market leader in providing insurance for the moving and storage industry for \$114 million (including post-closing adjustments). The initial purchase price (funded primarily with cash on hand) was based on Vanliner's estimated tangible book value at the date of closing and is subject to certain adjustments, including a four and one-half year balance sheet guarantee whereby both favorable and unfavorable developments related to the closing balance sheet inure to the seller, UniGroup, Inc. In accordance with accounting guidance, all assets acquired and liabilities assumed were recognized at their fair values as of the acquisition date. The purchase price allocation based on these fair values resulted in a gain on purchase of \$7 million (included in realized gains on subsidiaries). Vanliner's premiums associated with policies in force as of December 31, 2011 totaled approximately \$93 million. Pro forma results of operations for AFG assuming the acquisition of Vanliner had taken place at the beginning of 2010 would not differ significantly from actual reported results.

**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 assets and costs, and the assets and operations of the managed investment entities.

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

AFG's reportable segments and their components were determined based primarily upon similar economic characteristics, products and services.

Sales of property and casualty insurance outside of the United States represented 5% of AFG's revenues in 2011, and 4% in both 2010 and 2009.

**Table of Contents**

**AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED**

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

	2011	2010	2009
<b>Assets</b>			
Property and casualty insurance (a)	\$ 11,882	\$ 11,609	\$ 11,863
Annuity and supplemental insurance	20,451	17,766	15,476
Other	3,709	3,079	344
Total assets	\$ 36,042	\$ 32,454	\$ 27,683
<b>Revenues</b>			
Property and casualty insurance:			
Premiums earned:			
Specialty			
Property and transportation	\$ 1,412	\$ 1,167	\$ 909
Specialty casualty	872	873	917
Specialty financial	408	446	517
Other	67	64	69
Total premiums earned	2,759	2,550	2,412
Investment income	296	341	414
Realized gains (losses)	97	88	123
Other income	65	64	106
Total property and casualty insurance	3,217	3,043	3,055
Annuity and supplemental insurance:			
Investment income	944	856	784
Life, accident and health premiums	430	451	444
Realized gains (losses)	(23)		(86)
Other income	104	110	114
Total annuity and supplemental insurance	1,455	1,417	1,256
Other	78	37	9
Total revenues	\$ 4,750	\$ 4,497	\$ 4,320
<b>Operating Earnings Before Income Taxes</b>			
Property and casualty insurance:			
Underwriting:			
Specialty			
Property and transportation	\$ 113	\$ 140	\$ 236
Specialty casualty	39	47	63

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Specialty financial	61	112	134
Other	18	9	(9)
Other lines (b)	(51)	(12)	(7)
Total underwriting	180	296	417
Investment and other income, net	263	299	338
Realized gains (losses)	97	88	123
Total property and casualty insurance	540	683	878
Annuity and supplemental insurance:			
Operations	224	202	162
Realized gains (losses)	(23)		(86)
Total annuity and supplemental insurance	201	202	76
Other (c)	(181)	(196)	(142)
Total operating earnings before income taxes	\$ 560	\$ 689	\$ 812

(a) Not allocable to sub-segments.

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

(c) Includes holding company expenses, a second quarter 2011 special charge of \$9 million to increase asbestos and environmental reserves and \$24 million and \$64 million in losses of managed investment entities attributable to noncontrolling interests for the years ended December 31, 2011 and 2010, respectively.

**Table of Contents**

**AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED**

**D. Fair Value Measurements**

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

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

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

**Level 3** Valuations derived from market valuation techniques generally consistent with those used to estimate the fair values of Level 2 financial instruments in which one or more significant inputs are unobservable or when the market for a security exhibits significantly less liquidity relative to markets supporting Level 2 fair value measurements. The unobservable inputs may include management's own assumptions about the assumptions market participants would use based on the best information available in the circumstances. AFG's Level 3 is comprised of financial instruments, including liabilities of managed investment entities, whose fair value is estimated based on non-binding broker quotes or internally developed using significant inputs not based on, or corroborated by, observable market information. AFG's management is responsible for the valuation process and uses data from outside sources (including nationally recognized pricing services and broker/dealers) in establishing fair value. Valuation techniques utilized by pricing services and prices obtained from external sources are reviewed by AFG's internal investment professionals who are familiar with the securities being priced and the markets in which they trade to ensure the fair value determination is representative of an exit price. To validate the appropriateness of the prices obtained, these investment managers consider widely published indices (as benchmarks), recent trades, changes in interest rates, general economic conditions and the credit quality of the specific issuers. In addition, the Company communicates directly with the pricing service regarding the methods and assumptions used in pricing, including verifying, on a test basis, the inputs used by the service to value specific securities.

**Table of Contents**

**AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED**

Assets and liabilities measured at fair value at December 31 are summarized below (in millions):

	Level 1	Level 2	Level 3	Total
2011				
Assets:				
Available for sale ( AFS ) fixed maturities:				
U.S. Government and government agencies	\$ 248	\$ 134	\$	\$ 382
States, municipalities and political subdivisions		3,794	83	3,877
Foreign government		254		254
Residential MBS		3,487	361	3,848
Commercial MBS		2,821	19	2,840
All other corporate	9	10,078	519	10,606
Total AFS fixed maturities	257	20,568	982	21,807
Trading fixed maturities		439	1	440
Equity securities	888	29	11	928
Assets of managed investment entities ( MIE )	290	2,724	44	3,058
Variable annuity assets (separate accounts) (a)		548		548
Other investments		71		71
Total assets accounted for at fair value	\$ 1,435	\$ 24,379	\$ 1,038	\$ 26,852
Liabilities:				
Liabilities of managed investment entities	\$ 194	\$	\$ 2,593	\$ 2,787
Derivatives in annuity benefits accumulated			395	395
Total liabilities accounted for at fair value	\$ 194	\$	\$ 2,988	\$ 3,182
2010				
Assets:				
Available for sale fixed maturities:				
U.S. Government and government agencies	\$ 251	\$ 216	\$	\$ 467
States, municipalities and political subdivisions		2,919	20	2,939
Foreign government		278		278
Residential MBS		3,563	312	3,875
Commercial MBS		2,117	6	2,123
All other corporate	9	9,201	436	9,646
Total AFS fixed maturities	260	18,294	774	19,328
Trading fixed maturities		390	3	393
Equity securities	461	208	21	690
Assets of managed investment entities	96	2,393	48	2,537
Variable annuity assets (separate accounts) (a)		616		616



Other investments			98		98			
Total assets accounted for at fair value	\$	817	\$	21,999	\$	846	\$	23,662
Liabilities:								
Liabilities of managed investment entities	\$	65	\$		\$	2,258	\$	2,323
Derivatives in annuity benefits accumulated						190		190
Total liabilities accounted for at fair value	\$	65	\$		\$	2,448	\$	2,513

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

During 2011 and 2010, there were no significant transfers between Level 1 and Level 2. Approximately 4% of the total assets measured at fair value on December 31, 2011, were Level 3 assets. Approximately 95% of these assets were priced using non-binding broker quotes. The fair values of the liabilities of managed investment entities were determined using non-binding broker quotes, which were reviewed by AFG's investment professionals.

**Table of Contents**

**AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED**

Changes in balances of Level 3 financial assets and liabilities during 2011, 2010 and 2009 are presented below (in millions). The transfers into and out of Level 3 were due to changes in the availability of market observable inputs. All transfers are reflected in the table at fair value as of the end of the reporting period.

	Balance at December 31, 2010	Total realized/unrealized gains (losses) included in Net income	Other comp. income (loss)	Purchases and issuances	Sales and settlements	Transfer into Level 3	Transfer out of Level 3	Balance at December 31, 2011
AFS fixed maturities:								
State and municipal	\$ 20	\$	\$ 4	\$ 58	(4)	\$ 17	\$ (12)	\$ 83
Residential MBS	312	3	(9)	42	(38)	127	(76)	361
Commercial MBS	6	1		9		13	(10)	19
All other corporate	436	2	15	236	(72)	90	(188)	519
Trading fixed maturities	3						(2)	1
Equity securities	21		1	2	(2)	2	(13)	11
Assets of MIE	48	(8)		32	(18)	9	(19)	44
Liabilities of MIE (*)	(2,258)			(401)	66			(2,593)
Embedded derivatives	(190)	(29)		(200)	24			(395)

(\*) Total realized/unrealized loss included in net income includes losses of \$3 million related to liabilities outstanding as of December 31, 2011. See *Note H Managed Investment Entities*.

	Balance at December 31, 2009	Consolidate Managed Inv. Entities	Total realized/unrealized gains (losses) included in Net income	Other comp. income (loss)	Purchases, sales, and issuances settlements	Transfer into Level 3	Transfer out of Level 3	Balance at December 31, 2010
AFS fixed maturities:								
State and municipal	\$ 23	\$	\$	\$ 1	\$ (4)	\$ 17	\$ (17)	\$ 20

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Residential MBS	435		7	26	17	27	(200)	312
Commercial MBS					6			6
All other corporate	311	(6)	(10)	10	100	118	(87)	436
Trading fixed maturities	1				4	2	(4)	3
Equity securities	25			(1)			(3)	21
Assets of MIE		90	8		(16)	26	(60)	48
Liabilities of MIE (*)		(2,084)	(220)		46			(2,258)
Embedded derivatives	(113)		(20)		(57)			(190)

(\*) Total realized/unrealized loss included in net income includes losses of \$213 million related to liabilities outstanding as of December 31, 2010. See *Note H Managed Investment Entities*.

	Balance at December 31, 2008	Net income	Total realized/unrealized gains (losses) included in Other comp. income (loss)	Purchases, sales, issuances and settlements	Net Transfer out of Level 3	Balance at December 31, 2009
AFS fixed maturities	\$ 706	\$ 7	\$ 89	\$ 292	\$ (325)	\$ 769
Trading fixed maturities	1					1
Equity securities	44	(13)	1	1	(8)	25
Other assets	5				(5)	
Embedded derivatives	(96)	(29)		12		(113)

F-17

**Table of Contents**

**AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES**  
**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 December 31.

	2011		2010	
	Carrying Value	Fair Value	Carrying Value	Fair Value
<b>Assets:</b>				
Cash and cash equivalents	\$ 1,324	\$ 1,324	\$ 1,099	\$ 1,099
Fixed maturities	22,247	22,247	19,721	19,721
Equity securities	928	928	690	690
Mortgage loans	401	401	468	469
Policy loans	252	252	264	264
Other investments derivatives	71	71	98	98
Assets of managed investment entities	3,058	3,058	2,537	2,537
Variable annuity assets (separate accounts)	548	548	616	616
<b>Liabilities:</b>				
Annuity benefits accumulated (*)	\$ 15,219	\$ 15,314	\$ 12,696	\$ 12,233
Long-term debt	934	1,010	952	1,023
Liabilities of managed investment entities	2,787	2,787	2,323	2,323
Variable annuity liabilities (separate accounts)	548	548	616	616
Other liabilities derivatives	23	23	14	14

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

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

**E. Investments**

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

	2011				2010			
	Amortized Cost	Fair Value	Gross Unrealized Gains	Unrealized Losses	Amortized Cost	Fair Value	Gross Unrealized Gains	Unrealized Losses
<b>Fixed maturities:</b>								
U.S. Government and government agencies States, municipalities and political subdivisions	\$ 363	\$ 382	\$ 19	\$	\$ 453	\$ 467	\$ 15	\$ (1)
Foreign government	3,613	3,877	267	(3)	2,927	2,939	53	(41)
Residential MBS	236	254	18		269	278	9	
Commercial MBS	3,858	3,848	170	(180)	3,781	3,875	222	(128)
	2,628	2,840	218	(6)	1,972	2,123	153	(2)

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All other corporate	9,864	10,606	802	(60)	9,088	9,646	602	(44)
Total fixed maturities	\$ 20,562	\$ 21,807	\$ 1,494	\$ (249)	\$ 18,490	\$ 19,328	\$ 1,054	\$ (216)
Common stocks	\$ 610	\$ 797	\$ 207	\$ (20)	\$ 312	\$ 543	\$ 232	\$ (1)
Perpetual preferred stocks	\$ 134	\$ 131	\$ 5	\$ (8)	\$ 146	\$ 147	\$ 6	\$ (5)

The non-credit related portion of other-than-temporary impairment charges are included in other comprehensive income (loss). Such charges taken for residential MBS still owned at December 31, 2011 and 2010, respectively, were \$227 million and \$258 million.

**Table of Contents**

**AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED**

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 December 31, 2011 and 2010.

	Less Than Twelve Months			Twelve Months or More		
	Unrealized Loss	Fair Value	Fair Value as % of Cost	Unrealized Loss	Fair Value	Fair Value as % of Cost
<b>2011</b>						
Fixed maturities:						
U.S. Government and government agencies	\$	\$ 2	100%	\$	\$	%
States, municipalities and political subdivisions	(2)	120	98%	(1)	59	98%
Foreign government		1	100%			%
Residential MBS	(59)	1,141	95%	(121)	473	80%
Commercial MBS	(6)	183	97%		18	100%
All other corporate	(43)	940	96%	(17)	114	87%
<b>Total fixed maturities</b>	<b>\$ (110)</b>	<b>\$ 2,387</b>	<b>96%</b>	<b>\$ (139)</b>	<b>\$ 664</b>	<b>83%</b>
Common stocks	\$ (19)	\$ 169	90%	\$ (1)	\$ 4	80%
Perpetual preferred stocks	\$ (1)	\$ 23	96%	\$ (7)	\$ 31	82%
<b>2010</b>						
Fixed maturities:						
U.S. Government and government agencies	\$ (1)	\$ 86	99%	\$	\$	%
States, municipalities and political subdivisions	(38)	1,180	97%	(3)	40	93%
Foreign government		37	99%			%
Residential MBS	(11)	412	97%	(117)	551	82%
Commercial MBS	(2)	83	98%		15	97%
All other corporate	(24)	1,020	98%	(20)	275	93%
<b>Total fixed maturities</b>	<b>\$ (76)</b>	<b>\$ 2,818</b>	<b>97%</b>	<b>\$ (140)</b>	<b>\$ 881</b>	<b>86%</b>
Common stocks	\$	\$ 21	99%	\$ (1)	\$ 4	88%

Perpetual preferred stocks	\$	\$	22	98%	\$	(5)	\$	37	88%
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At December 31, 2011, the gross unrealized losses on fixed maturities of \$249 million relate to approximately 850 securities. Investment grade securities (as determined by nationally recognized rating agencies) represented approximately 38% of the gross unrealized loss and 62% of the fair value.

**Gross Unrealized Losses on MBS** At December 31, 2011, gross unrealized losses on AFG's residential MBS represented 72% of the total gross unrealized loss on fixed maturity securities and 87% of the twelve months or more . Of the residential MBS that have been in an unrealized loss position (impaired) for 12 months or more (239 securities), approximately 27% of the unrealized losses and 49% of the fair value relate to investment grade rated securities. AFG analyzes its MBS for other-than-temporary impairment each quarter based upon expected future cash flows. Management estimates expected future cash flows based upon its knowledge of the MBS market, cash flow projections (which reflect loan to collateral values, subordination, vintage and geographic concentration) received from independent sources, implied cash flows inherent in security ratings and analysis of historical payment data. For 2011, AFG recorded in earnings \$52 million in other-than-temporary impairment charges related to its residential MBS.

**Gross Unrealized Losses on All Other Corporates** AFG recorded in earnings approximately \$6 million in other-than-temporary impairment charges on all other corporate securities during 2011. Management concluded that no additional charges for other-than-temporary impairments were required based on many factors, including AFG's ability and intent to hold the investments for a period of time sufficient to allow for anticipated recovery of its amortized cost, the length of time and the extent to which fair value has been below cost, analysis of historical and projected company-specific financial data, the outlook for industry sectors, and credit ratings.

**Table of Contents**

**AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED**

The following table is a progression of the credit portion of other-than-temporary impairments on fixed maturity securities for which the non-credit portion of an impairment has been recognized in other comprehensive income (loss)(in millions).

	2011	2010	2009
Balance at January 1	\$ 143	\$ 99	\$ 14
Additional credit impairments on:			
Previously impaired securities	44	44	26
Securities without prior impairments	8	9	72
Reductions disposals	(8)	(9)	(13)
Balance at December 31	\$ 187	\$ 143	\$ 99

The table below sets forth the scheduled maturities of available for sale fixed maturities as of December 31, 2011 (in millions). Asset-backed securities and other securities with sinking funds are reported at average maturity. Actual maturities may differ from contractual maturities because certain securities may be called or prepaid by the issuers. MBS had an average life of approximately 4 years at December 31, 2011.

	Amortized Cost	Fair Value Amount	%
Maturity			
One year or less	\$ 603	\$ 615	3%
After one year through five years	5,196	5,478	25
After five years through ten years	6,437	6,998	32
After ten years	1,840	2,028	9
	14,076	15,119	69
MBS	6,486	6,688	31
Total	\$ 20,562	\$ 21,807	100%

Certain risks are inherent in connection with fixed maturity securities, including loss upon default, price volatility in reaction to changes in interest rates, and general market factors and risks associated with reinvestment of proceeds due to prepayments or redemptions in a period of declining interest rates.

There were no investments in individual issuers that exceeded 10% of Shareholders' Equity at December 31, 2011 or 2010.



**Table of Contents**

**AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED**

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

	Pre-tax	Deferred Tax and Amounts Attributable to Noncontrolling Interests	Net
December 31, 2011			
Unrealized gain on:			
Fixed maturity securities	\$ 1,245	\$ (444)	\$ 801
Equity securities	184	(65)	119
Deferred policy acquisition costs	(572)	200	(372)
Annuity benefits and other liabilities	10	(3)	7
	\$ 867	\$ (312)	\$ 555
December 31, 2010			
Unrealized gain on:			
Fixed maturity securities	\$ 838	\$ (295)	\$ 543
Equity securities	232	(82)	150
Deferred policy acquisition costs	(340)	118	(222)
Annuity benefits and other liabilities	6	(2)	4
	\$ 736	\$ (261)	\$ 475

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

	Fixed Maturities	Equity Securities	Mortgage Loans and Other Investments	Other(a)	Tax Effects	Noncon- trolling Interests	Total
2011							
Realized before impairments	\$ 68	\$ 88	\$ (24)	\$ (4)	\$ (45)	\$ (2)	\$ 81
Realized impairments	(57)	(6)	(5)	16	18	1	(33)
Change in unrealized	407	(48)		(228)	(46)	(5)	80
2010							

Realized before impairments	146	36	(5)	(14)	(57)	(2)	104
Realized impairments	(79)	(1)	(6)	24	22		(40)
Change in unrealized	751	49		(316)	(169)	(2)	313
2009							
Realized before impairments	207	61	1	(23)	(82)	(5)	159
Realized impairments	(221)	(22)	(28)	68	72	1	(130)
Change in unrealized	2,005	126		(788)	(471)	(6)	866

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

**Table of Contents**

**AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED**

Realized gains (losses) on securities include net losses of less than \$1 million in 2011 and net gains of \$50 million in 2010 and \$157 million in 2009 from the mark-to-market of certain MBS, primarily interest-only securities with interest rates that float inversely with short-term rates. Gross realized gains and losses (excluding impairment writedowns and mark-to-market of derivatives) on available for sale fixed maturity and equity security investment transactions included in the Statement of Cash Flows consisted of the following (in millions):

	2011	2010	2009
Fixed maturities:			
Gross gains	\$ 77	\$ 108	\$ 92
Gross losses	(9)	(11)	(43)
Equity securities:			
Gross gains	90	35	82
Gross losses	(1)		(21)

**F. Derivatives**

As discussed under *Derivatives* in Note A, AFG uses derivatives in certain areas of its operations. AFG's derivatives do not qualify for hedge accounting under GAAP; changes in the fair value of derivatives are included in earnings.

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

Derivative	Balance Sheet Line	December 31, 2011		December 31, 2010	
		Asset	Liability	Asset	Liability
MBS with embedded derivatives	Fixed maturities	\$ 99	\$	\$ 101	\$
Interest rate swaptions	Other investments	5		21	
Indexed annuities (embedded derivative)	Annuity benefits accumulated		395		190
Equity index call options	Other investments	66		77	
Reinsurance contracts (embedded derivative)	Other liabilities		23		14
		\$ 170	\$ 418	\$ 199	\$ 204

The MBS with embedded derivatives consist primarily of interest-only MBS with interest rates that float inversely with short-term rates. AFG records the entire change in the fair value of these securities in earnings. These investments are part of AFG's overall investment strategy and represent a small component of AFG's overall investment portfolio.

AFG has entered into \$1 billion notional amount of pay-fixed interest rate swaptions (options to enter into pay-fixed/receive floating interest rate swaps at future dates expiring between 2012 and 2015) to mitigate interest rate risk in its annuity operations. AFG paid \$29 million to purchase these swaptions, which represents its maximum potential economic loss over the life of the contracts.

AFG's indexed annuities, which represented approximately one-third of annuity benefits accumulated at December 31, 2011, provide policyholders with a crediting rate tied, in part, to the performance of an existing stock market index. AFG attempts to mitigate the risk in the index-based component of these products through the purchase of call options on the appropriate index. AFG's strategy is designed so that an increase in the liabilities, due to an increase in the market index, will be generally offset by unrealized and realized gains on the call options purchased by AFG. Both the

index-based component of the annuities and the related call options are considered derivatives. As shown in the table below, both the embedded derivative and call options declined in value during 2011. The decline in fair value of the options reflects the relatively flat stock market during 2011. However, the negative impact of lower interest rates more than offset the positive impact of the flat stock market on the fair value of the indexed annuity embedded derivative.

F-22

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**Table of Contents**

**AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED**

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

The following table summarizes the gain (loss) included in the Statement of Earnings for changes in the fair value of these derivatives for 2011, 2010 and 2009 (in millions):

Derivative	Statement of Earnings Line	2011	2010	2009
MBS with embedded derivatives	Realized gains	\$	\$ 50	\$ 157
Interest rate swaptions	Realized gains	(24)	(7)	8
Indexed annuities (embedded derivative)	Annuity benefits	(29)	(20)	(29)
Equity index call options	Annuity benefits	(13)	41	26
Reinsurance contracts (embedded derivative)	Investment income	(9)	(9)	(25)
		\$ (75)	\$ 55	\$ 137

**G. Deferred Policy Acquisition Costs**

Deferred policy acquisition costs consisted of the following at December 31 (in millions):

	2011	2010
Property and casualty insurance	\$ 331	\$ 324
Annuity and supplemental insurance:		
Policy acquisition costs	995	888
Policyholder sales inducements	207	208
Present value of future profits ( PVFP )	144	164
Impact of unrealized gains and losses on securities	(572)	(340)
Total annuity and supplemental	774	920
	\$ 1,105	\$ 1,244

During 2011, 2010 and 2009, AFG capitalized \$20 million, \$33 million and \$32 million respectively, relating to sales inducements offered to annuity policyholders. Amortization of sales inducements was \$21 million, \$36 million and \$20 million in these periods, respectively.

The PVFP amounts in the table above are net of \$195 million and \$174 million of accumulated amortization at December 31, 2011 and 2010, respectively. Amortization of the PVFP was \$20 million in 2011, \$26 million in 2010 and \$29 million in 2009. During each of the next five years, the PVFP is expected to decrease at a rate of approximately one-sixth of the balance at the beginning of each respective year.

As discussed above under *Recent Accounting Standards*, AFG's current accounting for DPAC will change effective in 2012 and amounts included herein will be adjusted retrospectively. Deferred policy acquisition costs on an adjusted basis at December 31, 2011, will be \$901 million, consisting of \$189 million for the property and casualty subsidiaries and \$712 million for the annuity and supplemental subsidiaries.

**H. Managed Investment Entities**

AFG is the investment manager and has investments ranging from 7.5% to 51.1% of the most subordinate debt tranche of seven collateralized loan obligation entities or CLOs, which are considered variable interest entities. Upon formation between 2004 and 2011, these entities issued securities in various senior and subordinate classes and invested the proceeds primarily in secured bank loans, which serve as collateral for the debt securities issued by each particular CLO. None of the collateral was purchased from AFG. AFG's investments in the subordinate debt tranches of these entities receive residual income from the CLOs only after the CLOs pay operating expenses (including management fees to AFG), interest on and returns of capital to senior levels of debt securities. There are no contractual requirements for AFG to provide additional funding for these entities. AFG has not provided and does not intend to provide any financial support to these entities.

**Table of Contents**

**AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED**

AFG's maximum ultimate exposure to economic loss on its CLOs is limited to its investment in the CLOs, which had an aggregate fair value of \$98 million at December 31, 2011, and \$17 million at December 31, 2010.

In December 2011, AFG formed a new CLO, which issued \$450 million face amount of liabilities (including \$41 million face amount purchased by subsidiaries of AFG). In August 2011, AFG subsidiaries purchased \$49 million face amount of the most senior debt tranche of one of the existing CLOs for \$46 million.

In February 2012, one of the AFG CLOs was substantially liquidated at the instruction of the holder of the majority of the most subordinate debt tranche, as permitted by the CLO indentures. AFG intends to begin marketing a new CLO with a similar structure to the existing CLOs, which is expected to initially have both assets and liabilities of approximately \$410 million (similar in size to the liquidated CLO).

The revenues and expenses of the CLOs are separately identified in AFG's Statement of Earnings, after the elimination of management fees and earnings attributable to shareholders of AFG as measured by the change in the fair value of AFG's investments in the CLOs. Selected financial information related to the CLOs is shown below (in millions):

	Year ended December 31,	
	2011	2010
Gains (losses) on change in fair value of assets/liabilities (a):		
Assets	\$ (33)	\$ 150
Liabilities		(220)
Management fees paid to AFG	19	15
CLO earnings (losses) attributable to:		
AFG shareholders (b)	6	17
Noncontrolling interests (b)	(24)	(64)

(a) Included in AFG's Revenues.

(b) Included in AFG's Operating earnings before income taxes.

The aggregate unpaid principal balance of the CLOs' fixed maturity investments exceeded the fair value of the investments by \$120 million and \$69 million at December 31, 2011 and 2010. The aggregate unpaid principal balance of the CLOs' debt exceeded its fair value by \$306 million and \$301 million at those dates. The CLO assets include \$2 million and \$6 million in loans (aggregate unpaid principal balance of \$7 million and \$12 million, respectively) at December 31, 2011 and 2010 for which the CLOs are not accruing interest because the loans are in default.

**I. Goodwill and Other Intangibles**

Changes in the carrying value of goodwill during 2010 and 2011, by reporting segment, are presented in the following table (in millions):

	Property and Casualty	Annuity and Supplemental	Total
Balance January 1, 2010	\$ 152	\$ 56	\$ 208
Impairment charge		(22)	(22)
Balance December 31, 2010 and 2011	\$ 152	\$ 34	\$ 186





**Table of Contents**

**AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED**

In the third quarter of 2010, management decided to de-emphasize the sale of supplemental health insurance products through career agents, including the sale of a marketing subsidiary. As a result of this decision, AFG performed an interim impairment test of the goodwill associated with the reporting unit using an income valuation method based on discounted cash flows. Based on the results of this test, AFG recorded a goodwill impairment charge of \$22 million (included in realized gains (losses) on subsidiaries) to write off all of the goodwill related to this reporting unit. Included in other assets in AFG's Balance Sheet is \$41 million at December 31, 2011 and \$49 million at December 31, 2010 in amortizable intangible assets related to property and casualty insurance acquisitions. These amounts are net of accumulated amortization of \$47 million and \$35 million, respectively. Amortization of these intangibles was \$12 million in each of 2011 and 2010 and \$22 million in 2009. Future amortization of intangibles (weighted average amortization period of 3 years) is estimated to be \$14 million in 2012, \$13 million in each of 2013 and 2014, and less than \$1 million per year thereafter. Other assets also include \$8 million in non-amortizable intangible assets related to insurance licenses acquired in the acquisition of Vanliner in 2010.

**J. Long-Term Debt**

The carrying value of long-term debt consisted of the following at December 31 (in millions):

	2011	2010
<b>Direct obligations of AFG:</b>		
9-7/8% Senior Notes due June 2019	\$ 350	\$ 350
7% Senior Notes due September 2050	132	132
7-1/8% Senior Debentures due February 2034	115	115
Other	3	3
	600	600
<b>Subsidiaries:</b>		
Obligations of AAG Holding (guaranteed by AFG):		
7-1/2% Senior Debentures due November 2033	112	112
7-1/4% Senior Debentures due January 2034	86	86
Notes payable secured by real estate due 2012 through 2016	64	65
Secured borrowings (\$17 and \$18 guaranteed by AFG)	30	41
National Interstate bank credit facility	22	20
American Premier Underwriters 10-7/8% Subordinated Notes		8
	314	332
<b>Payable to Subsidiary Trusts:</b>		
AAG Holding Variable Rate Subordinated Debentures due May 2033	20	20
	\$ 934	\$ 952

At December 31, 2011, scheduled principal payments on debt for the subsequent five years were as follows: 2012 \$34 million, 2013 \$20 million, 2014 \$2 million, 2015 \$14 million and 2016 \$45 million.

As shown below at December 31 (in millions), the majority of AFG's long-term debt is unsecured obligations of the holding company and its subsidiaries:

	2011	2010
Unsecured obligations	\$ 840	\$ 846
Obligations secured by real estate	64	65
Other secured borrowings	30	41
	\$ 934	\$ 952

F-25

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**Table of Contents**

**AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED**

AFG can borrow up to \$500 million under its revolving credit facility which expires in August 2013. Amounts borrowed under this agreement bear interest at rates ranging from 1.75% to 3.00% (currently 2%) over LIBOR based on AFG's credit rating. No amounts were borrowed under this facility at December 31, 2011.

In May 2011, American Premier Underwriters, Inc. (American Premier) paid \$8 million to redeem its outstanding 10-7/8% Subordinated Notes at maturity. In September 2010, AFG issued \$132 million of 7% Senior Notes due in 2050.

Cash interest payments on long-term debt were \$74 million in 2011, \$68 million in 2010 and \$64 million in 2009. Interest expense in the Statement of Earnings includes interest credited on funds held by AFG's insurance subsidiaries under reinsurance contracts and other similar agreements as follows: \$10 million in 2011 and 2010 and \$7 million in 2009.

**K. Shareholders Equity**

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

**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.

At December 31, 2011, there were 12.8 million shares of AFG Common Stock reserved for issuance under AFG's stock incentive plans. Options are granted with an exercise price equal to the market price of AFG Common Stock at the date of grant. Options generally become exercisable at the rate of 20% per year commencing one year after grant; those granted to non-employee directors of AFG are fully exercisable upon grant. Options expire ten years after the date of grant. Data for stock options issued under AFG's stock incentive plans is presented below:

	Shares	Average Exercise Price	Average Remaining Contractual Term	Aggregate Intrinsic Value (in millions)
Outstanding at January 1, 2011	8,484,233	\$ 24.98		
Granted	1,122,525	\$ 34.34		
Exercised	(1,576,664)	\$ 21.14		
Forfeited/Cancelled	(107,620)	\$ 26.47		
Outstanding at December 31, 2011	7,922,474	\$ 27.05	6.0 years	\$ 78
Options exercisable at December 31, 2011	4,580,849	\$ 26.29	4.7 years	\$ 49

The total intrinsic value of options exercised during 2011, 2010 and 2009 was \$23 million, \$19 million and \$11 million, respectively. During 2011, 2010 and 2009, AFG received \$33 million, \$27 million and \$10 million, respectively, in cash from the exercise of stock options. The total tax benefit related to the exercises was \$7 million, \$6 million and \$4 million, respectively.

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 weighted average fair value of options granted during 2011, 2010 and 2009 was \$12.49 per share, \$8.90 per share and \$5.85 per share, respectively, based on the following assumptions:

	2011	2010	2009
Expected dividend yield	1.9%	2.2%	2.7%
Expected volatility	38%	39%	37%
Expected term (in years)	7.3	7.5	7.5
Risk-free rate	3.0%	3.2%	2.1%

F-26

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**Table of Contents**

**AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED**

The restricted Common Stock that AFG has granted generally vests over a three or four year period. Data relating to grants of restricted stock is presented below:

	Shares	Average Grant Date Fair Value
Outstanding at January 1, 2011	322,986	\$ 25.27
Granted	131,955	\$ 31.45
Vested	(39,819)	\$ 28.41
Outstanding at December 31, 2011	415,122	\$ 27.85

AFG issued 188,302 shares of Common Stock (fair value of \$33.99 per share) in the first quarter of 2011 under the Annual Co-CEO Equity Bonus Plan.

Total compensation expense related to stock incentive plans of AFG and its subsidiaries for 2011, 2010 and 2009 was \$22 million, \$20 million and \$13 million, respectively. Related tax benefits totaled \$7 million in 2011, \$6 million in 2010 and \$3 million in 2009. At December 31, 2011, there was \$23 million and \$8 million of unrecognized compensation expense related to nonvested stock options and restricted stock awards, respectively. These amounts are expected to be recognized over a weighted average of 3.2 and 2.4 years, respectively.

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

	Pretax Net Unrealized Gains (Losses) on Securities	Foreign Currency Translation Adjustment	Pension and Other Post- Retirement Plans Adjustment	Tax Effects	Noncon- trolling Interests	Accumulated Other Comprehensive Income (Loss)
<b>Balance at January 1, 2009</b>	\$ (1,058)	\$ (18)	\$ (11)	\$ 374	\$ 10	\$ (703)
Cumulative effect of accounting change	(27)			10		(17)
Unrealized holding gains on securities arising during the year	1,413			(490)	(9)	914
Realized gains included in net income	(70)			19	3	(48)
Foreign currency translation gains		19			(1)	18
Other			(2)	1		(1)

<b>Balance at December 31, 2009</b>	258(a)	1	(13)	(86)	3	163
Unrealized holding gains on securities arising during the year	596			(208)	(4)	384
Realized gains included in net income	(112)			39	2	(71)
Foreign currency translation gains		8				8
Other	(6)			2	(1)	(5)
<b>Balance at December 31, 2010</b>	736(a)	9	(13)	(253)		479
Unrealized holding gains on securities arising during the year	238			(84)	(7)	147
Realized gains included in net income	(105)			37	2	(66)
Unrealized gains of subsidiary sold	(2)			1		(1)
Foreign currency translation losses		(2)			(1)	(3)
Other			1			1
<b>Balance at December 31, 2011</b>	\$ 867	\$ 7	\$ (12)	\$ (299)	\$ (6)	\$ 557

(a) Includes \$25 million, \$17 million and \$98 million at December 31, 2011, 2010 and 2009 in net pretax unrealized losses (\$15 million, \$11 million and \$63 million, respectively, net of tax) related to securities for which only the credit portion of an other-than-temporary impairment has been recorded in earnings.

**Table of Contents**

**AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED**

**L. Income Taxes**

The following is a reconciliation of income taxes at the statutory rate of 35% and income taxes as shown in the Statement of Earnings (in millions):

	2011	2010	2009
Earnings before income taxes	\$ 560	\$ 689	\$ 812
Income taxes at statutory rate	\$ 196	\$ 241	\$ 284
Effect of:			
Change in valuation allowance	44	(1)	(7)
Losses of managed investment entities	9	23	
Goodwill impairment charge		8	
Subsidiaries not in AFG's tax return	5	6	8
Tax exempt interest	(23)	(16)	(10)
Other	9	5	7
Provision for income taxes as shown on the Statement of Earnings	\$ 240	\$ 266	\$ 282

Total earnings before income taxes include losses subject to tax in foreign jurisdictions of \$31 million in 2011, \$12 million in 2010 and \$71 million in 2009.

The total income tax provision (credit) consists of (in millions):

	2011	2010	2009
Current taxes:			
Federal	\$ 186	\$ 214	\$ 239
State	4	4	6
Foreign		(1)	1
Deferred taxes:			
Federal	23	63	51
Foreign	27	(14)	(15)
Provision for income taxes	\$ 240	\$ 266	\$ 282

For income tax purposes, AFG and its subsidiaries had the following carryforwards available at December 31, 2011 (in millions):

	Expiring	Amount
Operating Loss - U.S.	2012 - 2020	\$ 73
	2021 - 2025	73
Operating Loss - United Kingdom	indefinite	79

Deferred income tax assets and liabilities reflect temporary differences between the carrying amounts of assets and liabilities recognized for financial reporting purposes and the amounts recognized for tax purposes. The significant components of deferred tax assets and liabilities included in the Balance Sheet at December 31, were as follows (in millions):

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	2011	2010
Deferred tax assets:		
Federal net operating loss carryforwards	\$ 51	\$ 52
Foreign underwriting losses	42	32
Insurance claims and reserves	435	404
Employee benefits	94	93
Other, net	52	68
Total deferred tax assets before valuation allowance	674	649
Valuation allowance against deferred tax assets	(97)	(54)
Total deferred tax assets	577	595
Deferred tax liabilities:		
Subsidiaries not in AFG's tax return	(61)	(56)
Investment securities	(441)	(324)
Deferred acquisition costs	(278)	(331)
Total deferred tax liabilities	(780)	(711)
Net deferred tax liability	\$ (203)	\$ (116)

F-28

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**Table of Contents**

**AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED**

AFG's net deferred tax liability at December 31, 2011 and 2010, is included in other liabilities in AFG's Balance Sheet. The likelihood of realizing deferred tax assets is reviewed periodically; any adjustments required to the valuation allowance are made in the period during which developments requiring an adjustment become known.

Foreign underwriting losses in the table above include the net operating loss carryforward and other deferred tax assets related to the Marketform Lloyd's insurance business, which resulted primarily from underwriting losses in its run-off Italian public hospital medical malpractice business that has not been written since 2008. During the fourth quarter of 2011, AFG recorded losses in other lines written by its Lloyd's insurance business. Net operating losses can be carried forward indefinitely to offset future taxable income in the United Kingdom, and management expects these businesses to produce underwriting profits in future years. Nevertheless, because the Marketform Lloyd's insurance business is in a cumulative loss position for the last three years, and the fourth quarter 2011 losses were not limited to the run-off Italian public hospital medical malpractice business, there is uncertainty concerning the realization of the deferred tax benefits associated with the losses. Accordingly, AFG recorded a \$44 million valuation allowance against the deferred tax assets related to the Lloyd's insurance business in 2011, approximately \$34 million of which related to prior year losses. AFG will be able to reduce this valuation allowance in future periods when income is generated by the Lloyd's business.

In addition to the valuation allowance related to the Marketform Lloyd's insurance business discussed above, the gross deferred tax asset has also been reduced by a \$50 million valuation allowance related to a portion of AFG's net operating loss carryforwards ( NOL ) that is subject to the separate return limitation year ( SRLY ) tax rules. A SRLY NOL can be used only by the entity that created it and only in years that the consolidated group has taxable income. The changes in the deferred tax liabilities related to investment securities and deferred acquisition costs at year end 2011 compared to 2010 are due primarily to the increase in unrealized gains on fixed maturity securities.

A progression of the liability for uncertain tax positions, excluding interest and penalties, follows (in millions):

	2011	2010	2009
Balance at January 1	\$ 52	\$ 36	\$ 36
Additions for tax positions of current year	7	16	
Balance at December 31	\$ 59	\$ 52	\$ 36

AFG increased its liability for uncertain tax positions by \$7 million in 2011 and \$16 million in 2010, exclusive of interest, to reflect uncertainty as to the timing of tax return inclusion of income related to certain securities. Because the ultimate recognition of income with respect to these securities is highly certain, the recording of this liability resulted in an offsetting reduction in AFG's deferred tax liability. Accordingly, the ultimate resolution of this item will not impact AFG's annual effective tax rate but could accelerate the payment of taxes.

The total unrecognized tax benefits and related interest that, if recognized, would impact the effective tax rate is \$51 million at December 31, 2011. This amount does not include tax and interest totaling \$17 million paid to the IRS in 2005 and 2006 for which a suit for refund has been filed (discussed below). AFG's provision for income taxes included \$3 million in 2011 and \$2 million in both 2010 and 2009 of interest (net of federal benefit). AFG's liability for interest related to unrecognized tax benefits was \$15 million at December 31, 2011 and \$12 million at December 31, 2010 (net of federal benefit); no penalties were accrued at those dates.

**Table of Contents**

**AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED**

AFG's 2011, 2010, 2009 and 2008 tax years remain subject to examination by the IRS. In addition, AFG has several tax years for which there are ongoing disputes. AFG filed a suit for refund in the U.S. District Court in Southern Ohio as a result of its dispute with the IRS regarding the calculation of tax reserves for certain annuity reserves pursuant to Actuarial Guideline 33. In June 2010, the Court issued a final summary judgment in favor of AFG. The IRS has appealed the decision and the Sixth Circuit Court of Appeals is scheduled to hear the case in early March 2012. Ultimate resolution may require revised tax calculations for the years 1996-2005, possibly requiring a revised application of tax attribute carryovers or carrybacks, both capital and ordinary, to the affected years, and is contingent upon formal review and acceptance by the IRS. Resolution of the case could result in a decrease in the liability for unrecognized tax benefits by up to \$36 million and a decrease in related accrued interest of \$15 million. These amounts do not include tax and interest paid to the IRS in 2005 and 2006, for which the suit was filed, totaling \$17 million.

Cash payments for income taxes, net of refunds, were \$157 million, \$196 million and \$190 million for 2011, 2010 and 2009, respectively.

**M. Contingencies**

Establishing property and casualty insurance reserves for claims 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. For this group of claims, traditional actuarial techniques that rely on historical loss development trends cannot be used and a range of reasonably possible losses cannot be estimated. 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 (PCTC) and its subsidiaries, prior to its bankruptcy reorganization in 1978 and certain manufacturing operations disposed of by American Premier and GAFRI.

AFG completed a comprehensive study of asbestos and environmental exposures in the second quarter of 2011 with the assistance of outside actuarial and engineering firms and specialty outside counsel. The study resulted in asbestos and environmental charges of \$50 million for the property and casualty group and \$9 million for the former railroad and manufacturing operations.

The insurance group's liability for asbestos and environmental reserves was \$454 million at December 31, 2011; related recoverables from reinsurers (net of allowances for doubtful accounts) at that date were \$92 million.

At December 31, 2011, American Premier and its subsidiaries had liabilities for environmental and personal injury claims aggregating \$84 million. The environmental claims consist of a number of proceedings and claims seeking to impose responsibility for hazardous waste remediation costs related to certain sites formerly owned or operated by the railroad and manufacturing operations. Remediation costs are difficult to estimate for a number of reasons, including the number and financial resources of other potentially responsible parties, the range of costs for remediation alternatives, changing technology and the time period over which these matters develop. The personal injury claims include pending and expected claims, primarily by former employees of PCTC, for injury or disease allegedly caused by exposure to excessive noise, asbestos or other substances in the workplace.

At December 31, 2011, GAFRI had a liability of approximately \$8 million for environmental costs and certain other matters associated with the sales of its former manufacturing operations.

While management believes AFG has recorded adequate reserves for the items discussed in this note, the outcome is uncertain and could result in liabilities that may vary from amounts AFG has currently recorded. Such amounts could have a material effect on AFG's future results of operations and financial condition.

**Table of Contents**

**AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED**

**N. Quarterly Operating Results (Unaudited)**

The operations of certain AFG business segments are seasonal in nature. While insurance premiums are recognized on a relatively level basis, claim losses related to adverse weather (snow, hail, hurricanes, tornadoes, etc.) may be seasonal. The profitability of AFG's crop insurance business is primarily recognized during the second half of the year as crop prices and yields are determined. Quarterly results necessarily rely heavily on estimates. These estimates and certain other factors, such as the discretionary sales of assets, cause the quarterly results not to be necessarily indicative of results for longer periods of time.

The following are quarterly results of consolidated operations for the two years ended December 31, 2011 (in millions, except per share amounts). Quarterly earnings per share do not add to year-to-date amounts due to changes in shares outstanding.

	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter	Total Year
<b>2011</b>					
Revenues	\$ 1,039	\$ 1,093	\$ 1,335	\$ 1,283	\$ 4,750
Net earnings, including noncontrolling interests	49	37	107	127	320
Net earnings attributable to shareholders	83	55	96	109	343
Earnings attributable to shareholders per common share:					
Basic	\$ .80	\$ .53	\$ .96	\$ 1.11	\$ 3.39
Diluted	.79	.52	.94	1.10	3.33
Average number of Common Shares:					
Basic	104.6	102.7	99.7	98.2	101.3
Diluted	106.2	104.4	101.3	99.8	102.9
<b>2010</b>					
Revenues	\$ 1,034	\$ 1,052	\$ 1,255	\$ 1,156	\$ 4,497
Net earnings, including noncontrolling interests	88	100	126	109	423
Net earnings attributable to shareholders	106	108	132	133	479
Earnings attributable to shareholders per common share:					
Basic	\$ .94	\$ .98	\$ 1.22	\$ 1.24	\$ 4.38
Diluted	.93	.97	1.21	1.23	4.33
Average number of Common Shares:					
Basic	112.0	110.2	108.2	106.7	109.2
Diluted	113.1	111.8	109.5	108.1	110.5

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Pretax realized gains on securities (including other-than-temporary impairments) and favorable (unfavorable) prior year development of AFG's liability for losses and loss adjustment expenses ( LAE ) were as follows (in millions):

	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter	Total Year
Realized Gains on Securities					
2011	\$	\$	\$	\$	\$
2010	4	19	8	49	76
		11	57	29	101
Prior Year Development Favorable (Unfavorable)					
2011	\$	\$	\$	\$	\$
2010	21	(13)	34	27	69
	39	57	14	48	158

F-31

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**Table of Contents**

**AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED**

Unfavorable prior year development (in the table above) for the second quarter of 2011 includes pretax special charges of \$50 million to strengthen property and casualty insurance reserves for asbestos and environmental exposures. Results for the second quarter of 2011 also include pretax special charges of \$9 million to strengthen reserves for asbestos and environmental exposures related to AFG's railroad and manufacturing operations, pretax catastrophe losses of \$23 million primarily from tornadoes and pretax realized gains of \$33 million from the sales of a portion of AFG's investment in Verisk Analytics, Inc. (Verisk). The 2011 fourth quarter includes a \$34 million special charge for a valuation allowance against deferred tax assets and \$40 million of pretax realized gains on sales of Verisk.

Results for 2010 include pretax catastrophe losses of \$34 million in the second quarter, primarily from hailstorms in Oklahoma. Results for the third quarter of 2010 include a pretax gain of \$26 million from the sale of Verisk and \$39 million in adverse reserve development related to Marketform, primarily its run-off Italian public hospital medical malpractice business.

**O. Insurance**

Securities owned by U.S.-based insurance subsidiaries having a carrying value of approximately \$1.2 billion at December 31, 2011, were on deposit as required by regulatory authorities. At December 31, 2011, AFG and its subsidiaries had \$173 million in undrawn letters of credit (\$16 million of which was collateralized) supporting the underwriting capacity of its U.K.-based Lloyd's insurer.

**Property and Casualty Insurance Reserves** The liability for losses and LAE for long-term scheduled payments under certain workers' compensation insurance has been discounted at 6%, an approximation of long-term investment yields. As a result, the total liability for losses and loss adjustment expenses at December 31, 2011, has been reduced by \$30 million.

The following table provides an analysis of changes in the liability for losses and loss adjustment expenses, net of reinsurance (and grossed up), over the past three years (in millions). Favorable development in 2011 was due primarily to lower than expected severity in certain businesses within the Specialty casualty sub-segment and lower than expected frequency in crop business within the Property and transportation sub-segment, partially offset by the \$50 million special charge to increase asbestos and environmental reserves. Favorable development in 2010 was primarily in the Specialty casualty and Specialty financial sub-segments. Favorable development in 2009 was in the Specialty financial, Specialty casualty and Property and transportation sub-segments.

	2011	2010	2009
Balance at beginning of period	\$ 4,164	\$ 3,899	\$ 4,154
Provision for losses and LAE occurring in the current year	1,813	1,615	1,385
Net decrease in provision for claims of prior years	(69)	(158)	(198)
Total losses and LAE incurred	1,744	1,457	1,187
Payments for losses and LAE of:			
Current year	(652)	(360)	(504)
Prior years	(969)	(1,116)	(998)
Total payments	(1,621)	(1,476)	(1,502)
Reserves of businesses acquired		287	
Foreign currency translation and other	(5)	(3)	60
Balance at end of period	4,282	4,164	3,899

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Add back reinsurance recoverables, net of allowance	2,238	2,249	2,513
Gross unpaid losses and LAE included in the Balance Sheet	\$ 6,520	\$ 6,413	\$ 6,412

F-32

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**Table of Contents**

**AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED**

**FHLB Funding Agreements** Great American Life Insurance Company ( GALIC ), a wholly-owned annuity and supplemental insurance subsidiary, is a member of the Federal Home Loan Bank of Cincinnati ( FHLB ). The FHLB makes advances and provides other banking services to member institutions. Members are required to purchase stock in the FHLB in addition to maintaining collateral deposits that back any funds advanced. GALIC s \$22 million investment in FHLB capital stock at December 31, 2011, is included in other investments at cost. Membership in the FHLB provides the annuity and supplemental insurance operations with a substantial additional source of liquidity. During the fourth quarter of 2011, the FHLB advanced GALIC \$240 million (included in annuity benefits accumulated at December 31, 2011) under various funding agreements at interest rates ranging from .02% to .03% over LIBOR (average rate of .31% at December 31, 2011). These advances must be repaid within 5 to 7 years, but GALIC has the option to prepay all or a portion of the advances on a monthly basis. The advances on these agreements are collateralized by commercial mortgage-backed securities with a fair value of \$301 million (included in available for sale fixed maturity securities) at December 31, 2011. Interest credited on the funding agreements, which is included in annuity benefits, was approximately \$100,000 in 2011.

**Net Investment Income** The following table shows (in millions) investment income earned and investment expenses incurred by AFG s insurance group.

	2011	2010	2009
Insurance group investment income:			
Fixed maturities	\$ 1,142	\$ 1,112	\$ 1,142
Equity securities	26	11	11
Other	65	61	44
Total investment income	1,233	1,184	1,197
Insurance group investment expenses (*)	(34)	(25)	(38)
Net investment income	\$ 1,199	\$ 1,159	\$ 1,159

(\*) Included primarily in Other operating and general expenses in the Statement of Earnings.

**Statutory Information** AFG s U.S.-based insurance subsidiaries are required to file financial statements with state insurance regulatory authorities prepared on an accounting basis prescribed or permitted by such authorities (statutory basis). Net earnings (loss) and policyholders surplus on a statutory basis for the insurance subsidiaries were as follows (in millions):

	Net Earnings (Loss)			Policyholders Surplus	
	2011	2010	2009	2011	2010
Property and casualty companies	\$ 375	\$ 624	\$ 574	\$ 1,976	\$ 2,101
Life insurance companies	190	213	(76)	1,225	1,153

**Reinsurance** In the normal course of business, AFG s insurance subsidiaries cede reinsurance to other companies to diversify risk and limit maximum loss arising from large claims. To the extent that any reinsuring companies are unable to meet obligations under agreements covering reinsurance ceded, AFG s insurance subsidiaries would remain liable. The following table shows (in millions) (i) amounts deducted from property and casualty written and earned premiums in connection with reinsurance ceded, (ii) written and earned premiums included in income for reinsurance assumed and (iii) reinsurance recoveries represent ceded losses and loss adjustment expenses.





**Table of Contents**

**AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED**

	2011	2010	2009
Direct premiums written	\$ 4,061	\$ 3,542	\$ 3,731
Reinsurance assumed	45	47	32
Reinsurance ceded	(1,336)	(1,181)	(1,452)
 Net written premiums	 \$ 2,770	 \$ 2,408	 \$ 2,311
 Direct premiums earned	 \$ 4,062	 \$ 3,653	 \$ 3,854
Reinsurance assumed	41	45	32
Reinsurance ceded	(1,344)	(1,148)	(1,474)
 Net earned premiums	 \$ 2,759	 \$ 2,550	 \$ 2,412
 Reinsurance recoveries	 \$ 770	 \$ 395	 \$ 898

AFG has reinsured approximately \$16 billion in face amount of life insurance at December 31, 2011 and \$18 billion at December 31, 2010. Life written premiums ceded were \$44 million, \$49 million and \$54 million for 2011, 2010 and 2009, respectively.

**Variable Annuities** At December 31, 2011, the aggregate guaranteed minimum death benefit value (assuming every variable annuity policyholder died on that date) on AFG's variable annuity policies exceeded the fair value of the underlying variable annuities by \$63 million, compared to \$52 million at December 31, 2010. Death benefits paid in excess of the variable annuity account balances were less than \$1 million in each of the last three years.

**P. Additional Information**

Losses and loss adjustment expenses included charges for possible losses on reinsurance recoverables of less than \$1 million in 2011, 2010 and 2009. The aggregate allowance for losses on reinsurance recoverables amounted to approximately \$26 million and \$28 million at December 31, 2011 and 2010.

**Operating Leases** Total rental expense for various leases of office space and equipment was \$54 million in 2011 and \$42 million in each of 2010 and 2009. Future minimum rentals, related principally to office space, required under operating leases having initial or remaining noncancelable lease terms in excess of one year at December 31, 2011, were as follows: 2012 \$52 million; 2013 \$49 million; 2014 \$44 million; 2015 \$37 million; 2016 \$33 million; and \$197 million thereafter.

**Financial Instruments with Off-Balance-Sheet Risk** On occasion, AFG and its subsidiaries have entered into financial instrument transactions that may present off-balance-sheet risks of both a credit and market risk nature. These transactions include commitments to fund loans, loan guarantees and commitments to purchase and sell securities or loans. At December 31, 2011, AFG and its subsidiaries had commitments to fund credit facilities and contribute limited partnership capital totaling up to \$25 million.

**Restrictions on Transfer of Funds and Assets of Subsidiaries** Payments of dividends, loans and advances by AFG's subsidiaries are subject to various state laws, federal regulations and debt covenants that limit the amount of dividends, loans and advances that can be paid. Under applicable restrictions, the maximum amount of dividends available to AFG in 2012 from its insurance subsidiaries without seeking regulatory clearance is \$546 million. Additional amounts of dividends, loans and advances require regulatory approval.

**Benefit Plans** AFG expensed approximately \$26 million in 2011, \$30 million in 2010 and \$34 million in 2009 for its retirement and employee savings plans.

**Table of Contents**

**AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED**

**Q. Condensed Consolidating Information**

AFG has guaranteed all of the outstanding public 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)

	AFG	GAFRI	AAG Holding	All Other Subs	Consol. Entries	Consolidated
<b>DECEMBER 31, 2011</b>						
<b>Assets:</b>						
Cash and investments	\$ 456	\$ 32	\$	\$ 25,090	\$ (1)	\$ 25,577
Recoverables from reinsurers and prepaid reinsurance premiums				3,351		3,351
Agents' balances and premiums receivable				565		565
Deferred policy acquisition costs				1,105		1,105
Assets of managed investment entities				3,058		3,058
Other assets	105	5	5	2,309	(38)	2,386
Investment in subsidiaries and affiliates	4,866	2,055	2,146	643	(9,710)	
<b>Total assets</b>	<b>\$ 5,427</b>	<b>\$ 2,092</b>	<b>\$ 2,151</b>	<b>\$ 36,121</b>	<b>\$ (9,749)</b>	<b>\$ 36,042</b>
<b>Liabilities and Equity:</b>						
Unpaid losses and loss adjustment expenses and unearned premiums	\$	\$	\$	\$ 8,004	\$	\$ 8,004
Annuity, life, accident and health benefits and reserves				17,148	(1)	17,147
Liabilities of managed investment entities				2,787		2,787
Long-term debt	600		220	115	(1)	934
Other liabilities	282	20	109	2,266	(198)	2,479
<b>Total liabilities</b>	<b>882</b>	<b>20</b>	<b>329</b>	<b>30,320</b>	<b>(200)</b>	<b>31,351</b>
<b>Total shareholders' equity</b>	<b>4,545</b>	<b>2,072</b>	<b>1,822</b>	<b>5,655</b>	<b>(9,549)</b>	<b>4,545</b>
<b>Noncontrolling interests</b>				<b>146</b>		<b>146</b>

Total liabilities and equity	\$ 5,427	\$ 2,092	\$ 2,151	\$ 36,121	\$ (9,749)	\$ 36,042
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**DECEMBER 31, 2010****Assets:**

Cash and investments	\$ 412	\$ 33	\$	\$ 22,228	\$ (3)	\$ 22,670
Recoverables from reinsurers and prepaid reinsurance premiums				3,386		3,386
Agents' balances and premiums receivable				535		535
Deferred policy acquisition costs				1,244		1,244
Assets of managed investment entities				2,537		2,537
Other assets	36	6	5	2,050	(15)	2,082
Investment in subsidiaries and affiliates	4,816	1,899	1,996	671	(9,382)	
<b>Total assets</b>	<b>\$ 5,264</b>	<b>\$ 1,938</b>	<b>\$ 2,001</b>	<b>\$ 32,651</b>	<b>\$ (9,400)</b>	<b>\$ 32,454</b>

**Liabilities and Equity:**

Unpaid losses and loss adjustment expenses and unearned premiums	\$	\$	\$	\$ 7,947	\$	\$ 7,947
Annuity, life, accident and health benefits and reserves				14,556	(1)	14,555
Liabilities of managed investment entities				2,323		2,323
Long-term debt	600	1	219	133	(1)	952
Other liabilities	194	19	110	1,888	(154)	2,057
<b>Total liabilities</b>	<b>794</b>	<b>20</b>	<b>329</b>	<b>26,847</b>	<b>(156)</b>	<b>27,834</b>
<b>Total shareholders' equity</b>	<b>4,470</b>	<b>1,918</b>	<b>1,672</b>	<b>5,654</b>	<b>(9,244)</b>	<b>4,470</b>
Noncontrolling interests				150		150
<b>Total liabilities and equity</b>	<b>\$ 5,264</b>	<b>\$ 1,938</b>	<b>\$ 2,001</b>	<b>\$ 32,651</b>	<b>\$ (9,400)</b>	<b>\$ 32,454</b>

**Table of Contents**

**AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED**  
**CONDENSED CONSOLIDATING STATEMENT OF EARNINGS**

(In millions)

	AFG	GAFRI	AAG Holding	All Other Subs	Consol. Entries	Consolidated
<b>FOR THE YEAR ENDED</b>						
<b>DECEMBER 31, 2011</b>						
<b>Revenues:</b>						
Property and casualty insurance premiums	\$	\$	\$	\$ 2,759	\$	\$ 2,759
Life, accident and health premiums				430		430
Realized gains (losses)		(1)		75	(1)	73
Income of managed investment entities				72		72
Investment and other income	2	11		1,430	(27)	1,416
Equity in earnings of subsidiaries	710	189	216		(1,115)	
Total revenues	712	199	216	4,766	(1,143)	4,750
<b>Costs and Expenses:</b>						
Insurance benefits and expenses				3,671		3,671
Interest charges on borrowed money	64		25	16	(20)	85
Expenses of managed investment entities				71		71
Other operating and general expenses	65	15	5	284	(6)	363
Total costs and expenses	129	15	30	4,042	(26)	4,190
Operating earnings before income taxes	583	184	186	724	(1,117)	560
Provision (credit) for income taxes	240	62	64	283	(409)	240
Net earnings, including noncontrolling interests	343	122	122	441	(708)	320
Less: Net earnings (loss) attributable to noncontrolling interests				(23)		(23)

<b>Net Earnings Attributable to Shareholders</b>	\$	343	\$	122	\$	122	\$	464	\$	(708)	\$	343
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**FOR THE YEAR ENDED  
DECEMBER 31, 2010**

**Revenues:**

Property and casualty insurance premiums	\$		\$		\$		\$	2,550	\$		\$	2,550
Life, accident and health premiums								451				451
Realized gains (losses)				(2)				90				88
Income of managed investment entities								23				23
Investment and other income		4		11				1,392		(22)		1,385
Equity in earnings of subsidiaries		850		195		242				(1,287)		
<b>Total revenues</b>		<b>854</b>		<b>204</b>		<b>242</b>		<b>4,506</b>		<b>(1,309)</b>		<b>4,497</b>

**Costs and Expenses:**

Insurance benefits and expenses								3,297				3,297
Interest charges on borrowed money		58				25		17		(22)		78
Expenses of managed investment entities								55				55
Other operating and general expenses		51		16		5		306				378
<b>Total costs and expenses</b>		<b>109</b>		<b>16</b>		<b>30</b>		<b>3,675</b>		<b>(22)</b>		<b>3,808</b>

Operating earnings before income taxes		745		188		212		831		(1,287)		689
Provision (credit) for income taxes		266		72		72		314		(458)		266
Net earnings, including noncontrolling interests		479		116		140		517		(829)		423
Less: Net earnings (loss) attributable to noncontrolling interests								(56)				(56)

<b>Net Earnings Attributable to Shareholders</b>	\$	479	\$	116	\$	140	\$	573	\$	(829)	\$	479
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**Table of Contents**

**AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED**  
**CONDENSED CONSOLIDATING STATEMENT OF EARNINGS**

(In millions)

	AFG	GAFRI	AAG Holding	All Other Subs	Consol. Entries	Consolidated
<b>FOR THE YEAR ENDED DECEMBER 31, 2009</b>						
<b>Revenues:</b>						
Property and casualty insurance premiums	\$	\$	\$	\$ 2,412	\$	\$ 2,412
Life, accident and health premiums				444		444
Realized gains (losses)		(7)		44	1	38
Investment and other income	2	10		1,437	(23)	1,426
Equity in earnings of subsidiaries	896	73	115		(1,084)	
Total revenues	898	76	115	4,337	(1,106)	4,320
<b>Costs and Expenses:</b>						
Insurance benefits and expenses				2,978		2,978
Interest charges on borrowed money	50		25	15	(23)	67
Other operating and general expenses	47	20	6	391	(1)	463
Total costs and expenses	97	20	31	3,384	(24)	3,508
Operating earnings before income taxes	801	56	84	953	(1,082)	812
Provision (credit) for income taxes	282	17	26	327	(370)	282
Net earnings, including noncontrolling interests	519	39	58	626	(712)	530
Less: Net earnings (loss) attributable to noncontrolling interests				11		11
<b>Net Earnings Attributable to Shareholders</b>	\$ 519	\$ 39	\$ 58	\$ 615	\$ (712)	\$ 519





**Table of Contents**

**AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED**  
**CONDENSED CONSOLIDATING STATEMENT OF CASH FLOWS**

(In millions)

	AFG	GAFRI	AAG Holding	All Other Subs	Consol. Entries	Consolidated
<b>FOR THE YEAR ENDED</b>						
<b>DECEMBER 31, 2011</b>						
<b>Operating Activities:</b>						
Net earnings, including noncontrolling interests	\$ 343	\$ 122	\$ 122	\$ 441	\$ (708)	\$ 320
Adjustments:						
Equity in net earnings of subsidiaries	(440)	(124)	(142)		706	
Dividends from subsidiaries	542	3	38		(583)	
Other operating activities, net	17	(1)	2	327	2	347
Net cash provided by (used in) operating activities	462		20	768	(583)	667
<b>Investing Activities:</b>						
Purchases of investments, property and equipment	(54)			(5,940)		(5,994)
Returns of capital from (capital contributions to) subsidiaries	(27)	14	(1)		14	
Proceeds from maturities and redemptions of investments	4	9		2,230		2,243
Proceeds from sales of investments, property and equipment	5			1,489		1,494
Managed investment entities:						
Purchases of investments				(1,563)		(1,563)
Proceeds from sales and redemptions of investments				1,391		1,391
Other investing activities, net				(10)		(10)
Net cash provided by (used in) investing activities	(72)	23	(1)	(2,403)	14	(2,439)
<b>Financing Activities:</b>						
Annuity receipts				3,326		3,326
Annuity surrenders, benefits and withdrawals				(1,321)		(1,321)
Net transfers from (to) variable annuity assets				39		39

Additional long-term borrowings				2		2
Reductions of long-term debt				(20)		(20)
Issuances of managed investment entities' liabilities				394		394
Retirement of managed investment entities' liabilities				(66)		(66)
Issuances of Common Stock	37			2		39
Capital contributions from (returns of capital to) parent		16	(19)	(143)	146	
Repurchases of Common Stock	(315)					(315)
Cash dividends paid	(67)	(40)		(383)	423	(67)
Other financing activities, net				(14)		(14)
Net cash provided by (used in) financing activities	(345)	(24)	(19)	1,816	569	1,997
<b>Net change in cash and cash equivalents</b>	45	(1)		181		225
Cash and cash equivalents at beginning of year	370	20		709		1,099
Cash and cash equivalents at end of year	\$ 415	\$ 19	\$	\$ 890	\$	\$ 1,324

**Table of Contents**

**AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED**  
**CONDENSED CONSOLIDATING STATEMENT OF CASH FLOWS**  
(In millions)

	AFG	GAFRI	AAG Holding	All Other Subs	Consol. Entries	Consolidated
<b>FOR THE YEAR ENDED</b>						
<b>DECEMBER 31, 2010</b>						
<b>Operating Activities:</b>						
Net earnings, including noncontrolling interests	\$ 479	\$ 116	\$ 140	\$ 517	\$ (829)	\$ 423
Adjustments:						
Equity in net earnings of subsidiaries	(548)	(121)	(159)		828	
Dividends from subsidiaries	550		16		(566)	
Other operating activities, net		(2)	1	441	1	441
Net cash provided by (used in) operating activities	481	(7)	(2)	958	(566)	864
<b>Investing Activities:</b>						
Purchases of investments, property and equipment	(13)	(5)		(5,417)		(5,435)
Purchase of subsidiaries				(128)		(128)
Capital contributions to subsidiaries	(97)	(7)	(5)		109	
Proceeds from maturities and redemptions of investments		11		2,141		2,152
Proceeds from sales of investments, property and equipment				1,593		1,593
Managed investment entities:						
Purchases of investments				(1,008)		(1,008)
Proceeds from sales and redemptions of investments				1,018		1,018
Other investing activities, net				103		103
Net cash provided by (used in) investing activities	(110)	(1)	(5)	(1,698)	109	(1,705)
<b>Financing Activities:</b>						
Annuity receipts				2,282		2,282
Annuity surrenders, benefits and withdrawals				(1,221)		(1,221)
				7		7

Net transfers from (to) variable annuity assets						
Additional long-term borrowings	128			31		159
Reductions of long-term debt				(39)		(39)
Retirement of managed investment entities liabilities				(45)		(45)
Issuances of Common Stock	31			1		32
Capital contributions from parent		16	7	86	(109)	
Repurchases of Common Stock	(292)					(292)
Cash dividends paid	(63)			(566)	566	(63)
Other financing activities, net	(2)			2		
Net cash provided by (used in) financing activities	(198)	16	7	538	457	820
<b>Net change in cash and cash equivalents</b>	173	8		(202)		(21)
Cash and cash equivalents at beginning of year	197	12		911		1,120
Cash and cash equivalents at end of year	\$ 370	\$ 20	\$	\$ 709	\$	\$ 1,099

**Table of Contents**

**AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED**  
**CONDENSED CONSOLIDATING STATEMENT OF CASH FLOWS**  
(In millions)

	AFG	GAFRI	AAG Holding	All Other Subs	Consol. Entries	Consolidated
<b>FOR THE YEAR ENDED DECEMBER 31, 2009</b>						
<b>Operating Activities:</b>						
Net earnings, including noncontrolling interests	\$ 519	\$ 39	\$ 58	\$ 626	\$ (712)	\$ 530
Adjustments:						
Equity in net earnings of subsidiaries	(583)	(51)	(79)		713	
Dividends from subsidiaries	636	3			(639)	
Other operating activities, net	14	4	(3)	371	(1)	385
Net cash provided by (used in) operating activities	586	(5)	(24)	997	(639)	915
<b>Investing Activities:</b>						
Purchases of investments, property and equipment	(14)	(15)		(4,991)		(5,020)
Purchase of subsidiaries				(5)		(5)
Capital contributions to subsidiaries	(170)	(141)	(116)		427	
Proceeds from maturities and redemptions of investments	1	2		1,942		1,945
Proceeds from sales of investments, property and equipment	15	1		2,319		2,335
Other investing activities, net				(38)		(38)
Net cash provided by (used in) investing activities	(168)	(153)	(116)	(773)	427	(783)
<b>Financing Activities:</b>						
Annuity receipts				1,434		1,434
Annuity surrenders, benefits and withdrawals				(1,273)		(1,273)
Net transfers from (to) variable annuity assets				(10)		(10)
Additional long-term borrowings	522			59		581
Reductions of long-term debt	(776)			(9)		(785)

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Issuances of Common Stock	14			1		15
Capital contributions from parent		168	140	119	(427)	
Repurchases of Common Stock	(81)					(81)
Cash dividends paid	(60)			(639)	639	(60)
Other financing activities, net				(97)		(97)
Net cash provided by (used in) financing activities	(381)	168	140	(415)	212	(276)
<b>Net change in cash and cash equivalents</b>	37	10		(191)		(144)
Cash and cash equivalents at beginning of year	160	2		1,102		1,264
Cash and cash equivalents at end of year	\$ 197	\$ 12	\$	\$ 911	\$	\$ 1,120

F-40

**Table of Contents**

**PART III**

The information required by the following Items will be included in AFG's definitive Proxy Statement for the 2012 Annual Meeting of Shareholders which will be filed with the Securities and Exchange Commission within 120 days after the end of the Registrant's fiscal year and is incorporated herein by reference.

**ITEM 10 Directors, Executive Officers of the Registrant and Corporate Governance**

**ITEM 11 Executive Compensation**

**ITEM 12 Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters**

**ITEM 13 Certain Relationships and Related Transactions, and Director Independence**

**ITEM 14 Principal Accountant Fees and Services**

**PART IV**

**ITEM 15**

**Exhibits and Financial Statement Schedules**

(a) Documents filed as part of this Report:

1. Financial Statements are included in Part II, Item 8.
2. Financial Statement Schedules:
  - A. Selected Quarterly Financial Data is included in Note N to the Consolidated Financial Statements.
  - B. Schedules filed herewith for 2011, 2010 and 2009:

I	Condensed Financial Information of Registrant	Page S-2
V	Supplemental Information Concerning Property-Casualty Insurance Operations	S-4

All other schedules for which provisions are made in the applicable regulation of the Securities and Exchange Commission have been omitted as they are not applicable, not required, or the information required thereby is set forth in the Financial Statements or the notes thereto.

3. Exhibits see Exhibit Index on page E-1.



**Table of Contents**

Schedule

SCHEDULE I CONDENSED FINANCIAL INFORMATION OF REGISTRANT

**AMERICAN FINANCIAL GROUP, INC. PARENT ONLY**

SCHEDULE I CONDENSED FINANCIAL INFORMATION OF REGISTRANT

(In Millions)

**Condensed Balance Sheet**

	December 31	
	2011	2010
<b>Assets:</b>		
Cash and investments	\$ 456	\$ 412
Investment in subsidiaries (a)	4,866	4,816
Other assets	105	36
Total assets	\$ 5,427	\$ 5,264
<b>Liabilities and Equity:</b>		
Long-term debt	\$ 600	\$ 600
Other liabilities	282	194
Shareholders' equity	4,545	4,470
Total liabilities and equity	\$ 5,427	\$ 5,264

**Condensed Statement of Earnings**

	Year ended December 31,		
	2011	2010	2009
<b>Revenues:</b>			
Dividends from subsidiaries	\$ 544	\$ 554	\$ 673
Equity in undistributed earnings of subsidiaries	166	296	223
Investment and other income (b)	2	4	2
Total revenues	712	854	898
<b>Costs and Expenses:</b>			
Interest charges on intercompany borrowings	11	12	13
Interest charges on other borrowings	53	46	37
Other operating and general expenses	65	51	47
Total costs and expenses	129	109	97
Operating earnings before income taxes	583	745	801
Provision for income taxes	240	266	282
<b>Net Earnings Attributable to Shareholders</b>	<b>\$ 343</b>	<b>\$ 479</b>	<b>\$ 519</b>

- (a) Investment in subsidiaries includes intercompany receivables and payables.
- (b) Includes mark-to-market adjustments on trading securities.

S-2

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**Table of Contents**

**AMERICAN FINANCIAL GROUP, INC. PARENT ONLY**  
**SCHEDULE I CONDENSED FINANCIAL INFORMATION OF REGISTRANT CONTINUED**  
(In Millions)

**Condensed Statement of Cash Flows**

	Year ended December 31,		
	2011	2010	2009
<b>Operating Activities:</b>			
Net earnings attributable to shareholders	\$ 343	\$ 479	\$ 519
Adjustments:			
Equity in net earnings of subsidiaries	(440)	(548)	(583)
Dividends from subsidiaries	542	550	636
Other operating activities, net	17		14
Net cash provided by operating activities	462	481	586
<b>Investing Activities:</b>			
Purchases of investments, property and equipment	(54)	(13)	(14)
Net capital contributions to subsidiaries	(27)	(97)	(170)
Proceeds from maturities and redemptions of investments	4		1
Proceeds from sales of investments, property and equipment	5		15
Other investing activities, net			
Net cash used in investing activities	(72)	(110)	(168)
<b>Financing Activities:</b>			
Additional long-term borrowings		128	522
Reductions of long-term debt			(776)
Issuances of Common Stock	37	31	14
Repurchases of Common Stock	(315)	(292)	(81)
Cash dividends paid on Common Stock	(67)	(63)	(60)
Other financing activities, net		(2)	
Net cash provided by (used in) financing activities	(345)	(198)	(381)
<b>Net change in cash and cash equivalents</b>	<b>45</b>	<b>173</b>	<b>37</b>
Cash and cash equivalents at beginning of year	370	197	160
Cash and cash equivalents at end of year	\$ 415	\$ 370	\$ 197

**Table of Contents**

SCHEDULE V SUPPLEMENTAL INFORMATION CONCERNING  
**AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES**  
 SCHEDULE V SUPPLEMENTAL INFORMATION CONCERNING  
**PROPERTY-CASUALTY INSURANCE OPERATIONS**  
**THREE YEARS ENDED DECEMBER 31, 2011**  
**(IN MILLIONS)**

COLUMN A	COLUMN B	COLUMN C	COLUMN D	COLUMN E	COLUMN F	COLUMN G	COLUMN H	COLUMN I	COLUMN J	COLUMN K
	(a)									
	RESERVES FOR UNPAID DEFERRED CLAIMS (b)						CLAIMS AND CLAIM MORTIZATION AND ADJUSTMENT OF EXPENSES DEFERRED CLAIMS INCURRED RELATED AND			
AFFILIATION	POLICY CLAIMS DEDUCTED	DISCOUNT (c)				NET	TO	POLICY CLAIM		
WITH REGISTRANT	ACQUISITION COSTS	ADJUSTMENT EXPENSES	UNEARNED PREMIUMS	ESTIMATED CURRENT YEAR PREMIUMS	PREVIOUS YEAR PREMIUMS	ACQUISITION COSTS	ADJUSTMENT EXPENSES	UNEARNED PREMIUMS	ESTIMATED CURRENT YEAR PREMIUMS	PREVIOUS YEAR PREMIUMS
CONSOLIDATED PROPERTY-CASUALTY ENTITIES										
2011	\$ 331	\$ 6,520	\$ 30	\$ 1,484	\$ 2,759	\$ 269	\$ 1,813	\$ (69)	\$ 682	\$ 1,621 \$ 2,770
2010	\$ 324	\$ 6,413	\$ 32	\$ 1,534	\$ 2,550	\$ 317	\$ 1,615	\$ (158)	\$ 637	\$ 1,476 \$ 2,408
2009						\$ 2,412	\$ 394	\$ 1,385	\$ (198)	\$ 649 \$ 1,502 \$ 2,311

- (a) Grossed up for reinsurance recoverables of \$2,238 and \$2,249 at December 31, 2011 and 2010, respectively.
- (b) Discounted at approximately 6%.
- (c) Grossed up for prepaid reinsurance premiums of \$409 and \$422 at December 31, 2011 and 2010, respectively.

**Table of Contents**

**Signatures**

Pursuant to the requirements of Section 13 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.

Signed: February 28, 2012

BY: /s/ CARL H. LINDNER III

Carl H. Lindner III  
Co-Chief Executive Officer

BY: /s/ S. CRAIG LINDNER

S. Craig Lindner  
Co-Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this Report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated:

Signature	Capacity	Date
/s/ CARL H. LINDNER III Carl H. Lindner III	Director	February 28, 2012
/s/ S. CRAIG LINDNER S. Craig Lindner	Director	February 28, 2012
/s/ THEODORE H. EMMERICH Theodore H. Emmerich	Director*	February 28, 2012
/s/ JAMES E. EVANS James E. Evans	Director	February 28, 2012
/s/ TERRY S. JACOBS Terry S. Jacobs	Director*	February 28, 2012
/s/ GREGORY G. JOSEPH Gregory G. Joseph	Director*	February 28, 2012
/s/ KENNETH C. AMBRECHT Kenneth C. Ambrecht	Director	February 28, 2012
/s/ WILLIAM W. VERITY William W. Verity	Director	

William W. Verity		February 28, 2012
/s/ JOHN I. VON LEHMAN	Director*	February 28, 2012
John I. Von Lehman		
/s/ KEITH A. JENSEN	Senior Vice President (principal financial and accounting officer)	February 28, 2012
Keith A. Jensen		
* Member of the Audit Committee		

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**Table of Contents**

**INDEX TO EXHIBITS  
AMERICAN FINANCIAL GROUP, INC.**

Number	Exhibit Description	
3(a)	Amended and Restated Articles of Incorporation, filed as Exhibit 3(a) to AFG's Form 10-K for 1997.	(*)
3(b)	Amended and Restated Code of Regulations, filed as Exhibit 3 to AFG's Form 8-K filed on December 11, 2008.	(*)
4	Instruments defining the rights of security holders.	Registrant has no outstanding debt issues exceeding 10% of the assets of Registrant and consolidated subsidiaries
	Material Contracts:	
10(a)	Amended and Restated Directors' Compensation Plan, filed as Exhibit 10(a) to AFG's Form 10-K for 2009.	(*)
10(b)	Amended and Restated Deferred Compensation Plan, filed as Exhibit 10(b) to AFG's Form 10-K for 2008.	(*)
10(c)	2011 Co-CEO Equity Bonus Plan, filed as Annex A to AFG's Proxy statement filed on March 30, 2011.	(*)
10(d)	2011 Annual Senior Executive Bonus Plan, filed as Annex B to AFG's Proxy statement filed on March 30, 2011.	(*)
10(e)	Amended and restated Nonqualified Auxiliary RASP, filed as Exhibit 10(f) to AFG's Form 10-K for 2008.	(*)
10(f)	2005 Stock Incentive Plan included in AFG's 2005 Proxy, filed on April 15, 2005.	(*)
10(g)	Credit Agreement, dated March 29, 2006 among American Financial Group, Inc. and AAG Holding Company, Inc., each as Borrowers, and several lenders, filed as Exhibit 10.2 to AFG's Form 8-K filed on March 30, 2006.	(*)
10(h)	Amendment to Credit Agreement dated March 29, 2006, among American Financial Group, Inc., AAG Holding Company, Inc., each as borrowers, and several lenders, filed as Exhibit 10(i) to AFG's Form 10-K for 2007.	(*)
10(i)		(*)

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Credit Agreement dated August 2, 2010, among American Financial Group, Inc., Bank of America, N.A., as Administrative Agent, and several lenders, filed as Exhibit 99.2 to AFG's Form 8-K filed on August 3, 2010.

(\*) Incorporated herein by reference.

E-1

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**Table of Contents**

**INDEX TO EXHIBITS CONTINUED  
AMERICAN FINANCIAL GROUP, INC.**

Number	Exhibit Description
12	Computation of ratios of earnings to fixed charges.
21	Subsidiaries of the Registrant.
23	Consent of independent registered public accounting firm.
31(a)	Certification of Co-Chief Executive Officer pursuant to Section 302(a) of the Sarbanes-Oxley Act of 2002.
31(b)	Certification of Co-Chief Executive Officer pursuant to Section 302(a) of the Sarbanes-Oxley Act of 2002.
31(c)	Certification of Chief Financial Officer pursuant to Section 302(a) of the Sarbanes-Oxley Act of 2002.
32	Certification of Co-Chief Executive Officers and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101	The following financial information from American Financial Group's Form 10-K for the year ended December 31, 2011, formatted in XBRL (Extensible Business Reporting Language):  (i) Consolidated Balance Sheet  (ii) Consolidated Statement of Earnings  (iii) Consolidated Statement of Changes in Equity  (iv) Consolidated Statement of Cash Flows  (v) Notes to Consolidated Financial Statements  (vi) Financial Statement Schedules