

AMERICAN FINANCIAL GROUP INC  
Form 10-K  
March 01, 2007

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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, 2006

Commission File No. 1-13653

AMERICAN FINANCIAL GROUP

**, INC.**

Incorporated under the Laws of Ohio

IRS Employer I.D. No. 31-1544320

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

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

| <u>Title of Each Class</u>                     | <u>Name of Each Exchange on Which Registered</u>        |
|--|---|
| Common Stock                                   | New York Stock Exchange and Nasdaq Global Select Market |
| 7-1/8% Senior Debentures due December 15, 2007 | New York Stock Exchange                                 |
| 7-1/8% Senior Debentures due April 15, 2009    | New York Stock Exchange                                 |
| 7-1/8% Senior Debentures due February 3, 2034  | 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:

None

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

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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. [X]

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

Large Accelerated Filer  Accelerated Filer  Non-Accelerated Filer

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: \$2.4 billion.

Indicate the number of shares outstanding of each of the Registrant's classes of common stock, as of the latest practicable date: 119,415,711 shares (excluding 14,930,088 shares owned by a subsidiary) as of February 1, 2007.

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Documents Incorporated by Reference:

Proxy Statement for 2007 Annual Meeting of Stockholders (portions of which are incorporated by reference into Part III hereof).

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AMERICAN FINANCIAL GROUP, INC.

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## FORWARD-LOOKING STATEMENTS

This Form 10-K, chiefly in Items 1, 3, 5, 7 and 8, contains 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", "estimates", "intends", "plans", "seeks", "could", "may", "should", "will" or the negative version of those words or other comparable terminology. Such forward-looking statements include statements relating to: expectations concerning market and other conditions and their effect on future premiums, revenues, earnings and investment activities; recoverability of asset values; expected losses and the adequacy of reserves for asbestos, environmental pollution and mass tort claims; rate increases; and improved loss experience.

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

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

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

## PART I

## ITEM 1

Business

Please refer to "Forward-Looking Statements" following the Index in front of this Form 10-K.

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, indexed and variable annuities and a variety of supplemental insurance products. AFG was incorporated as an Ohio corporation in 1997. Its address is One 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.)

At February 1, 2007, AFG's Chairman of the Board (Carl H. Lindner) and its Co-CEOs (Carl H. Lindner III and S. Craig Lindner, sons of the Chairman) beneficially owned 11.2%, 6.9% and 6.8%, respectively, of AFG's outstanding Common Stock. Another son (Keith E. Lindner) publicly reported in April 2006 that he beneficially owned shares representing 7.7% of AFG's outstanding Common Stock.

### Three-for-two Stock Split

All share and per share amounts (except number of shares authorized and the stated value of \$1.00 per share) presented in this Annual Report on Form 10-K have been adjusted for all periods presented to reflect the effect of a three-for-two Common Stock split that became effective December 15, 2006.

### Property and Casualty Insurance Operations

The property and casualty group reports to a single senior executive and is comprised of multiple business units that 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, 2006.

The primary objectives of AFG's property and casualty insurance operations are to achieve solid underwriting profitability and provide excellent service to its policyholders. 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% is indicative of 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 95.7% for the period 2004 to 2006 (or 93.1% excluding a 2005 charge of \$179 million related to asbestos, environmental and other mass tort matters) as compared to 97.5% for the property and casualty industry over the same period (Source: "Best's Review/Preview - Property/Casualty" - January 2007 Edition). AFG believes that its specialty niche focus, product line

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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.

Generally, financial data is reported in accordance with generally accepted accounting principles ("GAAP") for shareholder and other investment purposes and reported on a statutory basis for insurance regulatory purposes. In general, statutory accounting results in lower capital and surplus and lower net earnings than result from application of GAAP. Major differences include charging policy acquisition costs to expense as incurred rather than spreading the

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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; and charging to surplus certain 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.

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):

|  | <u>2006</u>    | <u>2005</u>    | <u>2004</u>    |
|--|----------------|----------------|----------------|
| Gross written premiums (a)                         | \$3,921        | \$3,640        | \$3,646        |
| Ceded reinsurance (a)                              | <u>(1,263)</u> | <u>(1,192)</u> | <u>(1,417)</u> |
| Net written premiums                               | <u>\$2,658</u> | <u>\$2,448</u> | <u>\$2,229</u> |
| Net earned premiums                                | \$2,563        | \$2,366        | \$2,110        |
| Loss and LAE                                       | 1,480          | 1,510          | 1,416          |
| Asbestos, environmental and other mass tort charge | -              | 179            | -              |
| Underwriting expenses                              | <u>765</u>     | <u>652</u>     | <u>582</u>     |
| Underwriting gain                                  | <u>\$ 318</u>  | <u>\$ 25</u>   | <u>\$ 112</u>  |
| GAAP ratios:                                       |                |                |                |
| Loss and LAE ratio                                 | 57.7%          | 71.4%          | 67.2%          |
| Underwriting expense ratio                         | <u>29.9</u>    | <u>27.6</u>    | <u>27.6</u>    |
| Combined ratio (b)                                 | <u>87.6</u>    | <u>99.0</u>    | <u>94.8</u>    |
|  | %              | %              | %              |
| Statutory ratios:                                  |                |                |                |
| Loss and LAE ratio                                 | 58.7%          | 74.7%          | 68.5%          |
| Underwriting expense ratio                         | <u>29.9</u>    | <u>27.9</u>    | <u>27.8</u>    |

|                                       |             |              |             |
|---------------------------------------|-------------|--------------|-------------|
| Combined ratio (b)                    | <u>88.6</u> | <u>102.6</u> | <u>96.3</u> |
|                                       | %           | %            | %           |
| Industry statutory combined ratio (c) |             |              |             |
| All lines                             | 93.3%       | 100.8%       | 98.5%       |
| Commercial lines                      | 94.3%       | 99.7%        | 100.2%      |

- (a) Excludes the following premiums that were written under special arrangements on behalf of, and fully reinsured to, a former subsidiary (following its sale in 2003) and the purchaser of the Japanese division (sold in 2001): 2006 - \$13 million; 2005 - \$59 million; and 2004 - \$91 million.
- (b) The combined ratios include 7.6 percentage points for GAAP and 7.7 percentage points for statutory in 2005 related to the strengthening of reserves for asbestos, environmental and other mass tort exposures and 2.2 percentage points for GAAP and 2.3 percentage points for statutory in 2005 and 1.8 percentage points in 2004 related to hurricanes.
- (c) Ratios are derived from "Best's Review/Preview - Property/Casualty" (January 2007 Edition).

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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, forest fires, 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 hurricanes and tornadoes, were \$22 million in 2006; \$60 million in 2005; and \$36 million in 2004.

AFG generally seeks to reduce its exposure to catastrophes through individual risk selection, including minimizing coastal exposures, and the purchase of reinsurance. Due to recent upward revisions in industry models of correlated catastrophe exposure associated with writing both workers' compensation and excess property coverage in California, AFG decided to stop writing most of its earthquake-exposed excess property coverage in California beginning in April 2006. This excess property business had net written premiums of \$17 million in 2005. Prior to this action, AFG's excess property exposure to a catastrophic earthquake that industry models indicate could occur once in every 500 years (a "500-year event") was approximately 10% of AFG's shareholders' equity. Once the existing excess property policies expire in 2007, AFG's excess property exposure to a California earthquake 500-year event will be reduced to less than 1% of AFG's equity.

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 such specialty businesses:

#### Property and Transportation

|                         |  |
|-------------------------|--|
| Inland and Ocean Marine | Provides coverage primarily for builder's risk, contractor's 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

Markets customized insurance programs for various transportation operations (such as busses and trucks), and a specialized physical damage product for the trucking industry.

Specialty Casualty

Executive and Professional Liability

Markets coverage for attorneys and for directors and officers of businesses and not-for-profit organizations.

Umbrella and Excess Liability

Provides higher layer liability coverage in excess of primary layers.

Excess and Surplus

Specially designed insurance products offered to those that can't find coverage in standard markets.

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.

Collateral Protection

Provides coverage for insurance risk management programs for lending and leasing institutions.

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California Workers' Compensation

Workers' Compensation

Writes coverage for prescribed benefits payable to employees (principally in California) who are injured on the job.

Management believes specialization is the key element to the underwriting success of these business units. Each unit has separate management with significant operating autonomy to oversee the important operational functions of its business such as underwriting, pricing, marketing, policy processing and claims service. 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 2006, AFG gained new multi-peril crop premium volume from the 2005 acquisition of Farmers Crop Insurance Alliance and expanded the geographic focus of its property and inland marine operations.

The U.S. geographic distribution of these businesses' statutory direct written premiums in 2006 compared to 2002 is shown below. Amounts exclude business written under special arrangements on behalf of, and fully reinsured to, the purchasers of the divisions sold.

|            | <u>2006</u> | <u>2002</u> |              | <u>2006</u> | <u>2002</u> |
|------------|-------------|-------------|--------------|-------------|-------------|
| California | 17.8%       | 21.4%       | Pennsylvania | 2.5%        | 2.7%        |
| Texas      | 8.8         | 9.9         | Ohio         | 2.4         | 2.9         |
| Florida    | 8.8         | 5.5         | Michigan     | 2.4         | 2.1         |
| Illinois   | 5.4         | 4.3         | Georgia      | 2.3         | 3.0         |



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|            |     |     |                |              |              |
|------------|-----|-----|----------------|--------------|--------------|
| New York   | 4.6 | 5.7 | North Carolina | 2.1          | *            |
| Oklahoma   | 2.7 | 2.8 | Indiana        | 2.0          | *            |
| New Jersey | 2.7 | 2.6 | Missouri       | *            | 2.0          |
|            |     |     | Other          | <u>35.5</u>  | <u>35.1</u>  |
|            |     |     |                | <u>100.0</u> | <u>100.0</u> |
|            |     |     |                | %            | %            |

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

The following table sets forth a distribution of statutory net written premiums for AFG's specialty insurance businesses by NAIC annual statement line for 2006 compared to 2002.

|                        | <u>2006</u>  | <u>2002</u>  |
|------------------------|--------------|--------------|
| Other liability        | 24.1%        | 30.1%        |
| Workers' compensation  | 12.9         | 16.2         |
| Inland marine          | 11.1         | 7.2          |
| Allied lines           | 8.6          | 2.5          |
| Auto physical damage   | 7.9          | 4.8          |
| Auto liability         | 7.8          | 8.7          |
| Commercial multi-peril | 7.0          | 8.6          |
| Fidelity and surety    | 5.2          | 5.8          |
| Collateral protection  | 4.9          | 5.3          |
| Product liability      | 4.3          | 2.7          |
| Ocean marine           | 2.7          | 3.7          |
| Other                  | <u>3.5</u>   | <u>4.4</u>   |
|                        | <u>100.0</u> | <u>100.0</u> |
|                        | %            | %            |

For a discussion of the performance of AFG's specialty businesses see *Management's Discussion and Analysis - "Results of Operations - Property and Casualty Insurance - Underwriting."*

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The following table shows independent ratings and 2006 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. AFG believes that maintaining an S&P rating of at least "A-" is important to compete successfully in certain lines of business.

|                |             |
|----------------|-------------|
| <u>Ratings</u> | Net Written |
|----------------|-------------|

| <u>Company</u>                | <u>AM Best</u> | <u>S&amp;P</u> | <u>Premiums</u> |
|-------------------------------|----------------|----------------|-----------------|
| Great American Pool(*)        | A              | A              | \$1,666         |
| Republic Indemnity            | A              | A              | 285             |
| Mid-Continent                 | A              | A              | 321             |
| American Empire Surplus Lines | A              | A              | 115             |
| National Interstate           | A              | not rated      | 242             |
| Other                         |                |                | <u>29</u>       |
|                               |                |                | <u>\$2,658</u>  |

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

### 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 from 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 generally 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 enters into reinsurance agreements to reduce its net exposure under such policies to an acceptable level. Reinsurance continues to be available for this type of 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 market availability at reasonable prices for such reinsurance has become more difficult over the past two years, 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 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 line-by-line basis. AFG increased its overall net premium retention by approximately \$150 million in 2006 compared to 2004 in order to retain the benefit of certain profitable specialty businesses.

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. Excluding Infinity Property and Casualty Corporation, Mitsui Marine and Fire Insurance Company of America and Ohio

Casualty Corporation (discussed below), recoverables from the following companies were individually

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between 5% and 10% of AFG's total reinsurance recoverable (net of payables to reinsurers) at December 31, 2006: Swiss Reinsurance America Corporation, XL Reinsurance America, Inc., Munich Reinsurance America, Inc., Berkley Insurance Company, Everest Reinsurance Company and General Reinsurance Corporation.

During 2004, AFG negotiated commutations (lump-sum cash settlements) totaling \$58.3 million with certain of its reinsurance carriers who had experienced deteriorating financial condition. AFG's \$28.9 million loss on these commutations represents the differential between the consideration received from the reinsurers and the related reduction of reinsurance recoverable.

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):

| <u>Coverage</u>                                | <u>Retention<br/>Maximum</u> | <u>Reinsurance<br/>Coverage(a)</u> |
|--|------------------------------|------------------------------------|
| California Workers' Compensation               | \$ 1.0                       | \$149.0                            |
| Other Workers' Compensation                    | 2.0                          | 48.0                               |
| Commercial Umbrella                            | 4.0                          | 46.0                               |
| Property - General                             | 2.0                          | 28.0                               |
| Property - Catastrophe (other than earthquake) | 21.2                         | 98.8                               |
| Property - Catastrophe (earthquake)            | 21.2                         | 128.8                              |

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

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 20% to 30% 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. AFG currently reinsures 50% of premiums not reinsured by the FCIC in the private market and purchases stop loss protection coverage for the remaining portion of the business.

Included in the Balance Sheet caption "recoverables from reinsurers and prepaid reinsurance premiums" were approximately \$245 million on paid losses and LAE and \$2.3 billion on unpaid losses and LAE at December 31, 2006. These amounts are net of allowances of approximately \$20 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):

|   | <u>2006</u> | <u>2005</u> | <u>2004</u> |
|---|-------------|-------------|-------------|
| Reinsurance ceded   | \$1,276     | \$1,251     | \$1,508     |
| Reinsurance assumed - including<br>involuntary pools and associations | 189         | 65          | 62          |

Reinsurance assumed includes \$152 million in 2006 and \$20 million in 2005 related to the purchase of the multi-peril crop and crop hail insurance business of Farmers Crop Insurance Alliance, Inc.

In connection with the transfer of a portion of GAI's personal lines business to Infinity in 2003 and the sales of the Japanese division to Mitsui in 2001 and the commercial lines division to Ohio Casualty in 1998, GAI agreed to issue and renew

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policies related to the businesses transferred until each purchaser received the required approvals and licensing to begin writing business on their own behalf. The Infinity agreement was effective until January 1, 2006. The Mitsui and Ohio Casualty agreements ended at the end of 2003 and in early 2001, respectively. Under these agreements, GAI ceded 100% of these premiums to the respective purchaser. In 2006, 2005, and 2004, premiums (included in the table above) of \$13 million, \$59 million and \$91 million, respectively, were ceded under these agreements. At December 31, 2006, AFG's recoverables from reinsurers included \$384 million related to these transactions.

#### 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.

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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, 2006. 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. For example, the percentage of the December 31, 2002 reserve liability paid in 2003 includes approximately 20 percentage points for reserves of Infinity at its sale date in February 2003. See *Note O - "Insurance - 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.

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|   | <u>1996</u> | <u>1997</u> | <u>1998</u> | <u>1999</u> | <u>2000</u> | <u>2001</u> | <u>2002</u> | <u>2003</u> | <u>2004</u> | <u>2005</u> |
|---|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| <u>Liability for unpaid losses and loss adjustment expenses</u> |             |             |             |             |             |             |             |             |             |             |
| :   |             |             |             |             |             |             |             |             |             |             |
| As originally estimated   | \$3,404     | \$3,489     | \$3,305     | \$3,224     | \$3,192     | \$3,253     | \$3,400     | \$2,850     | \$3,103     | \$3,500     |
| As re-estimated at  |             |             |             |             |             |             |             |             |             |             |
| December 31, 2006   | 4,035       | 4,086       | 3,624       | 3,686       | 3,879       | 4,028       | 4,046       | 3,254       | 3,275       | 3,400       |

Liability re-estimated

|                   |        |        |        |        |        |        |        |        |        |       |
|-------------------|--------|--------|--------|--------|--------|--------|--------|--------|--------|-------|
| :                 |        |        |        |        |        |        |        |        |        |       |
| One year later    | 100.9% | 104.5% | 97.8%  | 98.1%  | 105.1% | 105.2% | 104.9% | 104.9% | 105.8% | 98.5% |
| Two years later   | 105.9% | 104.6% | 96.3%  | 100.1% | 105.1% | 111.3% | 110.3% | 113.6% | 105.5% |       |
| Three years later | 105.2% | 102.9% | 97.4%  | 99.0%  | 109.9% | 115.2% | 118.2% | 114.2% |        |       |
| Four years later  | 103.6% | 105.4% | 96.0%  | 102.6% | 113.1% | 122.1% | 119.0% |        |        |       |
| Five years later  | 106.9% | 105.7% | 99.2%  | 105.7% | 119.7% | 123.8% |        |        |        |       |
| Six years later   | 107.7% | 108.1% | 102.0% | 112.6% | 121.5% |        |        |        |        |       |
| Seven years later | 109.8% | 110.2% | 108.1% | 114.3% |        |        |        |        |        |       |
| Eight years later | 111.5% | 115.8% | 109.7% |        |        |        |        |        |        |       |
| Nine years later  | 117.3% | 117.1% |        |        |        |        |        |        |        |       |
| Ten years later   | 118.5% |        |        |        |        |        |        |        |        |       |

Cumulative deficiency

|                  |             |             |            |             |             |             |             |             |            |     |
|------------------|-------------|-------------|------------|-------------|-------------|-------------|-------------|-------------|------------|-----|
|                  | <u>18.5</u> | <u>17.1</u> | <u>9.7</u> | <u>14.3</u> | <u>21.5</u> | <u>23.8</u> | <u>19.0</u> | <u>14.2</u> | <u>5.5</u> |     |
| (redundancy) (a) | %           | %           | %          | %           | %           | %           | %           | %           | %          | (%) |

Cumulative paid as of

|                   |       |       |       |       |       |       |       |       |       |       |
|-------------------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|
| :                 |       |       |       |       |       |       |       |       |       |       |
| One year later    | 33.8% | 41.7% | 28.3% | 34.8% | 38.3% | 33.6% | 43.1% | 27.7% | 25.8% | 24.5% |
| Two years later   | 58.0% | 56.6% | 51.7% | 52.7% | 52.2% | 62.9% | 62.1% | 47.3% | 41.4% |       |
| Three years later | 66.7% | 70.8% | 62.4% | 60.0% | 71.4% | 76.3% | 74.1% | 59.9% |       |       |
| Four years later  | 77.3% | 78.6% | 65.6% | 72.5% | 81.6% | 84.9% | 81.8% |       |       |       |
| Five years later  | 82.8% | 81.1% | 73.9% | 80.6% | 87.5% | 90.7% |       |       |       |       |
| Six years later   | 84.6% | 86.9% | 80.8% | 84.6% | 91.9% |       |       |       |       |       |
| Seven years later | 89.6% | 92.8% | 83.8% | 88.1% |       |       |       |       |       |       |

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|                   |       |       |       |
|-------------------|-------|-------|-------|
| Eight years later | 95.1% | 95.0% | 86.7% |
| Nine years later  | 97.1% | 97.2% |       |
| Ten years later   | 99.1% |       |       |

(a) Cumulative deficiency (redundancy):

Special A&E charges,  
settlements and  
reallocations

|  |            |            |            |            |             |             |             |            |              |
|--|------------|------------|------------|------------|-------------|-------------|-------------|------------|--------------|
|  | 15.3%      | 15.0%      | 9.4%       | 9.6%       | 9.7%        | 6.4%        | 5.3%        | 6.3%       | 5.8%         |
|  | <u>3.2</u> | <u>2.1</u> | <u>0.3</u> | <u>4.7</u> | <u>11.8</u> | <u>17.4</u> | <u>13.7</u> | <u>7.9</u> | <u>(0.3)</u> |

|       |             |             |            |             |             |             |             |             |            |    |
|-------|-------------|-------------|------------|-------------|-------------|-------------|-------------|-------------|------------|----|
| Other | %           | %           | %          | %           | %           | %           | %           | %           | %)         | %) |
|       | <u>18.5</u> | <u>17.1</u> | <u>9.7</u> | <u>14.3</u> | <u>21.5</u> | <u>23.8</u> | <u>19.0</u> | <u>14.2</u> | <u>5.5</u> |    |

|       |   |   |   |   |   |   |   |   |   |    |
|-------|---|---|---|---|---|---|---|---|---|----|
| Total | % | % | % | % | % | % | % | % | % | %) |
|-------|---|---|---|---|---|---|---|---|---|----|

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

|  |             |             |             |             |             |             |             |             |             |             |
|--|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
|  | <u>1996</u> | <u>1997</u> | <u>1998</u> | <u>1999</u> | <u>2000</u> | <u>2001</u> | <u>2002</u> | <u>2003</u> | <u>2004</u> | <u>2005</u> |
|--|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|

As originally estimated:

|                           |                |                |                |                |                |                |                |                |                |                |
|---------------------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|
| Net liability shown above | \$3,404        | \$3,489        | \$3,305        | \$3,224        | \$3,192        | \$3,253        | \$3,400        | \$2,850        | \$3,103        | \$3,500        |
| Add reinsurance           | <u>720</u>     | <u>736</u>     | <u>1,468</u>   | <u>1,571</u>   | <u>1,324</u>   | <u>1,525</u>   | <u>1,804</u>   | <u>2,059</u>   | <u>2,234</u>   | <u>2,234</u>   |
| recoverables              | <u>\$4,124</u> | <u>\$4,225</u> | <u>\$4,773</u> | <u>\$4,795</u> | <u>\$4,516</u> | <u>\$4,778</u> | <u>\$5,204</u> | <u>\$4,909</u> | <u>\$5,337</u> | <u>\$5,734</u> |

Gross liability

As re-estimated at

December 31, 2006:

|                           |                |                |                |                |                |                |                |                |                |                |
|---------------------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|
| Net liability shown above | \$4,035        | \$4,086        | \$3,624        | \$3,686        | \$3,879        | \$4,028        | \$4,046        | \$3,254        | \$3,275        | \$3,400        |
| Add reinsurance           | <u>1,324</u>   | <u>1,422</u>   | <u>2,028</u>   | <u>2,211</u>   | <u>2,117</u>   | <u>2,301</u>   | <u>2,445</u>   | <u>2,598</u>   | <u>2,492</u>   | <u>2,492</u>   |
| recoverables              | <u>\$5,359</u> | <u>\$5,508</u> | <u>\$5,652</u> | <u>\$5,897</u> | <u>\$5,996</u> | <u>\$6,329</u> | <u>\$6,491</u> | <u>\$5,852</u> | <u>\$5,767</u> | <u>\$5,892</u> |

Gross liability

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| Gross cumulative   |             |             |             |             |             |             |             |             |            |   |
|--|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|------------|---|
|  | <u>29.9</u> | <u>30.4</u> | <u>18.4</u> | <u>23.0</u> | <u>32.8</u> | <u>32.5</u> | <u>24.7</u> | <u>19.2</u> | <u>8.1</u> |   |
| deficiency (a)   | %           | %           | %           | %           | %           | %           | %           | %           | %          | % |
| <hr/>  |             |             |             |             |             |             |             |             |            |   |
| (a) Gross cumulative deficiency:                         |             |             |             |             |             |             |             |             |            |   |
| Special A&E charges,<br>settlements and<br>reallocations | 16.3%       | 16.1%       | 8.0%        | 8.0%        | 8.5%        | 5.0%        | 3.9%        | 4.2%        | 3.9%       |   |
|  | <u>13.6</u> | <u>14.3</u> | <u>10.4</u> | <u>15.0</u> | <u>24.3</u> | <u>27.5</u> | <u>20.8</u> | <u>15.0</u> | <u>4.2</u> |   |
| Other  | %           | %           | %           | %           | %           | %           | %           | %           | %          | % |
|  | <u>29.9</u> | <u>30.4</u> | <u>18.4</u> | <u>23.0</u> | <u>32.8</u> | <u>32.5</u> | <u>24.7</u> | <u>19.2</u> | <u>8.1</u> |   |
| Total  | %           | %           | %           | %           | %           | %           | %           | %           | %          | % |

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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 \$179 million of special charges (\$169 million for A&E and \$10 million for other mass tort claims) related to losses recorded in 2005, but incurred before 1995, 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 years ago, even though such coverage was not intended. Other factors affecting development in recent years 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, 2006 are as follows (in millions):

|   |                |
|---|----------------|
| Liability reported on a SAP basis, net of \$202 million<br>of retroactive reinsurance | \$3,697        |
| Reinsurance recoverables, net of allowance  | 2,309          |
| Other   | <u>22</u>      |
| Liability reported on a GAAP basis  | <u>\$6,028</u> |

Asbestos and Environmental Reserves ("A&E")

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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 in years before 1987. 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 Reserves"* and Note M - *"Commitments and Contingencies"* to the Financial Statements.

AFG has undertaken periodic reviews of its A&E reserves with the aid of an independent actuarial firm and specialty outside counsel. In the third quarter of 2005, AFG completed a comprehensive study of its asbestos and environmental exposures relating to the run-off operations of its property and casualty group. As a result of its study, AFG recorded a pretax charge of \$169 million, net of \$32 million in reinsurance recoverables. Management expects to conduct such a study every two years with the next study in 2007. For a discussion of the A&E reserve strengthening, see *Management's Discussion and Analysis - "Results of Operations - Asbestos and Environmental Reserve Charge."*

The following table (in millions) is a progression of A&E reserves.

|   | <u>2006</u>    | <u>2005</u>    | <u>2004</u>    |
|---|----------------|----------------|----------------|
| Reserves at beginning of year                           | \$461.0        | \$330.6        | \$399.9        |
| Incurred losses and LAE                                 | -              | 169.3          | -              |
| Paid losses and LAE                                     | (32.2)         | (38.9)         | (45.4)         |
| Reserves transferred with sale of a subsidiary          | -              | -              | (49.4)         |
| Reserves not previously classified as A&E               | <u>3.5</u>     | <u>-</u>       | <u>25.5</u>    |
| <br>  |                |                |                |
| Reserves at end of year, net of reinsurance recoverable | 432.3          | 461.0          | 330.6          |
| <br>  |                |                |                |
| Reinsurance recoverable, net of allowance               | <u>85.4</u>    | <u>79.4</u>    | <u>55.9</u>    |
| <br>  |                |                |                |
| Gross reserves at end of year                           | <u>\$517.7</u> | <u>\$540.4</u> | <u>\$386.5</u> |

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The survival ratio, which is an industry measure of A&E claim reserves, is derived by dividing reserves for A&E exposures by average annual paid losses over the past three years. At December 31, 2006, AFG's survival ratio is approximately 19.5 times paid losses for the asbestos reserves (13.5 times excluding amounts associated with the A.P. Green settlement) and 11.4 times paid losses for total A&E reserves (8.6 times excluding A.P. Green), see *Legal Proceedings* for a discussion of the A.P. Green settlement. In March 2006, A.M. Best reported its estimate that the property and casualty insurance industry's three year survival ratio for A&E reserves was approximately 7.8 times paid losses at December 31, 2004.

### Other Mass Tort Reserves

In addition to A&E claims, AFG faces exposure from other types of mass tort claims including those relating to breast implants, lead, silica, exposure to industrial chemicals, and other



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latent injuries. Similar to A&E, other mass tort claims are subject to uncertainties that are significantly greater than those presented by other types of claims.

AFG's reserves for other mass torts, net of \$3.5 million in reinsurance recoverable, were \$15.6 million at December 31, 2006. AFG recorded a pretax charge of \$10 million in the third quarter of 2005 to increase its liability for other mass torts. Other mass tort paid losses and LAE were \$2.5 million in 2006, \$3.6 million in 2005 and \$2.4 million in 2004.

### Marketing

The property and casualty insurance group directs its sales efforts primarily through independent property and casualty insurance agents and brokers, although 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 profitability of all of the 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. 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. 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"), an 81% owned subsidiary. GAFRI's primary insurance subsidiaries include Great American Life Insurance Company ("GALIC"), Annuity Investors Life Insurance Company ("AILIC"), Loyal American Life Insurance Company ("Loyal"), United Teacher Associates Insurance Company ("UTA"), Continental General Insurance Company ("CGIC") and Central Reserve Life Insurance Company ("CRLIC"). These companies market retirement products, primarily fixed, indexed and variable annuities, and various forms of supplemental insurance. All of these companies sell their products through independent producers. In addition, CGIC and CRLIC use captive agents. GAFRI and its subsidiaries employed approximately 1,000 persons at December 31, 2006.

In August 2006, GAFRI acquired Ceres Group, Inc. ("Ceres") for approximately \$204 million in cash. Prior to the acquisition, Ceres' two primary insurance subsidiaries, CGIC and CRLIC, sold health and life insurance products through two primary business segments. Its senior segment included Medicare supplement and other senior health, life and annuity products for individuals age 55 and over.

Its medical segment included major medical health insurance for individuals, families, associations and small businesses. In connection with the acquisition, Ceres' insurance subsidiaries entered into reinsurance agreements under which all of Ceres' medical business and half of its in-force senior business were ceded to unaffiliated companies. Following the acquisition, Ceres paid a \$60 million return of capital distribution to GAFRI. GAFRI expects the

retained Ceres business to generate approximately \$150 million in statutory premiums in 2007.

In January 2006, GAFRI acquired the fixed annuity business written by Old Standard Life Insurance Company through a reinsurance transaction resulting in an increase of approximately \$280 million in both annuity benefits accumulated and cash and investments.

In January 2006, GAFRI sold its subsidiary, Great American Life Assurance Company of Puerto Rico ("GAPR"), for \$37.5 million in cash.

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

| <u>Company</u> | <u>Principal Products</u>    | 2006<br><u>Statutory<br/>Premiums</u> | <u>Policies<br/>In Force</u> | <u>AM Best<br/>Rating</u> | <u>S&amp;P<br/>Rating</u> |
|----------------|------------------------------|---------------------------------------|------------------------------|---------------------------|---------------------------|
| GALIC          | Fixed and indexed annuities  | \$1,135                               | 395,000                      | A                         | A-                        |
| AILIC          | Fixed and variable annuities | 277                                   | 93,000                       | A                         | A-                        |
| UTA            | Supplemental insurance       | 229                                   | 206,000                      | A-                        | Not rated                 |
| Loyal          | Supplemental insurance       | 33                                    | 180,000                      | A                         | Not rated                 |
| CGIC           | Supplemental insurance       | 42                                    | 130,000                      | B++                       | Not rated                 |
| CRLIC          | Supplemental insurance       | 11                                    | 32,000                       | B++                       | Not rated                 |

GAFRI's statutory premiums over the last three years were as follows (in millions):

|  | <u>Premiums</u> |                |                |
|--|-----------------|----------------|----------------|
|  | <u>2006</u>     | <u>2005</u>    | <u>2004</u>    |
| Indexed-annuities                          | \$ 681          | \$ 78          | \$ 6           |
| Traditional single premium fixed annuities | 335             | 440            | 401            |
| 403(b) traditional fixed annuities         | 273             | 239            | 255            |
| Variable annuities                         | <u>87</u>       | <u>92</u>      | <u>105</u>     |
| Total annuities                            | 1,376           | 849            | 767            |
| Supplemental insurance                     | 309             | 254            | 229            |
| Life insurance                             | <u>42</u>       | <u>44</u>      | <u>47</u>      |
| Total                                      | <u>\$1,727</u>  | <u>\$1,147</u> | <u>\$1,043</u> |

GAFRI 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. GAFRI 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 not-for-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. GAFRI's insurance entities also compete in markets other than the sale of tax-deferred annuities. Ratings are an important competitive factor; GAFRI believes that these entities can successfully compete in these markets with their respective ratings.

GAFRI's operations could be materially and adversely affected by ratings downgrades. In connection with recent reviews by independent rating agencies, management indicated that it intends to maintain lower ratios of debt to capital than it has in recent years and intends to maintain the capital of its significant insurance subsidiaries at levels

currently indicated by the rating agencies as appropriate for the current ratings. Items that could adversely affect capital levels include (i) an extended period of low interest rates and a resulting significant narrowing of annuity "spread" (the difference between earnings received by GAFRI on its investments less amount credited to policyholders' annuity accounts); (ii) investment impairments; (iii) a sustained decrease in the stock market; (iv) adverse mortality or morbidity; (v) changes in capital levels associated with current rating agency requirements; and (vi) higher than planned dividends paid due to liquidity needs of GAFRI's holding companies.

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## Annuities

GAFRI'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, GAFRI seeks to maintain a desired spread between the yield on its investment portfolio and the rate it credits. GAFRI 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.

During 2006, GAFRI sold nearly \$700 million in indexed annuities, almost nine times the amount sold in 2005. This growth reflects both the success of new products introduced in mid-2005 and agent recruitment. An indexed annuity provides policyholders with 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). GAFRI purchases call options designed to offset the effect of the index participation in the liabilities associated with indexed annuities.

In addition to traditional fixed rate and indexed annuities, GAFRI 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. GAFRI 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 GAFRI earns a spread on amounts deposited.

## Supplemental Insurance Products

Loyal and UTA offer a variety of supplemental insurance products through independent agents. Principal products include coverage for Medicare supplement, cancer, long-term care, accidental injury, short-term disability and hospital indemnity. CGIC and CRLIC offer Medicare supplement and other supplemental insurance products for individuals age 55 and older through independent agents and a captive agency force.

Although GALIC no longer issues new life insurance policies, it continues to service and receive renewal premiums on its in-force block of approximately 180,000 policies and \$30 billion gross (\$9 billion net) of life insurance in force at December 31, 2006.

## Marketing

The majority of GAFRI's FPDAs are sold in qualified markets under sections 403(b), 457 and 401(k) of the Internal Revenue Code. In the 403(b) and 457 markets, schools, government agencies and certain other not-for-profit organizations may allow employees to save for retirement through contributions made on a before-tax basis. In the 401(k) market, both for-profit and not-for-profit organizations may establish qualified retirement plans whereby employees are eligible to save for retirement through contributions made primarily on a before-tax basis. Federal income taxes are not payable on pretax contributions or earnings until amounts are withdrawn.

GAFRI sells its fixed rate annuities primarily through a network of 200 managing general agents ("MGAs") who, in turn, direct approximately 2,800 actively producing

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independent agents. The top 15 MGAs accounted for approximately one-half of GAFRI's fixed rate annuity premiums in 2006. No one MGA represented more than 10% of total fixed annuity premiums in 2006.

In recent years, GAFRI has offered its variable annuity as an ancillary product solely through its 403(b) and 401(k) sales channels. Nearly one-half of GAFRI's variable annuity sales in 2006 were made through a wholly-owned subsidiary, Great American Advisors, Inc. ("GAA"). GAA is a broker/dealer licensed in all 50 states to sell stocks, bonds, options, mutual funds and variable insurance contracts through independent representatives and financial institutions. GAA also acts as the principal underwriter and distributor for GAFRI's variable annuity products.

GAFRI is licensed to sell its fixed annuity products in all 50 states; it is licensed to sell its variable products in all states except New York and Vermont. In 2006, no individual state accounted for more than 10% of GAFRI's annuity premiums other than California (14%) and Washington (13%). At December 31, 2006, GAFRI had approximately 385,000 annuity policies in force.

## Competition

GAFRI's insurance companies 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 GAFRI's insurance companies compete. Competitors include (i) individual insurers and insurance groups, (ii) mutual funds and (iii) other financial institutions. In a broader sense, GAFRI's insurance companies compete for retirement savings with a variety of financial institutions offering a full range of financial services. Financial institutions have demonstrated a growing interest in marketing investment and savings products other than traditional deposit accounts.

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 shape 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.

## 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), 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) and apartments in Louisville, Pittsburgh and Tampa Bay. These operations employed approximately 500 full-time employees at December 31, 2006.

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## Investment Portfolio

### General

A summary of AFG's fixed maturity investments and other stocks is shown in Note D to the financial statements. Portfolio yields are shown below.

|                                       | <u>2006</u> | <u>2005</u> | <u>2004</u> |
|---------------------------------------|-------------|-------------|-------------|
| Yield on Fixed Income Securities (a): |             |             |             |
| Excluding realized gains and losses   | 5.8%        | 5.7%        | 5.7%        |
| Including realized gains and losses   | 5.6%        | 5.6%        | 6.1%        |
| Yield on Stocks (a):                  |             |             |             |
| Excluding realized gains and losses   | 3.0%        | 3.8%        | 6.1%        |
| Including realized gains and losses   | 8.8%        | 11.9%       | 72.5%       |
| Yield on Investments (a)(b):          |             |             |             |
| Excluding realized gains and losses   | 5.7%        | 5.6%        | 5.7%        |
| Including realized gains and losses   | 5.7%        | 5.8%        | 7.9%        |

(a) Based on amortized cost; excludes effects of changes in unrealized gains.

(b) Excludes "Real Estate and Other Investments."

The table below compares total returns on AFG's fixed income 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 industry. Both AFG's performance and the indices include changes in unrealized gains and losses.

|   | <u>2006</u> | <u>2005</u> | <u>2004</u> |
|---|-------------|-------------|-------------|
| Total return on AFG's fixed income securities | 5.0%        | 3.4%        | 6.0%        |
| Lehman Universal Bond Index                   | 5.0%        | 2.7%        | 5.0%        |
| Total return on AFG's equity securities       | 19.1%       | 5.8%        | 31.5%       |
| Standard & Poors 500 Index                    | 15.8%       | 4.9%        | 10.9%       |

### Fixed Maturity Investments

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AFG's bond portfolio is invested primarily in taxable bonds. The National Association of Insurance Commissioners ("NAIC") assigns quality ratings which range from Class 1 (highest quality) to Class 6 (lowest quality). The following table shows AFG's available for sale bonds and redeemable preferred stocks, by NAIC designation (and comparable Standard & Poor's Corporation rating) as of December 31, 2006 (dollars in millions).

| NAIC<br>Rating | Comparable S&P Rating     | Amortized       | Fair Value      |            |
|----------------|---------------------------|-----------------|-----------------|------------|
|                |                           | Cost            | Amount          | %          |
| 1              | AAA, AA, A                | \$11,558        | \$11,491        | 79%        |
| 2              | BBB                       | <u>2,240</u>    | <u>2,242</u>    | <u>15</u>  |
|                | Total investment grade    | <u>13,798</u>   | <u>13,733</u>   | <u>94</u>  |
| 3              | BB                        | 353             | 356             | 2          |
| 4              | B                         | 396             | 404             | 3          |
| 5              | CCC, CC, C                | 95              | 96              | 1          |
| 6              | D                         | <u>21</u>       | <u>35</u>       | <u>*</u>   |
|                | Total noninvestment grade | <u>865</u>      | <u>891</u>      | <u>6</u>   |
|                | Total                     | <u>\$14,663</u> | <u>\$14,624</u> | <u>100</u> |

%

(\*) less than 1%

AFG invests in bonds and redeemable preferred stocks that have primarily intermediate-term maturities. This practice is designed to allow flexibility in reacting to fluctuations of interest rates.

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### Equity Investments

At December 31, 2006, AFG held \$729 million in stocks, the largest of which represents a \$123 million investment in National City Corporation, a Cleveland-based commercial bank. In 2004, AFG received National City shares in the merger of Provident Financial Group and National City and realized a pretax gain of \$214 million on the transaction.

### 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 2007 from its insurance subsidiaries without seeking regulatory clearance is approximately \$484 million.

Legislation has been proposed to establish a procedure for larger, commercial insurers to be regulated under an optional federal charter. The implications of this proposal on AFG's insurance operations cannot be determined at this time.

In October 2004, the New York State Attorney General brought suit against Marsh and McLennan Companies, Inc. alleging, among other things, that the firm had manipulated the insurance market through specified conduct, including bid rigging and price fixing. The New York State Attorney General also stated that the evidence implicated certain insurance companies, none of which were AFG subsidiaries. Some of the parties identified in these matters have resolved their issues with the Attorney General, and, in addition to paying fines, have agreed to change their business practices with respect to contingent commissions and certain other matters. Regulators in other states commenced investigations of insurance companies concerning the specified practices identified by the New York Attorney General. Insurance subsidiaries of AFG received and responded to inquiries from several states where AFG does business. AFG cannot estimate the scope or breadth of the issues that may be investigated by the various insurance departments, the results, timeframe and impact, if any, that the resolution of these inquiries may have on its business or the property and casualty insurance industry generally.

In response to inquiries from several insurance departments, AFG has engaged in an extensive internal review of its business arrangements with insurance producers. After a significant amount of document review, AFG identified only two policy quotations requested by Marsh & McLennan which may have been used by Marsh in a manner similar to the actions described in the New York Attorney General's complaint against that company. The aggregate premium in the policy quotations was less than \$1 million.

The NAIC is an organization comprised of the chief insurance regulator for each of the 50 states and the District of Columbia. One of the NAIC's major roles is to develop model laws and regulations affecting insurance company operations and encourage uniform regulation through the adoption of such model laws in all states.

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

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## ITEM 1A

### Risk Factors

Following is a discussion of the most significant risk factors to investors in AFG securities.

Intense competition could adversely affect AFG's profitability.

The specialty insurance business is highly competitive and, except for regulatory considerations, there are relatively few barriers to entry. 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 ACE Ltd., American International Group Inc., Arch Capital Group Ltd., Chubb Corp., Cincinnati Financial Corp., CNA Financial Corp., Philadelphia Consolidated Holdings Corp., Ohio Casualty Corp., Markel Corp., Hartford Financial Services Group, HCC Insurance Holdings, Inc., Rural Community Insurance Company, The St. Paul Travelers Companies Inc., W.R. Berkley Corp., XL Capital Ltd., and Zenith National Insurance Corp.

AFG's annuity and supplemental insurance businesses compete with individual insurers and insurance groups, mutual funds and other financial institutions. Competitors include ING Life Insurance and Annuity Company, Life Insurance Company of the Southwest, Midland National Life Insurance Company, Allianz Life Insurance Company of North America, Fidelity and Guaranty Life Insurance Company, Mutual of Omaha Insurance Company and Bankers Life and Casualty Company.

Competition is based on many factors, including service to policyholders and agents, product design, reputation for claims handling, ratings and financial strength. Price, commissions, profit sharing terms and interest crediting rates 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.

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

As previously discussed under "Regulation," AFG is subject to comprehensive regulation by government agencies in the states 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 generally intended for the protection of policyholders rather than securityholders.

There can be no assurance that existing insurance-related laws and regulations will not become more restrictive in the future or that new restrictive laws will not be enacted and, therefore, 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 insurers to maintain a commercially acceptable financial strength rating would have a significant negative effect on their ability to compete successfully.

As discussed under "Property and Casualty Insurance Operations" and "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, adversely impact AFG's ability to access the capital markets and increase AFG's borrowing costs.

AFG's results may fluctuate as a result of cyclical changes in the specialty insurance industry.

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 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. While AFG recorded favorable development of \$59 million in 2006, it recorded charges of \$181 million (primarily the A&E charge discussed under *Item 7 - "Management's Discussion and Analysis - Uncertainties"*) in 2005 and \$140 million in 2004 to increase reserves relating to prior accident years. 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 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 in 2006 (primarily from tornadoes) and in 2005 and 2004 (primarily due to hurricanes). Catastrophes (some of which are seasonal) can be caused by natural events such as hurricanes, windstorms, tornadoes, hailstorms, severe winter weather, earthquakes, explosions and fire, and by man-made events, such as terrorist attacks and riots. 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. For example, AFG has a correlated catastrophe exposure as a result of writing both workers' compensation and excess property coverage in California. 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.

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.

A significant decline in used car prices could negatively impact AFG's financial results.

AFG's residual value business is heavily impacted by the level of used car prices obtained at auction. A significant decrease in the market value of used automobiles could result in significant losses and may have a material adverse

impact on AFG's results of operations or its financial condition.

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: 2006 - \$1.3 billion (32%); 2005 - \$1.3 billion (34%); and 2004 - \$1.5 billion (40%). 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 is also subject to credit risk with respect to its reinsurers, as the ceding of risk to reinsurers does not relieve AFG of its liability to insureds.

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 and, on some policies, morbidity. 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. For example, AFG recorded pretax charges in 2005 of (i) \$15.8 million to DPAC and annuity liabilities due primarily to the negative effect of lower interest rates on expected future profits of its fixed annuity operations and (ii) \$13.6 million related to an unexpected increase in mortality in its run-off life operations.

The continued threat of terrorism and ongoing military and other actions 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, 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 actions and heightened security measures.

Adverse securities market conditions can have significant negative effects on AFG's investment portfolio.

AFG's results of operations depend in part on the performance of its invested assets. As of December 31, 2006, 84% of AFG's investment portfolio was invested in fixed maturity securities and 4% in equity 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. 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.

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.

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, Moody's and Fitch, independent corporate credit rating agencies. AFG's senior indebtedness is currently rated BBB by Standard & Poor's, Baa3 by Moody's and BBB+ by Fitch. 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 - "Property and Casualty Insurance Operations - Asbestos and Environmental Reserves ("A&E"),* *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. AFG is unable to predict the precise nature of the relief that may be sought or granted in any lawsuits or the effect that pending or future cases may have on AFG's business, operations, profitability or financial condition.

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

Carl H. Lindner is Chairman of the Board of Directors of AFG, and his sons, Carl H. Lindner III and S. Craig Lindner, are each Co-Chief Executive Officers and Directors of AFG. Carl H. Lindner, Carl H. Lindner III and S. Craig Lindner beneficially own 11.2%, 6.9% and 6.8% of AFG's outstanding Common Stock as of February 1, 2007. Another son, Keith E. Lindner, reported in April 2006 that he beneficially owned shares representing 7.7% of AFG's outstanding Common Stock. 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 as listed on the NYSE and Nasdaq Global Select Market constantly changes. During 2005 and 2006, AFG's common stock traded at prices ranging between \$18.64 and \$36.71. AFG's common stock price can fluctuate

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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; 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 650,000 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. A property and casualty insurance subsidiary owns approximately 179,000 square feet of office space on 17.5 acres of land in Richfield, Ohio, approximately half of which it occupies; the remaining space is leased to unaffiliated tenants. GAFRI subsidiaries own a 40,000 square foot office building in Austin, Texas and a 45,000 square foot office building in Mission, Kansas. Most of this space is used by the companies for their operations.

## ITEM 3

### Legal Proceedings

Please refer to "Forward-Looking Statements" following the Index in front of this Form 10-K.

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 asserting alleged injuries and damages from asbestos, environmental and other substances and workplace hazards and have established loss accruals for such potential liabilities. The ultimate loss for these claims may vary materially from amounts currently recorded as the conditions surrounding resolution of these claims continue to change.

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

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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. In 2004, American Premier reached an agreement on the allocation of environmental clean-up costs at its former railroad site in Paoli, Pennsylvania. The settlement became final and agreed upon amounts were paid in early 2005. American Premier has filed suit seeking reimbursement from others for portions of remediation costs incurred.

As previously reported, Great American Insurance Company and certain other insurers were parties to asbestos-related coverage litigation 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"). These claims alleged that the refractory materials manufactured, sold or installed by A.P. Green contained asbestos and resulted in bodily injury from exposure to asbestos. A.P. Green sought to recover defense and indemnity expenses related to those claims from a number of insurers, including Great American, and in an effort to maximize coverage asserted that Great American's policies were not subject to aggregate limits on liability, and that each insurer was liable for all sums that A.P. Green became legally obliged to pay.

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).

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 is for \$123.5 million (Great American has the option to pay in cash or over time with 5.25% interest). The agreement 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. No assurance can be made that all conditions will be met; no payments are required until completion of the process.

The Bankruptcy Court has ruled that the Debtors' plan of reorganization will require a resolicitation of votes from silica claimants as a condition of the Court's approval of the plan. The Court has set a further hearing on plan confirmation for March 2007.

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## PART II

## ITEM 5

Market for Registrant's Common Equity, Related Stockholder Mattersand Issuer Purchases of Equity Securities

Please refer to "Forward-Looking Statements" following the Index in front of this Form 10-K.

AFG Common Stock has been listed and traded on the New York Stock Exchange and the Nasdaq Global Select Market under the symbol AFG. In November 2006, AFG's Board of Directors approved a three-for-two common stock split. On December 15, 2006, one additional common share was issued for every two common shares held by shareholders of record on November 30, 2006. A total of 39,724,479 new shares were issued. All share and per share amounts (except the number of shares authorized and the stated value of \$1.00 per share) presented in this Annual Report on Form 10-K have been adjusted to reflect the effect of the split for all periods presented. The information presented in the table below represents the high and low sales prices per share reported on the NYSE Composite Tape.

|                | High    | 2006<br>Low | High    | 2005<br>Low |
|----------------|---------|-------------|---------|-------------|
| First Quarter  | \$28.30 | \$24.70     | \$21.25 | \$19.93     |
| Second Quarter | 29.70   | 27.08       | 22.64   | 18.64       |
| Third Quarter  | 32.13   | 27.15       | 23.42   | 21.50       |
| Fourth Quarter | 36.71   | 31.13       | 26.33   | 21.38       |

There were approximately 8,900 shareholders of record of AFG Common Stock at February 1, 2007. In 2006 and 2005, AFG declared and paid quarterly dividends of \$.092 and \$.083 per share, respectively. In November 2006, AFG announced its intent to increase its annual dividend to \$.40 per share of Common Stock, or \$.10 per share quarterly. AFG paid its first dividend at that rate in January 2007. 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.

Under AFG's shareholder-approved Stock Option Plan, 297,274 shares of AFG Common Stock (251,610 at an average price of \$34.83 per share in November and 45,664 at an average price of \$36.29 per share in December) were tendered in connection with the exercise of stock options for a total of 417,918 shares in the fourth quarter of 2006.

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## ITEM 6

Selected Financial Data

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

| 2006 | 2005 | 2004 | 2003 | 2002 |
|------|------|------|------|------|
|------|------|------|------|------|

Earnings Statement Data

|   |         |         |         |         |         |
|---|---------|---------|---------|---------|---------|
| :   |         |         |         |         |         |
| Total Revenues  | \$4,250 | \$3,984 | \$3,868 | \$3,323 | \$3,709 |
| Operating Earnings Before Income Taxes                            | 698     | 335     | 585     | 296     | 171     |
| Earnings from Continuing Operations                               | 428     | 196     | 366     | 319     | 121     |
| Discontinued Operations   | 25      | 11      | -       | (31)    | 4       |
| Cumulative Effect of Accounting Changes (a)                       | -       | -       | (6)     | 6       | (40)    |
| Net Earnings  | 453     | 207     | 360     | 294     | 85      |
| Basic Earnings (Loss) Per Common Share:                           |         |         |         |         |         |
| Earnings from Continuing Operations                               | \$ 3.63 | \$1.69  | \$3.31  | \$3.00  | \$1.17  |
| Discontinued Operations   | .21     | .09     | -       | (.30)   | .04     |
| Cumulative Effect of Accounting Change                            | -       | -       | (.05)   | .06     | (.39)   |
| Net Earnings Available to Common Shares                           | 3.84    | 1.78    | 3.26    | 2.76    | .82     |
| Diluted Earnings (Loss) Per Common Share:                         |         |         |         |         |         |
| Earnings from Continuing Operations                               | \$ 3.54 | \$1.66  | \$3.26  | \$2.99  | \$1.17  |
| Discontinued Operations   | .21     | .09     | -       | (.30)   | .04     |
| Cumulative Effect of Accounting Change                            | -       | -       | (.05)   | .06     | (.39)   |
| Net Earnings Available to Common Shares                           | 3.75    | 1.75    | 3.21    | 2.75    | .82     |
| Cash Dividends Paid Per Share of Common Stock                     | \$ .37  | \$ .33  | \$ .33  | \$ .33  | \$ .33  |
| Ratio of Earnings to Fixed Charges Including Annuity Benefits (b) | 2.62    | 1.77    | 2.42    | 1.68    | 1.35    |

Balance Sheet Data

|                      |          |          |          |          |          |
|----------------------|----------|----------|----------|----------|----------|
| :                    |          |          |          |          |          |
| Total Assets         | \$25,101 | \$22,816 | \$22,560 | \$20,312 | \$19,628 |
| Long-term Debt       | 921      | 1,000    | 1,106    | 1,102    | 945      |
| Minority Interest    | 284      | 261      | 220      | 188      | 471      |
| Shareholders' Equity | 2,929    | 2,458    | 2,431    | 2,076    | 1,726    |

(a) Reflects the implementation of required accounting changes.

(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 minority interest in earnings of subsidiaries having fixed charges and the undistributed equity in losses of investees. Fixed charges include interest (including interest credited to annuity policyholders' accounts 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* interest credited to annuity policyholders' accounts was 9.15, 4.58, 7.02, 3.66 and 2.35 for 2006, 2005, 2004, 2003 and 2002, respectively. Although the ratio of earnings to fixed charges *excluding* interest on annuities 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.

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ITEM 7

Management's Discussion and Analysis  
of Financial Condition and Results of Operations

INDEX TO MD&A

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Please refer to "Forward-Looking Statements" following the Index in front of this Form 10-K.

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.

## 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, 2006, AFG (parent) had over \$220 million in cash and securities and no amounts borrowed under its bank line of credit.

### Results of Operations

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

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." The 1990's were a soft market period; prices started to harden in 2000 and accelerated significantly following the terrorist attacks in 2001. Rate increases for AFG's specialty businesses moderated during the latter part of 2003 and that trend continued during 2004. While AFG's workers' compensation operations experienced significant rate decreases in 2005 and 2006, certain of AFG's other specialty operations experienced higher rate levels. Overall average pricing was flat for 2005 and 2006.

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AFG's net earnings for 2006 were \$453.4 million (\$3.75 per share diluted),

a \$247 million (119%) improvement over 2005, reflecting improved underwriting results, higher investment income, higher income from the sale of real estate (some of which is reported as discontinued operations) and the effect on 2005 earnings of charges in the annuity and supplemental insurance operations related to changes in actuarial assumptions.

## 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:

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- 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 non-insurance operations, and
- the determination of "other-than-temporary" impairment on investments.

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 regarding the emergence of future revenues and profits (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.

### LIQUIDITY AND CAPITAL RESOURCES

#### Ratios

AFG's debt to total capital ratio on a consolidated basis is shown below (dollars in millions). This ratio has improved from more than 40% at December 31, 2002. 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.

|                                | <u>December 31,</u> |             |
|--------------------------------|---------------------|-------------|
|                                | <u>2006</u>         | <u>2005</u> |
| Consolidated debt              | \$ 921              | \$1,000     |
| Total capital (*)              | 4,160               | 3,703       |
| Ratio of debt to total capital | 22.1%               | 27.0%       |

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

AFG's ratio of earnings to fixed charges, including annuity benefits as a fixed charge, was 2.62 for the year ended December 31, 2006. Excluding annuity benefits, this ratio was 9.15 for 2006. Although the ratio excluding interest on annuities is not required or encouraged to be disclosed under Securities and Exchange Commission rules, it is presented because interest credited to annuity policyholder accounts is not always considered a borrowing cost for an insurance company.

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, 2006, 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 and tax payments from subsidiaries, are insufficient to meet fixed charges in any period, AFG would be required to utilize parent company cash and marketable securities (\$221 million at December 31, 2006) or to generate cash through borrowings, sales of other assets, or similar transactions.

In March 2006, AFG and GAFRI replaced their existing credit agreements with a five-year revolving credit facility under which they can borrow a combined \$500 million. AFG and GAFRI have agreed not to borrow more than \$325 million and \$200 million, respectively, under the credit facility and AFG has agreed to guarantee amounts borrowed by GAFRI. Amounts borrowed bear interest at rates ranging from 0.5% to 1.25% over LIBOR based on AFG's credit rating. There were no amounts borrowed under this agreement at December 31, 2006. AFG believes that this credit agreement provides ample liquidity and can be used to obtain funds for operating subsidiaries or, if necessary, for the parent company.

During 2006 AFG repurchased \$43.5 million of its 7-1/8% debentures due 2009 for \$45.6 million in cash. During 2005, AFG repurchased \$15.6 million of its 7-1/8% Debentures due 2007 and \$71.2 million of its 7-1/8% Debentures due 2009 for \$92.6 million in cash.

All debentures issued by AFG (and GAFRI) are rated investment grade by three nationally recognized rating agencies. Under a currently effective shelf registration statement, AFG can offer additional equity or debt securities including 3.5 million shares of common stock remaining under an equity distribution agreement with UBS Securities LLC. The shelf registration provides AFG with flexibility to access the capital markets from time to time as market and other conditions permit.

For statutory accounting purposes, equity securities of non-affiliates are generally carried at fair value. At December 31, 2006, AFG's insurance companies owned publicly traded equity securities with a fair value of \$729 million. In addition, Great American Insurance Company owns GAFRI and National Interstate Corporation ("NATL") common stock with a fair value of \$915 million and a statutory carrying value of \$662 million. 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.

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.

#### Subsidiary Liquidity

As discussed above under *"Parent Holding Company Liquidity"*, in March 2006, AFG and GAFRI replaced their existing credit agreements. In addition, GAFRI can offer approximately \$250 million in additional equity or debt securities under a currently effective shelf registration. See Note Q - *"Subsequent Event"* to the financial statements.

During 2006, GAFRI repurchased \$68.5 million of its 6-7/8% Senior Notes due 2008 for \$70.8 million in cash. In 2005, GAFRI repurchased \$20.8 million of its 8-7/8% preferred securities for \$22.6 million in cash.

The liquidity requirements of AFG's insurance subsidiaries relate primarily to the liabilities associated with their

products as well as operating costs and expenses, payments of dividends and taxes to AFG and contributions of capital to their subsidiaries. Historically, cash flows from premiums and investment income have provided more than sufficient funds to meet these requirements without requiring a sale of investments or contributions from AFG. Funds received in excess

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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 January 2005, NATL, a majority-owned subsidiary that specializes in property and casualty insurance for the passenger transportation industry, issued 3,350,000 shares of its common stock in an initial public offering. A portion of the \$40.4 million of net proceeds from this offering was used to repay NATL's \$15 million promissory note to another AFG subsidiary. The remainder was used for other general corporate purposes. At December 31, 2006, AFG owned approximately 53% of NATL's common stock.

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

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

### 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).

|  | <u>Total</u>    | <u>Within<br/>One Year</u> | <u>2-3 Years</u> | <u>4-5 Years</u> | <u>More than<br/>5 Years</u> |
|--|-----------------|----------------------------|------------------|------------------|------------------------------|
| Annuity, Life, Accident &<br>Health Liabilities (a)                        | \$10,871        | \$1,256                    | \$2,205          | \$1,997          | \$5,413                      |
| Property and Casualty Unpaid<br>Losses and Loss Adjustment<br>Expenses (b) | 6,028           | 2,000                      | 2,100            | 900              | 1,028                        |
| Long-Term Debt, including<br>interest                                      | 2,078           | 121                        | 307              | 77               | 1,573                        |
| Operating Leases   | <u>142</u>      | <u>31</u>                  | <u>52</u>        | <u>36</u>        | <u>23</u>                    |
| Total  | <u>\$19,119</u> | <u>\$3,408</u>             | <u>\$4,664</u>   | <u>\$3,010</u>   | <u>\$8,037</u>               |

- (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 \$2.3 billion as follows: Within 1 year - \$800 million; 2-3 years - \$800 million; 4-5 years - \$300 million; and thereafter - \$409 million. Actual payments and their timing could differ significantly from these estimates.

The AFG Senior Convertible Notes due in 2033 are included in the above table at the first put date (2008).

As discussed in Note B to the financial statements, AFG will pay additional amounts for its Farmers Crop acquisition based on customer retention. Payments are not expected to exceed \$20 million over the next two years. AFG has no material contractual purchase obligations or other long-term liabilities at December 31, 2006.

### Off-Balance Sheet Arrangements

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

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### Investments

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

Nearly two-thirds of AFG's consolidated assets are invested in marketable securities. AFG's investment portfolio at December 31, 2006, contained \$14.6 billion in "Fixed maturities" classified as available for sale and \$729 million in "Other stocks", all carried at fair value with unrealized gains and losses reported as a separate component of shareholders' equity on an after tax basis. At December 31, 2006, AFG had pretax net unrealized losses of \$38.7 million on fixed maturities and net unrealized gains of \$123 million on other stocks.

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, 2006, the average life of AFG's fixed maturities was about six years.

Approximately 94% of the fixed maturities held by AFG were rated "investment grade" (credit rating of AAA to BBB) by nationally recognized rating agencies at December 31, 2006. Investment grade securities generally bear lower yields and

lower degrees of risk than those that are unrated or noninvestment grade. Management believes that the high quality investment portfolio should generate a stable and predictable investment return.

Investments in mortgage backed securities ("MBSs") represented 30% of AFG's fixed maturities at December 31, 2006. MBSs are subject to significant prepayment risk due to the fact that, in periods of declining interest rates, mortgages may be repaid more rapidly than scheduled as borrowers refinance higher rate mortgages to take advantage of lower rates. Substantially all of AFG's MBSs are rated "AAA" at December 31, 2006.

Summarized information for the unrealized gains and losses recorded in AFG's Balance Sheet at December 31, 2006, is shown in the following table (dollars in millions). Approximately \$147 million of available for sale "Fixed maturities" had no unrealized gains or losses at December 31, 2006.

|   | Securities<br>With<br>Unrealized<br><u>Gains</u> | Securities<br>With<br>Unrealized<br><u>Losses</u> |
|---|--|---|
| <u>Available for sale Fixed Maturities</u>  |  |   |
| Fair value of securities  | \$5,157  | \$9,320   |
| Amortized cost of securities  | \$5,017  | \$9,499   |
| Gross unrealized gain (loss)  | \$ 140   | (\$ 179)  |
| Fair value as % of amortized cost   | 103%   | 98%   |
| Number of security positions  | 1,252  | 1,493   |
| Number individually exceeding<br>\$2 million gain or loss                               | 2  | 1   |
| Concentration of gains (losses) by<br>type or industry (exceeding 5% of<br>unrealized): |  |   |
| Mortgage-backed securities  | \$ 21.6  | (\$ 69.9)   |
| Banks, savings and credit institutions  | 16.6   | (17.2)  |
| Gas and electric services   | 15.9   | (11.0)  |
| U.S. Government and government agencies   | 3.0  | (16.4)  |
| Air transportation and courier services   | 11.7   | (0.2)   |
| Insurance companies   | 9.6  | (9.7)   |
| State and municipal   | 7.0  | (11.4)  |
| Percentage rated investment grade   | 90%  | 97%   |

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The table below sets forth the scheduled maturities of AFG's available for sale fixed maturity securities at December 31, 2006, 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.

| <u>Maturity</u>                    | Securities<br>with<br>Unrealized<br><u>Gains</u> | Securities<br>with<br>Unrealized<br><u>Losses</u> |
|------------------------------------|--|---|
| One year or less                   | 3%   | 4%  |
| After one year through five years  | 28   | 24  |
| After five years through ten years | 41   | 29  |
| After ten years                    | <u>11</u>  | <u>5</u>  |
|                                    | 83   | 62  |
| Mortgage-backed securities         | <u>17</u>  | <u>38</u>   |
|                                    | <u>100</u>                                       | <u>100</u>  |
|                                    | %  | %   |

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

|  | Aggregate<br>Fair<br><u>Value</u> | Aggregate<br>Unrealized<br><u>Gain (Loss)</u> | Fair<br>Value as<br>% of Cost<br><u>Basis</u> |
|--|-----------------------------------|---|---|
| <u>Fixed Maturities at December 31, 2006</u> |                                   |   |   |
| Securities with unrealized gains:            |                                   |   |   |
| Exceeding \$500,000 (60 issues)              | \$ 668                            | \$ 52   | 108%  |
| Less than \$500,000 (1,192 issues)           | <u>4,489</u>                      | <u>88</u>                                     | 102   |
|  | <u>\$5,157</u>                    | <u>\$140</u>                                  | 103%  |
| Securities with unrealized losses:           |                                   |   |   |
| Exceeding \$500,000 (72 issues)              | \$1,633                           | (\$ 58)                                       | 97%   |
| Less than \$500,000 (1,421 issues)           | <u>7,687</u>                      | <u>( 121)</u>                                 | 98  |
|  | )                                 |   |   |
|  | <u>\$9,320</u>                    | <u>(\$179)</u>                                | 98%   |
|  | )                                 |   |   |

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

|   | Aggregate<br>Fair<br><u>Value</u> | Aggregate<br>Unrealized<br><u>Gain (Loss)</u> | Fair<br>Value as<br>% of Cost<br><u>Basis</u> |
|---|-----------------------------------|---|---|
| <u>Fixed Maturities with Unrealized<br/>Losses at December 31, 2006</u> |                                   |   |   |
| Investment grade with losses for:                                       |                                   |   |   |
| One year or less (454 issues)   | \$2,794                           | (\$ 26)                                       | 99%   |
| Greater than one year (964 issues)                                      | <u>6,197</u>                      | <u>( 146)</u>                                 | 98  |
|   | <u>\$8,991</u>                    | <u>(\$172)</u>                                | 98%   |

Non-investment grade with losses for:

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|                                   |               |               |     |
|-----------------------------------|---------------|---------------|-----|
| One year or less (39 issues)      | \$ 116        | (\$ 2)        | 98% |
| Greater than one year (36 issues) | <u>213</u>    | <u>( 5)</u>   | 98  |
|                                   | <u>\$ 329</u> | <u>(\$ 7)</u> | 98% |

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

- whether the unrealized loss is credit-driven or a result of changes in market interest rates,
- the extent to which fair value is less than cost basis,
- historical operating, balance sheet and cash flow data contained in issuer SEC filings and news releases,

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- near-term prospects for improvement in the issuer and/or its industry,
- third party research and communications with industry specialists,
- internally generated financial models and forecasts,
- discussions with issuer management, and
- ability and intent to hold the investment for a period of time sufficient to allow for any anticipated recovery in fair value.

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

AFG realized aggregate losses of \$7.6 million during 2006 on \$252 million in sales of fixed maturity securities (eight issues/issuers) that had individual unrealized losses greater than \$500,000 at December 31, 2005. These securities were "AAA" rated mortgage-backed securities, three of which increased in fair value by an aggregate of \$.7 million and five of which decreased in fair value by an aggregate of \$3.0 million from year-end 2005 to the sale date.

Net realized gains (losses) on securities sold and charges for "other than temporary" impairment on securities held were as follows (in millions):

|      | <u>Net Realized<br/>Gains on Sales</u> | <u>Charges for<br/>Impairment</u> | <u>Other</u> | <u>Total</u> |
|------|--|-----------------------------------|--------------|--------------|
|      |  | (a)                               |              |              |
| 2006 | \$ 51.8                                | (\$25.7)                          | \$2.9        | \$ 29.0      |
| 2005 | 37.2                                   | (16.1)                            | 2.8          | 23.9         |



|  |       |        |       |       |
|--|-------|--------|-------|-------|
| 2004   | 319.9 | (16.7) | (1.3) | 301.9 |
| (a) Adjustments to reflect the impact of realized gains and losses on the amortization of deferred policy acquisition costs. |       |        |       |       |

### 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 American Premier's contingencies arising out of its former operations.

### Property and Casualty Insurance Reserves

Estimating the liability for unpaid losses and 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.

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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 determining the Company's best estimate of the ultimate liability. 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 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

Management believes that each method has particular strengths and weakness 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

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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 the point estimate of the ultimate liability. This estimate may be the result of one test, or a weighted average of several tests, or a judgmental selection as the management team determines is appropriate.

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, 2006

|   | <u>Case</u> | <u>IBNR</u> | <u>LAE</u> | <u>Total Reserve</u> |
|---|-------------|-------------|------------|----------------------|
| Statutory Line of Business              |             |             |            |                      |
| Other liability - occurrence            | \$ 519      | \$1,444     | \$ 452     | \$2,415              |
| Workers' Compensation                   | 711         | 393         | 102        | 1,206                |
| Other liability - claims-made           | 294         | 314         | 168        | 776                  |
| Commercial Auto/Truck Liability/Medical | 115         | 155         | 59         | 329                  |
| Commercial multiple peril               | 125         | 94          | 98         | 317                  |
| Special property (fire, allied lines,   |             |             |            |                      |

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|                                       |                |                |                |                |
|---------------------------------------|----------------|----------------|----------------|----------------|
| inland marine, earthquake)            | 164            | 86             | 22             | 272            |
|                                       | <u>172</u>     | <u>400</u>     | <u>134</u>     | <u>706</u>     |
| Other lines                           |                |                |                |                |
| Total Statutory Reserves              | 2,100          | 2,886          | 1,035          | 6,021          |
| Adjustments for GAAP:                 |                |                |                |                |
| Loss reserve discounting              | (20)           | -              | -              | (20)           |
| Reclassify extracontractual reserves  | (21)           | -              | -              | (21)           |
| Canadian foreign currency translation | (3)            | -              | -              | (3)            |
|                                       | <u>17</u>      | <u>32</u>      | <u>2</u>       | <u>51</u>      |
| Reserves of foreign operations        |                |                |                |                |
|                                       | <u>(27)</u>    | <u>32</u>      | <u>2</u>       | <u>7</u>       |
| Total Adjustments for GAAP )          |                |                |                |                |
|                                       | <u>\$2,073</u> | <u>\$2,918</u> | <u>\$1,037</u> | <u>\$6,028</u> |

Total GAAP Reserves

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, 2006, to be deficient (for eight years) by as much as 17.4% and redundant (for two years) by as much as 1.7% (excluding the effect of special charges for asbestos, environmental and other mass tort exposures). This development illustrates the historical impact caused by variability in factors considered in estimating its insurance reserves.

Following is a discussion of certain critical variables affecting the estimation of the more significant lines of business (asbestos, environmental and other mass tort 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 our 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 5%) 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 \$41 million.

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

| <u>Line of business</u>                 | <u>Effect of 1%<br/>Change in<br/>Cost Trends</u> |
|---|---|
| Other Liability - Occurrence            | \$28  |
| Workers Compensation                    | 19  |
| Other Liability - Claims made           | 10  |
| Commercial Auto/Truck Liability/Medical | 4   |
| Commercial Multi-peril                  | 5   |

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, 2006, reserves (net of reinsurance) developed at the same rate as the average development of the most recent five years.

|   | <u>5-yr. Average<br/>Development(*)</u> | <u>Net Reserves(**)<br/>December 31, 2006</u> | <u>Effect on<br/>Net Earnings(**)</u> |
|---|---|---|---------------------------------------|
| Other Liability - Occurrence                | 2.8%                                    | \$936   | (\$26)                                |
| Workers' Compensation                       | 1.2%                                    | 757   | (9)                                   |
| Other Liability - Claims made               | 6.5%                                    | 483   | (31)                                  |
| Commercial Auto/Truck Liability/<br>Medical | (1.2%)                                  | 212   | 3                                     |
| Commercial Multi-peril                      | 3.4%                                    | 207   | (7)                                   |

(\*) Net of tax effect.

(\*\*) Excludes asbestos, environmental and other mass tort liabilities.

The following discussion describes key assumptions and important variables that materially 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 \$21 million in 2006, \$16 million in 2005 and \$9 million in 2004 related to its nursing home coverage where both the frequency and severity of claims were lower than previously projected. In addition, favorable development of \$15 million was recorded in 2006 in Mid-Continent's general liability business due to claim severity being less than predicted.

AFG recorded adverse loss development of \$26 million in 2005 on prior year umbrella and excess liability business as outside counsel costs exceeded expectations and certain judicial decisions and jury awards were worse than expected. In addition, \$8 million in adverse development was recorded in 2005 and \$11 million in 2004 on a run-off book of casualty business due to the frequency and severity of claims being significantly greater than predicted.

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.

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### 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
- Timing of claims reporting

AFG's workers' compensation business is written primarily in California. Significant reforms passed by the California state legislature in 2003 and in 2004 reduced employer premiums and set treatment standards for injured workers. AFG recorded favorable prior year loss development of \$20 million in 2006 and \$24 million in 2005 due primarily to the impact of the legislation on medical claim costs being more favorable than previously anticipated. AFG recorded \$22 million in adverse development during 2004 as favorable development from accident years 2002 and 2003 was more than offset by adverse development from 2001 and prior years resulting from claim severity increasing beyond previous expectations due to significantly higher medical cost trends.

While the standard actuarial techniques do reflect expected favorable impacts from the reforms, the magnitude of future cost savings depends on the implementation and interpretation of the reforms throughout the workers' compensation system over the next several years. 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 methods based on claim count and severity. Management reviewed the frequency, severity and loss and LAE ratios implied by the projections from the standard tests in light of the uncertainties of future cost savings and recent rate actions since the reforms, to determine the appropriate reserve level. Due to the long-tail nature of this business, AFG has been conservative in recognizing the benefits from the reform legislation until a higher percentage of claims have been paid and the ultimate impact of reforms can be determined.

### Other Liability - Claims Made

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

- Litigious climate
- The economy
- 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. Higher than anticipated claim frequency and severity, including the settlement of a large class action claim, caused adverse development in amounts recorded in prior years for directors' and officers' liability claims of \$42 million in 2004.

AFG recorded adverse prior year loss development of \$13 million in 2006 and \$15 million in 2005 on its legal professional liability business as claim severity continued to be higher than previous underlying assumptions.

While management applies the actuarial methods mentioned above, more judgment is involved in arriving at the final reserve to be held. The selection of tests and 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.

#### 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

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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 \$25 million in favorable prior year loss development in 2006 and \$10 million in 2005 for this line of business as claim severity was significantly 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 also includes reserves for a run-off book of homebuilders business covering contractors' liability for construction defects. Variables unique 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

Over the years, certain portions of the homebuilders business have experienced adverse interpretations of coverage, coupled with certain statutory changes relating to liability, causing higher than expected emergence of claims from older years. AFG recorded adverse prior year loss development of \$15 million in 2005 and \$30 million in 2004 on its run-off homebuilders business (mostly from exposures in California and Nevada). Management believes that changes in policy forms and endorsements implemented in 1998 will reduce AFG's exposure to such adverse interpretations.

#### Recoverables from Reinsurers and Availability of Reinsurance

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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.

In 2004, AFG recorded a loss of \$28.9 million to commute \$87.2 million of reinsurance recoverables with certain of its reinsurers that had experienced deteriorating financial condition. AFG has recorded reserves for doubtful collection of reinsurance recoverables on a case by case and overall basis. These estimates are subject to significant judgment and may vary significantly depending upon the reinsurers continued willingness and ability to pay amounts due.

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* -

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### "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.

|                             | <u>2006</u> | <u>2005</u> | <u>2004</u>  |
|-----------------------------|-------------|-------------|--------------|
| Before reinsurance (gross)  | 88.0%       | 96.4%       | 96.5%        |
| Effect of reinsurance       | <u>(.4)</u> | <u>2.6</u>  | <u>(1.7)</u> |
| )                           |             | )           |              |
| Actual (net of reinsurance) | <u>87.6</u> | <u>99.0</u> | <u>94.8</u>  |
|                             | %           | %           | %            |

### Asbestos and Environmental-related ("A&E") Reserves

Asbestos and environmental reserves of the property and casualty group consisted of the following (in millions):

|  | <u>December 31,</u> |             |
|--|---------------------|-------------|
|  | <u>2006</u>         | <u>2005</u> |
| Asbestos                                     | \$345.1             | \$366.0     |
| Environmental                                | <u>87.2</u>         | <u>95.0</u> |
| A&E reserves, net of reinsurance recoverable | 432.3               | 461.0       |
| Reinsurance recoverable, net of allowance    | <u>85.4</u>         | <u>79.4</u> |

|                    |                |                |
|--------------------|----------------|----------------|
| Gross A&E reserves | <u>\$517.7</u> | <u>\$540.4</u> |
|--------------------|----------------|----------------|

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

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. We, along with other insurers, are 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 we and other insurers will be successful in asserting additional defenses. Therefore, the future impact of such efforts is uncertain.

Approximately one-half 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 meaningful range of loss 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 detailed "ground up" studies adjusted for payments and identifiable changes, supplemented by management's review

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of industry information about such claims, with due consideration to individual claim situations. Estimating 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.

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.



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 \$21 million.

From time to time, AFG has engaged independent firms to work closely with its claims staff to study the A&E reserves of its insurance company subsidiaries. The most recent study was completed in the third quarter of 2005 and resulted in AFG recording a pretax charge of \$169 million to increase its A&E reserves. Management expects to conduct such a study every two years with the next study in 2007. For a discussion of the 2005 A&E reserve strengthening, see *Management's Discussion and Analysis - "Results of Operations - Asbestos and Environmental Reserve Charge."*

In February 2003, Great American Insurance Company entered into an agreement for the settlement of asbestos related coverage litigation 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. The settlement is for \$123.5 million (Great American has the option to pay in cash or over time with 5.25% interest), all of which was covered by reserves established prior to 2003, and anticipated reinsurance recoverables for this matter. The agreement allows up to 10% of the settlement to be paid in AFG Common Stock. The settlement has received the approval of the bankruptcy court supervising the reorganization of A.P. Green. It remains subject to the confirmation by the bankruptcy court 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. No assurance can be made that a plan of reorganization will be confirmed; no payments are required until completion of the process. The Bankruptcy Court has ruled that the Debtors' plan of reorganization will require a resolicitation of votes from silica claimants as a condition of the Court's approval of the plan. The Court has set a further hearing on plan confirmation for March, 2007.

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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.

|   | <u>2006</u> | <u>2005</u> | <u>2004</u> |
|---|-------------|-------------|-------------|
| Number of policyholders with no payments: |             |             |             |
| Asbestos                                  | 103         | 164         | 179         |
| Environmental                             | <u>273</u>  | <u>313</u>  | <u>293</u>  |
|   | 376         | 477         | 472         |
| Number of policyholders with payments:    |             |             |             |
| Asbestos                                  | 97          | 103         | 90          |
| Environmental                             | <u>15</u>   | <u>19</u>   | <u>18</u>   |
|   | <u>112</u>  | <u>122</u>  | <u>108</u>  |

|       |            |            |            |
|-------|------------|------------|------------|
| Total | <u>488</u> | <u>599</u> | <u>580</u> |
|-------|------------|------------|------------|

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

|               | <u>2006</u>   | <u>2005</u>   | <u>2004</u>   |
|---------------|---------------|---------------|---------------|
| Asbestos      | \$24.2        | \$16.6        | \$12.2        |
| Environmental | <u>8.0</u>    | <u>22.3</u>   | <u>33.2</u>   |
| Total         | <u>\$32.2</u> | <u>\$38.9</u> | <u>\$45.4</u> |

#### Other Mass Tort Reserves

In connection with the 2005 A&E study, AFG reviewed its reserves for other mass torts. This review resulted in a pretax charge of \$10 million. Other mass tort reserves consisted of the following (in millions):

|   | <u>December 31,</u> |               |
|---|---------------------|---------------|
|   | <u>2006</u>         | <u>2005</u>   |
| Reserves, net of reinsurance recoverable  | \$15.6              | \$17.8        |
| Reinsurance recoverable, net of allowance | <u>3.5</u>          | <u>2.8</u>    |
| Gross reserves                            | <u>\$19.1</u>       | <u>\$20.6</u> |

Other mass tort claims include alleged injuries and damages from exposure to lead, silica and various chemical substances, as well as other toxic hazards. Similar to A&E, other mass tort claims are subject to uncertainties that are significantly greater than those presented by other types of claims. While management believes that AFG's reserves for other mass tort 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 and unresolved issues such as whether coverage exists.

#### Contingencies related to American Premier's Former Operations

At December 31, 2006, American Premier had liabilities aggregating \$76.2 million for various environmental and occupational injury and disease claims and other contingencies arising out of the railroad operations and certain manufacturing operations disposed of by American Premier and its predecessor. Management expects to conduct a comprehensive review of these liabilities in conjunction with the property and casualty group's A&E study in 2007. For a discussion of the uncertainties in determining American Premier's ultimate liability, see Note M - "Commitments and Contingencies" to the Financial Statements.

General

The following table shows AFG's net earnings and diluted earnings per share as stated in the Statement of Earnings as well as the after tax effect of other items included in these GAAP measures that are listed below to assist investors in analyzing their impact on the trend in operating results (in millions, except per share amounts):

|   | <u>2006</u>   | <u>2005</u>   | <u>2004</u>   |
|---|---------------|---------------|---------------|
| Net earnings  | \$453.4       | \$206.6       | \$359.9       |
| After tax income (expense) items included in net earnings:          |               |               |               |
| Asbestos, environmental and other mass tort charges                 | -             | (121.6)       | (33.8)        |
| Gains on sales of New York assets and coal properties               | 29.0          | 37.1          | -             |
| Unlocking charge and write-off of deferred policy acquisition costs | -             | (15.6)        | -             |
| Tax resolution benefit  | 8.7           | -             | -             |
| Net earnings (losses) from investee corporations                    | (2.1)         | (5.1)         | (3.1)         |
| Realized investment gains   | 18.6          | 11.3          | 192.2         |
| Discontinued operations (a)   | 25.2          | 10.5          | -             |
| Cumulative effect of accounting changes                             | -             | -             | (5.6)         |
| Diluted per share amounts:  |               |               |               |
| <b>Net earnings</b>   | <b>\$3.75</b> | <b>\$1.75</b> | <b>\$3.21</b> |
| Asbestos, environmental and other mass tort charges                 | -             | (1.03)        | (.30)         |
| Gains on sales of New York assets and coal properties               | .24           | .32           | -             |
| Unlocking charge and write-off of deferred policy acquisition costs | -             | (.13)         | -             |
| Tax resolution benefit  | .07           | -             | -             |
| Investee corporations   | (.02)         | (.04)         | (.03)         |
| Realized investment gains   | .16           | .10           | 1.71          |
| Discontinued operations (a)   | .21           | .09           | -             |
| Cumulative effect of accounting changes                             | -             | -             | (.05)         |

(a) Includes after tax gains on sales of discontinued hotel operations of \$25.8 million (\$.21 per share) in 2006 and \$8.8 million (\$.07 per share) in 2005.

Excluding the effects of items shown in the table above, net earnings increased in 2006 and 2005 due primarily to improved property and casualty underwriting results, higher operating earnings in the annuity and supplemental insurance operations and increased investment income.

Property and Casualty Insurance - Underwriting

AFG reports its Specialty insurance business in the following components: (i) Property and Transportation, (ii) Specialty Casualty, (iii) Specialty Financial, and (iv) California Workers' Compensation.

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% is indicative of an underwriting profit. The combined ratio does not reflect investment income, other income or federal income taxes.

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.

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Over the last several years, AFG has been realigning its property and casualty business mix and focusing on rate adequacy in order to improve its operating profitability. Management has continued to direct capital in order to take advantage of certain specialty market opportunities. Management believes these actions have been successful and that the current mix of specialty businesses positions the Company for solid growth and continued profitability.

AFG's combined ratio has been better than the industry average for twenty of the last twenty-one years and excluding AFG's special A&E charges, for all twenty-one years. Management believes that AFG's insurance operations have performed better than the industry as a result of product line diversification, stringent underwriting discipline, alignment of incentives, and, more recently, a specialty niche focus.

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

|                                      | <u>2006</u>    | <u>2005</u>    | <u>2004</u>    |
|--------------------------------------|----------------|----------------|----------------|
| <u>Gross Written Premiums (GAAP)</u> |                |                |                |
| Property and transportation          | \$1,657        | \$1,357        | \$1,337        |
| Specialty casualty                   | 1,426          | 1,406          | 1,453          |
| Specialty financial                  | 535            | 493            | 468            |
| California workers' compensation     | 302            | 382            | 380            |
| Other                                | <u>1</u>       | <u>2</u>       | <u>8</u>       |
|                                      | <u>\$3,921</u> | <u>\$3,640</u> | <u>\$3,646</u> |
| <u>Net Written Premiums (GAAP)</u>   |                |                |                |
| Property and transportation          | \$1,036        | \$ 909         | \$ 683         |
| Specialty casualty                   | 839            | 743            | 740            |
| Specialty financial                  | 424            | 384            | 395            |
| California workers' compensation     | 285            | 344            | 339            |
| Other                                | <u>74</u>      | <u>68</u>      | <u>72</u>      |
|                                      | <u>\$2,658</u> | <u>\$2,448</u> | <u>\$2,229</u> |

Combined Ratios (GAAP)

|   |       |       |       |
|---|-------|-------|-------|
| Property and transportation                 | 82.3% | 83.0% | 80.7% |
| Specialty casualty                          | 84.9  | 91.3  | 99.8  |
| Specialty financial (a)                     | 110.2 | 121.3 | 108.9 |
| California workers' compensation            | 74.1  | 70.0  | 89.5  |
| Total Specialty                             | 87.5  | 91.2  | 94.1  |
| Aggregate (including discontinued lines)(b) | 87.6% | 99.0% | 94.8% |

(a) Includes 21.5 points in 2006, 28.7 points in 2005 and 16.2 points in 2004 for the effect of losses related to the residual value business.

(b) Includes 7.6 points in 2005 for the effect of strengthening the A&E and other mass tort loss reserves by \$179 million.

Gross written premiums for the specialty insurance operations increased 8% and net written premiums increased 9% in 2006 compared to 2005. Significant premium growth from the Property and transportation and Specialty financial groups was partially offset by a decline in the California workers' compensation premiums.

The specialty insurance operations generated an underwriting profit of \$322 million in 2006, \$115 million higher than in 2005, reflecting premium growth, rate adequacy in most of the businesses, lower catastrophe losses, and the impact of favorable reserve development within the Specialty casualty, Property and transportation and California workers' compensation groups. The 2006 results include \$22.2 million (0.9 points) of catastrophe losses compared to \$59.7 million (2.5 points) in the 2005 period.

Gross written premiums for the specialty business in 2005 were comparable to 2004, while net written premiums were 10% higher, reflecting the effect of increased premium retention in certain Property and transportation businesses. While certain operations experienced solid volume growth, overall premium levels for the Specialty insurance operations continued to be impacted by the moderating rate environment. Overall average rates for 2005 were about the same as 2004.

The property and casualty specialty insurance operations generated an underwriting profit of \$208 million for 2005, substantially higher than 2004. These results included a \$45 million charge against the residual value business and

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\$53 million for hurricane losses offset by strong profitability within the crop insurance operations and favorable reserve development within several operations. Results for 2004 included \$37 million for hurricane losses.

### Property and transportation

net written premiums for 2006 increased 14% over 2005 due primarily to growth in the property and inland marine and transportation operations and new premium volume from the 2005 acquisition of Farmers Crop Insurance Alliance. The growth in net written premiums was less than the gross written premium growth due to the effect of crop reinsurance programs. The 2006 underwriting results benefited from strong underwriting profits in the crop insurance division resulting from higher favorable reserve development and additional profits from the Farmers acquisition. This group's 2006 combined ratio was 82.3%, slightly better than its 2005 results, reflecting excellent profitability and continuing favorable reserve development in nearly all of the business lines and lower catastrophe losses. The 2006 underwriting results include 3.7 points of favorable reserve development and 2.0 points of catastrophe losses compared to 1.6 points of favorable development and 5.4 points of catastrophe losses in 2005.

Gross written premiums for 2005 were slightly higher than in 2004 as new premiums resulting from the acquisition of Farmers Crop Insurance Alliance and solid volume growth in the transportation, inland marine and equine businesses more than offset the effect of lower commodity prices earlier in the year which were used to establish crop insurance coverages and lower volume resulting from competitive pricing within the excess property insurance operations. Net written premiums increased 33% from 2004 reflecting a reduction in reinsurance ceded, principally in the crop insurance and inland marine operations. This group reported a combined ratio of 83.0%, 2.3 points higher than in 2004. While the crop insurance operations achieved strong profitability in 2005, the results were lower than the record profitability recorded in 2004. The transportation, marine and other agricultural operations also generated strong underwriting profits in 2005.

#### Specialty casualty

net written premiums for 2006 were 13% higher than in 2005 due primarily to volume growth and higher premium retention within several of the group's businesses as well as third quarter 2006 changes to reinsurance agreements within the specialized program business line, which resulted in the recapture of \$26 million in premiums previously ceded to reinsurers. This group's combined ratio improved 6.4 points for 2006 compared to 2005. Results for 2006 included about 1.2 points of favorable reserve development whereas the prior year period included 4.0 points of unfavorable reserve development.

Gross written premiums decreased 3% in 2005 while net written premiums remained about the same, reflecting lower volume resulting from stronger competition in many of the commercial casualty markets. This group generated an underwriting profit of \$63.4 million for 2005 with its combined ratio improving 8.5 points to 91.3%. This significant improvement is the result of a substantial decrease in unfavorable development in the executive liability operations along with strong underwriting profits from the excess and surplus lines and from coverage for not-for-profit businesses.

#### Specialty financial

net written premiums for 2006 increased 10% above the 2005 period reflecting premium growth principally in the financial institutions, lender services and surety and fidelity businesses. The group experienced disappointing results in 2006 resulting from losses within the automobile residual value business ("RVI"), which is in run-off. These losses were primarily attributable to lower than expected proceeds from the sale (at auction) of certain luxury cars and sport utility vehicles. Excluding the effect of the RVI business, this group's combined ratio was 88.7%, as the group's other operations are generating solid underwriting profits.

Gross written premiums grew 5% in 2005 compared to 2004 as a result of volume growth in the profitable fidelity and crime and several other lender services lines. Net written premiums decreased 3% in 2005 from 2004 reflecting the effect of the commutation of a reinsurance agreement in 2004 coupled with an increase in premiums ceded in 2005. A \$29.3 million after tax charge was recorded in 2005 in connection with a written offer by the Company to buy out residual value contracts covering a group of leases with one insured financial institution. As a result of our offer, the estimated ultimate losses related to this particular insured party exceeded

related unearned premium reserves, and accordingly, a premium deficiency was recognized. Excluding the effect of the RVI business, this group's 2005 combined ratio was 92.6%. Losses from the residual value business were partially offset by strong profitability in the fidelity and crime and financial institutions operations.

#### California workers' compensation

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continued to report excellent profitability in 2006. Net written premiums for 2006 were 17% below 2005, reflecting the effect of significantly lower rates, partly offset by new volume growth. This business experienced \$20.2 million (6.9 points) of favorable prior year reserve development in 2006 compared to \$24.4 million (7.0 points) in 2005. The underwriting results reflect the effects of the California workers' compensation reforms that have resulted in lower workers' compensation costs for employers and lower premium levels. Rate decreases in California, which are responsive to the improving claims environment, averaged about 32% in 2006 and 16% in 2005.

Gross and net written premiums for 2005 were about the same as 2004 as volume growth was offset by lower rates. The combined ratio for 2005 improved 19.5 points from 2004 reflecting the benefit of the improving claims environment resulting from the workers' compensation reforms enacted in California. The 2005 underwriting results included favorable prior year reserve development (discussed above) compared to unfavorable prior year reserve development in 2004 of \$21.8 million (6.4 points).

### Asbestos and Environmental Reserve Charge

AFG has undertaken periodic reviews of its asbestos and environmental reserves with the aid of an independent actuarial firm and specialty outside counsel. In 2005, AFG completed a comprehensive study of its A&E exposures relating primarily to the run-off operations of its property and casualty group. As a result of this study, AFG recorded a 2005 third quarter pretax charge of \$169 million, net of \$32 million in reinsurance recoverables. This charge resulted in an increase in asbestos reserves of \$124 million and environmental reserves of \$45 million. AFG's A&E reserves were \$432 million and \$461 million (net of reinsurance recoverables) at December 31, 2006 and 2005, respectively. Management expects to engage an independent actuarial firm to assist in conducting another study in 2007.

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, 2006, AFG's three year survival ratio was 19.5 times paid losses for the asbestos reserves and 11.4 times paid losses for the total A&E reserves (13.5 and 8.6 times paid losses, respectively, excluding amounts associated with the 2003 settlement of asbestos related coverage litigation for A.P. Green Industries). In March 2006, A.M. Best reported its estimate that the property and casualty insurance industry's three year survival ratio for A&E reserves was approximately 7.8 times paid losses at December 31, 2004.

The 2005 study reviewed open and closed A&E claims at June 30, 2005. With respect to asbestos, it considered both direct insurance and assumed reinsurance, products and non-products exposure, paid claims history, the pattern of new claims, settlements and projected development. As has been reported by others, the asbestos legal climate remains very difficult to predict. While some progress has been made in state asbestos tort reform, that progress has been somewhat offset by increased claims costs, increased defense costs, the assertion of non-products theories and an increasing number of claims against small to mid-sized insureds.

A primary driver of the increase in AFG's asbestos reserves in 2005 is the use by independent actuaries of evolving methodologies, including developing parameters for estimating loss adjustment expenses and reducing reliance on extrapolation techniques. In addition, the independent actuaries have indicated that their views have evolved regarding estimation of the potential exposure for both products and non-products claims. In the actuaries' view, this refined approach has increased estimates of the Company's indicated ultimate losses. The estimates of industry ultimate losses and AFG's historic premium market share have not changed since the

2001 study. In addition, there has been no significant change in AFG's payment patterns. In the 2005 study, the actuaries also have given additional weight to claims associated with peripheral defendants bringing direct insurance claims. The increase in the number of direct insurance claims from peripheral defendants has increased the projections of future defense cost and loss exposure.

While tort reform is helping in some jurisdictions, the legal climate in many jurisdictions continues to deteriorate, with larger verdict values being experienced. Expanding coverage interpretations by some courts also has led to increased exposure to some policies in certain jurisdictions.

With respect to the environmental claims, the 2005 study considered both direct insurance and assumed reinsurance, projected exposure at both National Priorities List ("NPL") sites and non-NPL sites, historic payment patterns, patterns of new claims, settlements and projected development. The increase in environmental reserves in 2005 is primarily due to an increase in clean up costs at certain sites above prior expectations and a recent unexpected increase in the number of new claims that have been reported to the Company. In addition, projected development on a few claims exceeded estimates in the previous 2001 study.

#### Other Mass Tort Charge

In connection with the review of A&E reserves in 2005, AFG reviewed its other mass tort exposures and recorded a \$10 million pretax charge. AFG's other mass tort reserves were \$16 million and \$18 million (net of reinsurance recoverables) at December 31, 2006 and 2005, respectively.

#### Loss development

As shown in *Note O - "Insurance - Insurance Reserves,"* AFG's property and casualty operations recorded favorable loss development of \$59 million in 2006 compared to unfavorable development of \$181 million in 2005 and \$140 million in 2004 related to prior accident years. Major areas of favorable (adverse) development were as follows (in millions):

|  | <u>2006</u> | <u>2005</u>    | <u>2004</u>    |
|--|-------------|----------------|----------------|
| Property and transportation                  | \$36        | \$ 14          | (\$ 16)        |
| Specialty casualty                           | 10          | (29)           | (75)           |
| Specialty financial                          | -           | (5)            | (13)           |
| California workers' compensation             | 20          | 24             | (22)           |
| Other specialty                              | <u>(5)</u>  | <u>(3)</u>     | <u>(2)</u>     |
|  | )           | )              | )              |
|  | 61          | 1              | (128)          |
| Asbestos, environmental and other mass torts | -           | (179)          | -              |
| Other  | <u>(2)</u>  | <u>(3)</u>     | <u>(12)</u>    |
|  | )           | )              | )              |
|  | <u>\$59</u> | <u>(\$181)</u> | <u>(\$140)</u> |



The favorable development in Property and transportation in 2006 and 2005 related primarily to lower than expected claim frequency and severity in specialty commercial automobile and ocean marine products. Also contributing to the favorable development in 2006 was lower than expected claim frequency and severity in the crop business. The improvement in both years was partially offset by continued adverse development on runoff homebuilders' liability business, which was the primary reason for the adverse development in 2004. In 2004, the adverse development was partially offset by favorable development in inland marine and agricultural-related coverages.

The favorable development in Specialty casualty in 2006 was driven by lower than expected frequency and severity in liability products for nursing homes and not-for-profit organizations partially offset by adverse development in professional liability (which mostly covers lawyers) and certain run-off businesses. Professional liability had higher than expected increases in claim severity in 2006 and 2005. The adverse development in 2005 was mainly in the professional liability and runoff casualty businesses partially offset by favorable development in the excess and surplus and not-for-profit businesses. Adverse development in excess casualty runoff impacted 2005 and 2004, reflecting higher frequency and severity of claims related to the 1999 through 2001 accident years. Adverse development in 2004 also includes amounts related to executive liability and the commutation of reinsurance. Adverse executive liability development resulted primarily from increased severity on one claim under a directors' and officers' liability policy, as both settlement and defense costs from a shareholder lawsuit increased beyond estimates.

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The adverse development in Specialty financial in 2005 and 2004 related to higher than expected severity on claims from accident years 2000 to 2003.

The favorable development in California workers' compensation in 2006 and 2005 reflects the impact of the workers' compensation reform legislation passed in 2003 and 2004. The adverse development in 2004 reflects the effect of additional information received on individual claims from prior years.

#### Life, Accident and Health Premiums and Benefits

The \$16.3 million decrease in life, accident and health premiums in 2006 reflects the January 2006 sale of GAPR partially offset by the effect of the August 2006 acquisition of Ceres. In addition to these transactions, the increase in life, accident and health benefits for 2006 reflects an increase in loss experience in GAFRI's supplemental insurance business. The Ceres acquisition broadens GAFRI's distribution in both the independent agent and captive agent channels. The increase in life, accident and health premiums and benefits in 2005 reflects the addition of new distribution sources for GAFRI's supplemental insurance products.

#### Investment Income

Changes in investment income reflect fluctuations in market rates and changes in average invested assets. The increase in investment income for 2006 and 2005 reflects increases of \$1.1 billion (7%) and \$1.4 billion (10%), respectively, in average cash and investments in each year. AFG's yield on fixed income securities, excluding realized gains, was about 5.8% in 2006, and 5.7% in 2005 and 2004.

#### Gains (Losses) on Securities

Realized gains for 2006 includes a \$23.6 million pretax gain in the first quarter on the sale of AFG's interest in The Cincinnati Reds. In 2004, AFG received common and preferred shares equivalent to 8.1 million common shares of National City Corporation in exchange for its ownership interest in Provident Financial Group and realized a \$214.3 million pretax gain on the transaction.

Realized gains (losses) on sales of securities include provisions for other than temporary impairment of securities still held of \$25.7 million in 2006, \$16.1 million in 2005 and \$16.7 million in 2004. Impairment charges for 2006 include \$10.3 million to writedown two equity security positions.

### Losses on Sales of Subsidiaries

In January 2006, GAFRI completed the sale of its subsidiary, Great American Life Assurance Company of Puerto Rico, for \$37.5 million in cash. Results for GAFRI in 2005 included a \$3.4 million estimated loss on the sale. Results for 2006 include an additional \$463,000 realized loss offsetting a like amount of earnings recorded in 2006 prior to the sale.

### Real Estate Operations

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

|                                      | <u>2006</u> | <u>2005</u> | <u>2004</u> |
|--------------------------------------|-------------|-------------|-------------|
| Other income                         | \$134.9     | \$136.2     | \$67.9      |
| Other operating and general expenses | 67.1        | 61.2        | 51.0        |
| Interest charges on borrowed money   | 2.7         | 2.0         | 2.0         |
| Minority interest expense            | 3.4         | 1.4         | 1.8         |

Income from real estate operations includes pretax gains of \$44.6 million on the sale of New York real estate assets in 2006 and \$57.0 million on the sales of coal reserves in 2005. Other income also includes net pretax gains on the sales of other real estate assets of \$23.2 million in 2006, \$12.0 million in 2005 and \$12.7 million in 2004.

### Real Estate Operations - Discontinued

In June 2006, GAFRI sold Chatham Bars Inn, a resort hotel located on Cape Cod, Massachusetts, for \$166 million. After sales expenses, contingencies and the write-off of certain deferred acquisition costs on annuities associated with the gain recognition, GAFRI recognized a pretax gain of

approximately \$48.7 million. In October 2005, GAFRI sold the Driskill Hotel in Austin, Texas for \$53 million. After sale expenses, profit sharing payments and a write-off of DPAC associated with the gain, GAFRI recognized a pretax gain of

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\$16.5 million. The operating results and gains on the sales of Chatham and Driskill are included in discontinued operations in the Statement of Operations. See *Note L - "Discontinued Operations."*

### Other Income

Other income increased \$57.1 million (19%) in 2005 compared to 2004 due primarily to pretax gains of \$57.0 million on the coal reserves sales mentioned above under "Real Estate Operations."

### Annuity Benefits

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

Annuity benefits for 2006 increased slightly compared to 2005 as the effect of internal growth and the acquisition of Old Standard Life fixed annuity business were offset by the effect of the fourth quarter 2005 "unlocking" charge discussed below, lower average effective crediting rates and the sale of GAPR.

In the fourth quarter of 2006, GAFRI conducted its annual review of the actual results and future assumptions underlying its annuity operations, including assumptions related to future interest rates and persistency. There were no significant adjustments or "unlockings" necessary. In 2005, primarily as a result of the continuing low interest rate environment, GAFRI "unlocked" the actuarial assumptions related to its annuity business in force and recorded a pretax charge of approximately \$11.6 million to insurance liabilities related to that business. In 2004, these liabilities were increased by approximately \$5 million due to trends in actual experience.

### Annuity and Supplemental Insurance Acquisition Expenses

Annuity and supplemental insurance acquisition expenses include amortization of annuity, supplemental insurance and run-off life business deferred policy acquisition costs ("DPAC") as well as a portion of commissions on sales of insurance products. Annuity and supplemental insurance acquisition expenses also include amortization of the present value of future profits of businesses acquired. The \$8.4 million decrease in annuity and supplemental insurance acquisition expenses for 2006 compared to 2005 reflects the effect of the fourth quarter 2005 DPAC write-offs discussed below and the January 2006 sale of GAPR, partially offset by the Ceres and Old Standard Life acquisitions and other growth in the annuity and supplemental insurance businesses.

As a result of the 2006 annual review of actual results and future assumptions discussed above under "*Annuity Benefits*," no significant "unlockings" were deemed necessary. In 2005, GAFRI recorded net charges of \$4.2 million to annuity and supplemental insurance acquisition expenses primarily related to spread narrowing partially offset by the expected improved future persistency related to GAFRI's annuities, due to the impact of the current interest rate environment. Also in 2005, GAFRI recorded a \$13.6 million write-off of DPAC due to an unexpected increase in mortality in GAFRI's run-off life operations. Annuity and supplemental insurance acquisition expenses for 2004 were reduced by \$5.1 million related to favorable trends in actual experience.

The vast majority of GAFRI's DPAC asset relates to its fixed annuity, variable annuity and run-off life insurance lines of business. Continued spread compression, decreases in the stock market and adverse mortality experience could lead to further write-offs of DPAC in the future.

### Interest on Borrowed Money

Changes in interest expense result from fluctuations in market rates as well as changes in borrowings. AFG has generally financed its borrowings on a long-term basis which has resulted in higher current costs.

Interest expense decreased \$7 million (9%) in 2006 compared to 2005 due primarily to the retirement of debt in 2006 and late 2005.

Interest expense for 2005 decreased \$1.6 million compared to 2004 due primarily to the repurchase of subordinated debt due to subsidiary trusts in 2005 and 2004, partially offset by a higher effective interest rate on GAFRI's interest rate swap. See *Note A - "Accounting Policies - Derivatives"* to the Financial Statements for a discussion of GAFRI's interest rate swap.

#### Other Operating and General Expenses

Other operating and general expenses for 2006 include \$7.3 million in losses on retirement of debt and a \$4.2 million goodwill write-off in the annuity and supplemental insurance operations. Other operating and general expenses for 2005 include a \$9.5 million pretax charge to increase reserves related to environmental liabilities at GAFRI's former manufacturing operations and \$8.0 million in losses on debt retirements.

In 2004, other operating and general expenses include a \$52 million charge based on American Premier's settlement of litigation related to environmental clean-up costs at a former railroad site, a \$4 million goodwill write-off in the annuity and supplemental insurance operations and \$2.2 million in losses on debt retirements. Excluding these items and the above mentioned environmental charge and loss on debt retirements in 2005, other operating and general expenses were about the same in 2005 compared to 2004.

#### Income Taxes

Income tax expense in 2006 includes an \$8.7 million benefit related to the favorable resolution of certain tax issues in the second quarter. See *Note J - "Income Taxes"* to the Financial Statements for an analysis of items affecting AFG's effective tax rate.

#### Investee Corporation

Equity in losses of investee includes losses of a manufacturing business that was formerly a subsidiary. Equity in net losses of investee includes \$2.1 million in 2006 compared to \$1.2 million in 2005 and \$3.1 million in 2004 in losses from this business. In addition, equity in net losses of investee for 2005 includes a \$3.9 million after tax impairment writedown on this business.

#### Cumulative Effect of Accounting Changes

In 2004, AFG recorded a \$1.8 million charge (after tax and minority interest) resulting from GAFRI's implementation of Statement of Position ("SOP") 03-1. This charge resulted primarily from a change in accounting for persistency bonuses and two-tier annuities. In 2004, AFG recorded a \$3.8 million after tax charge resulting from implementation of EITF 03-16. This charge reflects the cumulative effect of changing from the cost method to the equity method of accounting for AFG's investment in a limited liability company. This charge reduced AFG's investment in this entity to zero.

#### RECENT ACCOUNTING STANDARDS

The following accounting standards are to be implemented by AFG in 2007.

#### Accounting

##### Standard

SOP 05-1

FIN 48

##### Subject of Standard

Accounting for Modifications of Insurance Contracts

Accounting for Uncertainty in Income Taxes

SOP 05-1, "Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection with Modifications or Exchanges of Insurance Contracts," provides guidance on accounting for deferred policy acquisition costs on certain internal replacements of insurance and investment contracts. SOP 05-1 defines an internal replacement as a modification in product benefits, features, rights or coverages that occurs by the exchange of a contract for a new contract, or by amendment, endorsement, or rider to a contract, or by the election of a feature or coverage within a contract. The SOP is effective for internal replacements occurring in fiscal years beginning after December 15, 2006. The impact on AFG's financial statements of implementing this standard is not expected to be material. However, future modification or exchanges of annuity and supplemental insurance contracts could result in the write-off of a portion of deferred policy acquisition costs.

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FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes (an interpretation of FASB Statement No. 109)" ("FIN 48") is effective for fiscal years beginning after December 15, 2006. For more information on FIN 48, see *Income Taxes in Note A - "Accounting Policies"* to the Financial Statements.

#### Proposed Accounting Standard

The FASB has proposed an amendment to SFAS No. 128, "Earnings per Share." Currently, SFAS No. 128 allows companies issuing securities that can be settled in cash or stock (such as AFG's convertible notes) to exclude the issuable shares from the calculation of diluted earnings per share when there is a stated intent and ability to deliver cash in lieu of stock upon settlement or conversion. The proposed statement would require companies to assume settlement in stock (despite the ability and intent to settle in cash) and include those shares in the calculation of diluted earnings per share. Should the FASB proposal be adopted as proposed, AFG anticipates that it will amend the convertible note indenture to eliminate the option to settle the accreted value of the notes in shares, and thereby mitigate the proposal's impact on dilution.

## 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 substantially all fixed rate investments with primarily 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.

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The following table provides information about AFG's "available for sale" fixed maturity investments at December 31, 2006 and 2005, that are sensitive to interest rate risk. The table shows principal cash flows (in millions) and related weighted average interest rates by expected maturity date for each of the five subsequent years and for all years thereafter. Callable bonds and notes are included based on call date or maturity date depending upon which date produces the most conservative yield. Mortgage-backed securities ("MBS") and sinking fund issues are included based on maturity year adjusted for expected payment patterns. Actual cash flows may differ from those expected.

|            | <u>December 31, 2006</u>    |             |            | <u>December 31, 2005</u>    |             |
|------------|-----------------------------|-------------|------------|-----------------------------|-------------|
|            | <u>Principal Cash Flows</u> | <u>Rate</u> |            | <u>Principal Cash Flows</u> | <u>Rate</u> |
| 2007       | \$ 881                      | 5.4%        | 2006       | \$ 670                      | 5.5%        |
| 2008       | 1,176                       | 5.1         | 2007       | 717                         | 6.0         |
| 2009       | 1,106                       | 5.2         | 2008       | 1,152                       | 5.3         |
| 2010       | 1,389                       | 5.3         | 2009       | 1,104                       | 5.3         |
| 2011       | 1,796                       | 5.6         | 2010       | 1,762                       | 5.4         |
| Thereafter | <u>8,291</u>                | 5.8         | Thereafter | <u>8,800</u>                | 5.6         |
| Total      | <u>\$14,639</u>             | 5.6%        | Total      | <u>\$14,205</u>             | 5.6%        |
| Fair Value | <u>\$14,624</u>             |             | Fair Value | <u>\$14,327</u>             |             |

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#### Annuity Contracts

Substantially all of GAFRI's fixed rate annuity contracts permit GAFRI 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, GAFRI began issuing products with guaranteed minimum crediting rates of less than 3% in states where required approvals have been received. Actuarial assumptions used to estimate DPAC and certain annuity liabilities, as well as GAFRI's ability to maintain spread, could be impacted if the current interest rate environment continues for an extended period, or if increases in interest rates cause policyholder behavior to differ significantly from current expectations.

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

|      | <u>First</u> | <u>Second</u> | <u>Third</u> | <u>Fourth</u> | <u>Fifth</u> | <u>Thereafter</u> | <u>Total</u> | <u>Fair Value</u> |
|------|--------------|---------------|--------------|---------------|--------------|-------------------|--------------|-------------------|
| 2006 | \$1,016      | \$1,085       | \$ 971       | \$934         | \$933        | \$4,518           | \$9,457      | \$8,969           |
| 2005 | 907          | 945           | 1,013        | 897           | 880          | 3,775             | 8,417        | 8,060             |

At December 31, 2006, the average stated crediting rate on the in-force block of GAFRI's principal fixed annuity products was approximately 3.8%. The current stated crediting rates (excluding bonus interest) on new sales of GAFRI's fixed annuity products generally range from 3.0% to 4.0%. GAFRI estimates that its effective weighted-average crediting rate on its in-force business over the next five years will approximate 3.6%. 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.

GAFRI's indexed annuities represented nearly 9% of GAFRI's insurance reserves at December 31, 2006. These annuities provide policyholders with a crediting rate tied, in part, to the performance of an existing stock market index. GAFRI attempts to mitigate the risk in the index-based component of these products through the purchase of call options on the appropriate index. GAFRI'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 GAFRI. Under SFAS No. 133, 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 had a net effect of less than 1% of annuity benefits in 2006 and 2005.

### 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.

|            | <u>December 31, 2006</u>                    |             |            | <u>December 31, 2005</u>                    |             |
|------------|---|-------------|------------|---|-------------|
|            | <u>Scheduled<br/>Principal<br/>Payments</u> | <u>Rate</u> |            | <u>Scheduled<br/>Principal<br/>Payments</u> | <u>Rate</u> |
| 2007       | \$ 82.0                                     | 7.1%        | 2006       | \$ 18.8                                     | 6.7%        |
| 2008       | 222.0                                       | 4.4         | 2007       | 59.9  | 7.1         |
| 2009       | 184.4                                       | 7.1         | 2008       | 238.7                                       | 4.6         |
| 2010       | 2.9   | 7.6         | 2009       | 204.9                                       | 7.1         |
| 2011       | 9.1   | 10.1        | 2010       | 2.1   | 8.4         |
| Thereafter | <u>404.9</u>                                | 7.2         | Thereafter | <u>385.4</u>                                | 7.4         |
| Total      | <u>\$ 905.3</u>                             | 6.5%        | Total      | <u>\$909.8</u>                              | 6.6%        |
| Fair Value | <u>\$1,054.3</u>                            |             | Fair Value | <u>\$978.5</u>                              |             |

The AFG Senior Convertible Notes issued in 2003 are included in the above table at the first put date (2008). GAFRI has entered into interest rate swaps, which effectively convert its 6-7/8% fixed-rate Notes due in 2008 (included in the table above) to a floating rate of 3-month LIBOR plus 2.9%. The scheduled principal payments in the December 2005 table above were adjusted to reflect the repurchase of \$73.6 million in debt during the first two months of 2006.

On March 1, 2007, GAFRI will redeem all \$22 million of its 8-7/8% Subordinated Debentures due January 2027 (included as a scheduled 2007 payment at December 31, 2006, in the table above).

No amounts were borrowed under the AFG or GAFRI bank lines at December 31, 2006 or 2005.

ITEM 8

Financial Statements and Supplementary Data

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

Please refer to "Forward-Looking Statements" following the Index in front of this Form 10-K.

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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 the controls and procedures are effective. There have been no changes in AFG's internal control over financial reporting during the fourth fiscal quarter of 2006 that materially affected, or are reasonably likely to materially affect, AFG's internal control over financial reporting. Modifications were made in the fourth quarter to controls relating to emergency access by programmers to a subsidiary's information systems and to the quarterly financial statement close process at a subsidiary location. However, the related business processes and procedures did not materially change as a result of the modifications. 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, 2006, based on the criteria set forth in "Internal Control - Integrated Framework" issued by the Committee of Sponsoring Organizations of the Treadway Commission.

In conducting AFG's evaluation of the effectiveness of its internal control over financial reporting, AFG has not included Ceres Group, Inc. which was acquired in 2006. This acquisition constituted less than 4% of total assets as of December 31, 2006 and less than 2% of total revenues and net earnings for the year then ended. Refer to Note B to the consolidated financial statements for further discussion of this acquisition.

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, 2006. Management's assessment of the effectiveness of internal control over financial reporting as of December 31, 2006 has been audited by Ernst & Young LLP, an independent registered public accounting firm, as stated in their report, which is set forth below.

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## 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 management's assessment, included in the accompanying Management's Report on Internal Control Over Financial Reporting, that American Financial Group, Inc. (the Company) maintained effective internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). American Financial Group, Inc.'s management is responsible for maintaining effective internal control over financial reporting and for its assessment about the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of 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, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, 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.

As indicated in the accompanying Management's Report on Internal Control Over Financial Reporting, management's assessment of and conclusion on the effectiveness of internal control over financial reporting did not include the internal controls of the Ceres Group, Inc., which is included in the 2006 consolidated financial statements of American Financial Group, Inc. and constituted less than 4% of total assets as of December 31, 2006, and less than 2% of total revenues and net earnings for the year then ended. Management did not assess the effectiveness of internal control over financial reporting at this entity because the Company acquired this entity during 2006. Our audit of internal control over financial reporting of American Financial Group, Inc. also did not include an evaluation of the internal control over financial reporting of this acquired entity.

In our opinion, management's assessment that American Financial Group, Inc. maintained effective internal control over financial reporting as of December 31, 2006, is fairly stated, in all material respects, based on the COSO criteria. Also, in our opinion, American Financial Group, Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2006, 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. as of December 31, 2006 and 2005, and the related consolidated statements of earnings, changes in shareholders' equity and cash flows for each of the three years in the period ended December 31, 2006, and our report dated February 27, 2007, expressed an unqualified opinion thereon.

/s/ERNST & YOUNG LLP

Cincinnati, Ohio  
February 27, 2007

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, 2006 and 2005, and the related consolidated statements of earnings, changes in shareholders' equity and cash flows for each of the three years in the period ended December 31, 2006. 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, 2006 and 2005, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2006, 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 new accounting standards, the Company changed its methods of accounting for stock-based compensation in 2006 and for certain nontraditional long duration insurance contracts and separate accounts and for limited liability companies in 2004.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of American Financial Group, Inc.'s internal control over financial reporting as of December 31, 2006, based upon criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated February 27, 2007, expressed an unqualified opinion thereon.

**/s/ERNST & YOUNG LLP**

Cincinnati, Ohio

February 27, 2007

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AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES

## CONSOLIDATED BALANCE SHEET

(Dollars In Millions)

|  | <u>December 31,</u> |                   |
|--|---------------------|-------------------|
|  | <u>2006</u>         | <u>2005</u>       |
| Assets:  |                     |                   |
| Cash and cash equivalents  | \$ 1,329.0          | \$ 471.8          |
| Investments:   |                     |                   |
| Fixed maturities:  |                     |                   |
| Available for sale - at fair value<br>(amortized cost - \$14,663.0 and \$14,272.3) | 14,624.3            | 14,326.6          |
| Trading - at fair value  | 276.4               | 271.9             |
| Other stocks - at fair value<br>(cost - \$606.4 and \$501.5)                       | 729.4               | 556.7             |
| Policy loans   | 267.1               | 258.7             |
|  | <u>512.8</u>        | <u>338.3</u>      |
| Real estate and other investments  |                     |                   |
| Total cash and investments   | 17,739.0            | 16,224.0          |
| Recoverables from reinsurers and prepaid<br>reinsurance premiums                   | 3,625.2             | 3,263.1           |
| Agents' balances and premiums receivable   | 599.4               | 574.9             |
| Deferred policy acquisition costs  | 1,266.9             | 1,139.5           |
| Other receivables  | 425.0               | 388.1             |
| Variable annuity assets (separate accounts)  | 700.5               | 643.5             |
| Prepaid expenses, deferred charges and other assets                                | 577.3               | 416.0             |
|  | <u>167.8</u>        | <u>166.9</u>      |
| Goodwill   |                     |                   |
|  | <u>\$25,101.1</u>   | <u>\$22,816.0</u> |
| Liabilities and Capital:   |                     |                   |
| Unpaid losses and loss adjustment expenses   | \$ 6,027.7          | \$ 5,790.7        |
| Unearned premiums  | 1,653.9             | 1,644.0           |
| Annuity benefits accumulated   | 9,456.7             | 8,417.3           |
| Life, accident and health reserves   | 1,414.7             | 1,088.0           |
| Payables to reinsurers   | 314.9               | 298.7             |
| Long-term debt   | 921.0               | 999.7             |
| Variable annuity liabilities (separate accounts)                                   | 700.5               | 643.5             |
| Accounts payable, accrued expenses and other<br>liabilities                        | <u>1,398.9</u>      | <u>1,215.4</u>    |

|  |                   |                   |
|--|-------------------|-------------------|
| Total liabilities                                  | 21,888.3          | 20,097.3          |
| Minority interest                                  | 283.9             | 261.1             |
| Shareholders' Equity:                              |                   |                   |
| Common Stock, no par value                         |                   |                   |
| - 200,000,000 shares authorized                    |                   |                   |
| - 119,303,928 and 117,101,271 shares outstanding   | 119.3             | 117.1             |
| Capital surplus                                    | 1,220.5           | 1,155.6           |
| Retained earnings                                  | 1,533.6           | 1,134.1           |
|  | <u>55.5</u>       | <u>50.8</u>       |
| Accumulated other comprehensive income, net of tax | <u>2,928.9</u>    | <u>2,457.6</u>    |
| Total shareholders' equity                         | <u>\$25,101.1</u> | <u>\$22,816.0</u> |

See notes to consolidated financial statements.

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AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF EARNINGS

(In Millions, Except Per Share Data)

|  | <u>Year ended December 31,</u> |              |              |
|--|--------------------------------|--------------|--------------|
|  | <u>2006</u>                    | <u>2005</u>  | <u>2004</u>  |
| Income:                                  |                                |              |              |
| Property and casualty insurance premiums | \$2,563.1                      | \$2,366.5    | \$2,110.3    |
| Life, accident and health premiums       | 354.7                          | 371.0        | 351.4        |
| Investment income                        | 939.1                          | 865.3        | 800.2        |
| Realized gains (losses) on:              |                                |              |              |
| Securities                               | 29.0                           | 23.9         | 301.9        |
| Subsidiaries                             | (.5)                           | (3.4)        | -            |
| Other income                             | <u>364.7</u>                   | <u>361.1</u> | <u>304.0</u> |
|  | 4,250.1                        | 3,984.4      | 3,867.8      |
| Costs and Expenses:                      |                                |              |              |
| Property and casualty insurance:         |                                |              |              |

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|   |                 |                 |                 |
|---|-----------------|-----------------|-----------------|
| Losses and loss adjustment expenses                     | 1,480.3         | 1,689.1         | 1,416.3         |
| Commissions and other underwriting expenses             | 764.8           | 652.4           | 582.4           |
| Annuity benefits  | 343.7           | 341.6           | 313.6           |
| Life, accident and health benefits                      | 285.6           | 286.5           | 264.7           |
| Annuity and supplemental insurance acquisition expenses | 141.8           | 150.2           | 115.6           |
| Interest charges on borrowed money                      | 72.5            | 79.5            | 81.1            |
| Other operating and general expenses                    | <u>463.8</u>    | <u>450.2</u>    | <u>509.1</u>    |
|   | <u>3,552.5</u>  | <u>3,649.5</u>  | <u>3,282.8</u>  |
| Operating earnings before income taxes                  | 697.6           | 334.9           | 585.0           |
| Provision for income taxes                              | <u>235.7</u>    | <u>108.3</u>    | <u>184.5</u>    |
| Net operating earnings                                  | 461.9           | 226.6           | 400.5           |
| Minority interest expense                               | (31.6)          | (25.4)          | (31.9)          |
| Equity in net losses of investee, net of tax            | <u>(2.1)</u>    | <u>(5.1)</u>    | <u>(3.1)</u>    |
| Earnings from continuing operations                     | 428.2           | 196.1           | 365.5           |
| Discontinued operations, net of tax                     | 25.2            | 10.5            | -               |
| Cumulative effect of accounting changes, net of tax     | <u>-</u>        | <u>-</u>        | <u>(5.6)</u>    |
| Net Earnings  | <u>\$ 453.4</u> | <u>\$ 206.6</u> | <u>\$ 359.9</u> |
| Basic earnings per Common Share:                        |                 |                 |                 |
| Continuing operations                                   | \$ 3.63         | \$1.69          | \$3.31          |
| Discontinued operations                                 | .21             | .09             | -               |
| Cumulative effect of accounting changes                 | <u>-</u>        | <u>-</u>        | <u>(.05)</u>    |
| Net earnings available to Common Shares                 | <u>\$3.84</u>   | <u>\$1.78</u>   | <u>\$3.26</u>   |
| Diluted earnings per Common Share:                      |                 |                 |                 |
| Continuing operations                                   | \$3.54          | \$1.66          | \$3.26          |
| Discontinued operations                                 | .21             | .09             | -               |
| Cumulative effect of accounting changes                 | <u>-</u>        | <u>-</u>        | <u>(.05)</u>    |

|   |               |               |               |
|---|---------------|---------------|---------------|
| Net earnings available to Common Shares | <u>\$3.75</u> | <u>\$1.75</u> | <u>\$3.21</u> |
| Average number of Common Shares:        |               |               |               |
| Basic                                   | 118.0         | 115.8         | 110.4         |
| Diluted                                 | 120.5         | 117.8         | 112.2         |
| Cash dividends per Common Share         | \$ .37        | \$ .33        | \$ .33        |

See notes to consolidated financial statements.

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AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY

(Dollars In Millions)

|  | Common<br><u>Shares</u> | Common Stock<br>and Capital<br><u>Surplus</u> | Retained<br><u>Earnings</u> | Accumulated<br>Other<br>Comprehensive<br><u>Income</u> | <u>Total</u>  |
|--|-------------------------|---|-----------------------------|--|---------------|
| Balance at January 1, 2004                         | 109,584,128             | \$1,108.8                                     | \$ 664.7                    | \$302.6  | \$2,076.1     |
| Net earnings                                       | -                       | -   | 359.9                       | -  | 359.9         |
| Other comprehensive income (loss),<br>net of tax - |                         |   |                             |  | <u>(70.9)</u> |
| Change in unrealized gains on securities           | -                       | -   | -                           | (70.9)   |               |
| Total comprehensive income                         |                         |   |                             |  | 289.0         |
| Dividends on Common Stock                          | -                       | -   | (36.7)                      | -  | (36.7)        |
| Shares issued:                                     |                         |   |                             |  |               |
| Public offerings                                   | 4,018,500               | 81.9  | -                           | -  | 81.9          |

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|                                     |             |           |          |          |           |
|-------------------------------------|-------------|-----------|----------|----------|-----------|
| Exercise of stock options           | 2,029,047   | 34.9      | -        | -        | 34.9      |
| Dividend reinvestment plan          | 89,248      | 1.6       | -        | -        | 1.6       |
| Employee stock purchase plan        | 42,382      | .8        | -        | -        | .8        |
| Retirement plan contributions       | 210,485     | 4.2       | -        | -        | 4.2       |
| Deferred compensation distributions | 51,327      | 1.0       | -        | -        | 1.0       |
| Directors fees paid in stock        | 17,499      | .3        | -        | -        | .3        |
| Shares tendered in option exercises | (1,091,310) | (11.1)    | (11.6)   | -        | (22.7)    |
|                                     | <u>-</u>    | <u>.1</u> | <u>-</u> | <u>-</u> | <u>.1</u> |

Other

114,951,306      \$1,222.5    \$ 976.3      \$231.7    \$2,430.5

Balance at December 31, 2004

|  |   |      |          |      |                |
|--|---|------|----------|------|----------------|
| Net earnings                                       | - | \$ - | \$ 206.6 | \$ - | \$ 206.6       |
| Other comprehensive income (loss),<br>net of tax - |   |      |          |      | <u>(180.9)</u> |

|  |   |   |   |         |      |
|--|---|---|---|---------|------|
| Change in unrealized gains on securities | - | - | - | (180.9) | )    |
| Total comprehensive income               |   |   |   |         | 25.7 |

|                           |   |   |        |   |        |
|---------------------------|---|---|--------|---|--------|
| Dividends on Common Stock | - | - | (38.5) | - | (38.5) |
|---------------------------|---|---|--------|---|--------|

Shares issued:

|                                      |           |            |          |   |            |
|--------------------------------------|-----------|------------|----------|---|------------|
| Exercise of stock options            | 2,504,152 | 48.5       | -        | - | 48.5       |
| Dividend reinvestment plan           | 274,782   | 5.4        | -        | - | 5.4        |
| Employee stock purchase plan         | 39,641    | .9         | -        | - | .9         |
| Retirement plan contributions        | 207,774   | 4.5        | -        | - | 4.5        |
| Deferred compensation distributions  | 11,061    | .2         | -        | - | .2         |
| Directors fees paid in stock         | 13,980    | .3         | -        | - | .3         |
| Shares tendered in option exercises  | (901,425) | (9.6)      | (10.3)   | - | (19.9)     |
| Capital transactions of subsidiaries | -         | (8.0)      | -        | - | (8.0)      |
|                                      | <u>-</u>  | <u>8.0</u> | <u>-</u> |   | <u>8.0</u> |

Other

-



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|   |                    |                  |                  |                |                  |
|---|--------------------|------------------|------------------|----------------|------------------|
| Balance at December 31, 2005                      | <u>117,101,271</u> | <u>\$1,272.7</u> | <u>\$1,134.1</u> | <u>\$ 50.8</u> | <u>\$2,457.6</u> |
| Net earnings                                      | -                  | \$ -             | \$ 453.4         | \$ -           | \$ 453.4         |
| Other comprehensive income (loss),<br>net of tax: |                    |                  |                  |                |                  |
| Change in unrealized gains on securities          | -                  | -                | -                | (.1)           | (.1)             |
| Change in foreign currency translation            | -                  | (4.9)            | -                | 4.3            | <u>(.6)</u>      |
|   |                    |                  |                  | )              |                  |
| Total comprehensive income                        |                    |                  |                  |                | 452.7            |
| Dividends on Common Stock                         | -                  | -                | (43.2)           | -              | (43.2)           |
| Shares issued:                                    |                    |                  |                  |                |                  |
| Exercise of stock options                         | 2,421,667          | 59.4             | -                | -              | 59.4             |
| Dividend reinvestment plan                        | 185,211            | 5.0              | -                | -              | 5.0              |
| Employee stock purchase plan                      | 36,802             | 1.1              | -                | -              | 1.1              |
| Deferred compensation distributions               | 63,162             | 1.6              | -                | -              | 1.6              |
| Directors fees paid in stock                      | 12,780             | .4               | -                | -              | .4               |
| Shares tendered in option exercises               | (515,227)          | (6.0)            | (10.7)           |                | (16.7)           |
| Stock-based compensation expense                  | -                  | 7.0              | -                | -              | 7.0              |
| Capital transactions of subsidiaries              | -                  | 3.6              |                  | -              | 3.6              |
| Cash in lieu of stock-split<br>fractional shares  | (1,738)            | (.1)             | -                | -              | (.1)             |
| Other   | <u>-</u>           | <u>-</u>         | <u>-</u>         | <u>.5</u>      | <u>.5</u>        |
|   | <u>119,303,928</u> | <u>\$1,339.8</u> | <u>\$1,533.6</u> | <u>\$ 55.5</u> | <u>\$2,928.9</u> |
| Balance at December 31, 2006                      |                    |                  |                  |                |                  |

See notes to consolidated financial statements.

## AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES

## CONSOLIDATED STATEMENT OF CASH FLOWS

(In Millions)

|  | <u>Year ended December 31,</u> |                |                |
|--|--------------------------------|----------------|----------------|
|  | <u>2006</u>                    | <u>2005</u>    | <u>2004</u>    |
| Operating Activities:                                    |                                |                |                |
| Net earnings   | \$ 453.4                       | \$ 206.6       | \$ 359.9       |
| Adjustments:   |                                |                |                |
| Cumulative effect of accounting changes                  | -                              | -              | 5.6            |
| Equity in net losses of investees                        | 2.1                            | 5.1            | 3.1            |
| Minority interest  | 37.3                           | 28.0           | 32.4           |
| Depreciation and amortization                            | 167.0                          | 213.0          | 174.2          |
| Annuity benefits   | 343.7                          | 341.6          | 313.6          |
| Realized gains on investing activities                   | (144.9)                        | (103.4)        | (316.4)        |
| Net purchases/sales of trading securities                | (6.8)                          | 14.2           | (94.8)         |
| Deferred annuity and life acquisition costs              | (171.5)                        | (128.1)        | (120.1)        |
| Decrease (increase) in reinsurance and other receivables | (45.8)                         | 188.1          | (305.6)        |
| Decrease in other assets                                 | 36.2                           | 22.2           | 84.5           |
| Increase in insurance claims and reserves                | 278.6                          | 564.9          | 620.8          |
| Increase (decrease) in payable to reinsurers             | 16.0                           | (414.8)        | 105.6          |
| Increase (decrease) in other liabilities                 | (23.5)                         | 50.1           | 138.0          |
|  | <u>25.8</u>                    | <u>34.8</u>    | <u>6.9</u>     |
| Other, net   |                                |                |                |
|  | <u>967.6</u>                   | <u>1,022.3</u> | <u>1,007.7</u> |
| Net cash provided by operating activities                |                                |                |                |
| Investing Activities                                     |                                |                |                |
| :  |                                |                |                |
| Purchases of and additional investments in:              |                                |                |                |
| Fixed maturity investments                               | (2,829.2)                      | (4,134.9)      | (5,608.9)      |
| Equity securities  | (319.6)                        | (276.5)        | (188.5)        |
| Subsidiaries   | (206.5)                        | (17.5)         | (10.4)         |
| Real estate, property and equipment                      | (72.4)                         | (79.4)         | (56.4)         |
| Maturities and redemptions of fixed maturity investments | 995.4                          | 1,088.0        | 1,270.3        |
| Sales of:  |                                |                |                |
| Fixed maturity investments                               | 1,634.0                        | 1,757.0        | 3,642.7        |
| Equity securities  | 270.7                          | 265.8          | 254.4          |
| Subsidiaries   | 37.5                           | 1.8            | -              |
| Real estate, property and equipment                      | 135.2                          | 126.6          | 21.5           |

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|  |                  |                  |                 |
|--|------------------|------------------|-----------------|
| Increase in securities lending collateral                        | (158.9)          | -                | -               |
| Cash and cash equivalents of businesses<br>acquired or sold, net | 201.9            | 51.2             | (72.1)          |
|  | <u>(50.5)</u>    | <u>(37.9)</u>    | <u>.2</u>       |
| Decrease (increase) in other investments                         | )                | )                | )               |
|  | <u>(362.4)</u>   | <u>(1,255.8)</u> | <u>(747.2)</u>  |
| Net cash used in investing activities                            | )                | )                | )               |
| Financing Activities:  |                  |                  |                 |
| Fixed annuity receipts   | 1,378.2          | 854.4            | 686.3           |
| Annuity surrenders, benefits and withdrawals                     | (1,208.5)        | (936.1)          | (729.8)         |
| Net transfers from variable annuity assets                       | 25.5             | 11.4             | 1.4             |
| Additional long-term borrowings                                  | 117.5            | 29.7             | 195.4           |
| Reductions of long-term debt                                     | (209.9)          | (145.0)          | (200.6)         |
| Increase in securities lending obligation                        | 158.9            | -                | -               |
| Issuances of Common Stock  | 38.7             | 25.8             | 91.5            |
| Subsidiary's issuance of stock in<br>public offering             | -                | 40.4             | -               |
| Cash dividends paid on Common Stock                              | (38.2)           | (33.1)           | (35.1)          |
|  | <u>(10.2)</u>    | <u>(3.9)</u>     | <u>(1.4)</u>    |
| Other, net   | )                | )                | )               |
| Net cash provided by (used in) financing<br>activities           | )                | )                | )               |
|  | <u>252.0</u>     | <u>(156.4)</u>   | <u>7.7</u>      |
| Net Increase (Decrease) in Cash and Cash Equivalents             | 857.2            | (389.9)          | 268.2           |
|  | <u>471.8</u>     | <u>861.7</u>     | <u>593.5</u>    |
| Cash and cash equivalents at beginning of period                 |                  |                  |                 |
|  | <u>\$1,329.0</u> | <u>\$ 471.8</u>  | <u>\$ 861.7</u> |
| Cash and cash equivalents at end of period                       |                  |                  |                 |

See notes to consolidated financial statements.

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

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INDEX TO NOTES

A. Accounting Policies

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

The preparation of the financial statements 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.

**Stock Split**

In November 2006, AFG's Board of Directors approved a three-for-two common stock split. On December 15, 2006, one additional common share was issued for every two common shares held by shareholders of record on November 30, 2006. The total number of authorized shares and the \$1.00 stated value per share did not change. All other share and per share amounts presented in the financial statements have been retroactively adjusted to reflect the effect of the split for all periods presented.

**Investments**

Fixed maturity securities and equity securities classified as "available for sale" are reported at fair value with unrealized gains and losses reported as a separate component of shareholders' equity. Fixed maturities classified as "trading" are reported at fair value with changes in unrealized holding gains or losses during the period included in investment income. Loans receivable are carried primarily at the aggregate unpaid balance. Premiums and discounts on fixed maturity securities are amortized using the interest method; mortgage-backed securities are amortized over a period based on estimated future principal payments, including prepayments. Prepayment assumptions are reviewed periodically and adjusted to reflect actual prepayments and changes in expectations.

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

Emerging Issues Task Force ("EITF") Issue 03-16, "Accounting for Investments in Limited Liability Companies", under which limited liability companies ("LLCs") are deemed to be the same as limited partnerships for which the equity method of accounting is generally required for ownership levels of "more

than 3 to 5 percent", became effective in 2004. The cumulative effect of changing from the cost method to the equity method of accounting for AFG's investment in an LLC is shown separately in the Statement of Earnings.

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## AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

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

#### Derivatives

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

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

#### Goodwill

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

#### Reinsurance

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

Subsidiaries of AFG's 81%-owned subsidiary, Great American Financial Resources, Inc. ("GAFRI"), cede life insurance policies to a third party on a funds withheld basis where GAFRI retains the assets (securities)

associated with the reinsurance contracts. Interest is credited to the reinsurer based on the actual investment performance of the retained assets. These reinsurance contracts are considered to contain embedded derivatives (that must be adjusted to fair value) because the yield on the payables is based on specific blocks of the ceding companies' assets, rather than the overall creditworthiness of the ceding company. GAFRI determined that changes in the fair value of the underlying portfolios of fixed maturity securities is an appropriate measure of the value of the embedded derivative. GAFRI classifies the securities related to these transactions as "trading." The adjustment to fair value on the embedded derivatives offsets the investment income recorded on the adjustment to fair value of the related trading portfolios.

#### Deferred Policy Acquisition Costs ("DPAC")

Policy acquisition costs (principally commissions, premium taxes and other marketing and underwriting expenses) related to the production of new business are deferred. For the property and casualty companies, DPAC is limited based upon recoverability without any consideration for anticipated investment income and is charged against income ratably over the terms of the related policies. A premium deficiency is recognized if the sum of expected claims costs, claims adjustment expenses,

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### AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

unamortized acquisition costs and policy maintenance costs exceed the related unearned premiums. A premium deficiency would first be recognized by charging any unamortized acquisition costs to expense to the extent required to eliminate the deficiency. If the premium deficiency was greater than unamortized acquisition costs, a liability would be accrued for the excess deficiency and reported with unpaid losses and loss adjustment expenses.

DPAC related to annuities and universal life insurance products is deferred to the extent deemed recoverable and amortized, with interest, in relation to the present value of expected gross profits on the policies. To the extent that realized gains and losses result in adjustments to the amortization of DPAC related to annuities, such adjustments are reflected as components of realized gains. DPAC related to annuities is also adjusted, net of tax, for the change in amortization that would have been recorded if the unrealized gains (losses) from securities had actually been realized. This adjustment is included in unrealized gains on marketable securities, a component of "Accumulated Other Comprehensive Income, net of tax" in the shareholders' equity section of the Balance Sheet.

DPAC related to traditional life and health insurance is amortized over the expected premium paying period of the related policies, in proportion to the ratio of annual premium revenues to total anticipated premium revenues. DPAC includes the present value of future profits on business in force of insurance companies acquired by GAFRI, which represents the portion of the costs to acquire companies that is allocated to the value of the right to receive future cash flows from insurance contracts existing at the date of acquisition. The present value of future profits is amortized with interest in relation to expected gross profits of the acquired policies for annuities and universal life products and in relation to the premium paying period for traditional life and health insurance products.

#### Annuity and Supplemental Insurance Acquisition Expenses

Annuity and supplemental insurance acquisition expenses on the Statement of Earnings consists primarily of amortization of DPAC related to the annuity, supplemental insurance

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and run-off life businesses. This line item also includes certain marketing and commission costs that are expensed as paid.

### Unpaid Losses and Loss Adjustment Expenses

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

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

### Annuity Benefits Accumulated

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

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## AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

2004, GAFRI implemented Statement of Position 03-1, "Accounting and Reporting by Insurance Enterprises for Certain Nontraditional Long-Duration Contracts and for Separate Accounts," by changing its accounting for persistency bonuses and two-tier annuities. The effect of this change (\$1.8 million) is included in the cumulative effect of accounting changes in the Statement of Earnings.

### Life, Accident and Health Reserves

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

### Variable Annuity Assets and Liabilities

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

## Premium Recognition

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

## Payable to Subsidiary Trusts

Certain subsidiaries own trusts that issued preferred securities and, in turn, purchased a like amount of subordinated debt from their parent company. Interest and principal payments from the parent fund the respective trust obligations. AFG does not consolidate these trusts because they are "variable interest entities" in which AFG is not considered to be the primary beneficiary. Accordingly, the subordinated debt due to the trusts is included in "long-term debt" in the Balance Sheet and the related interest expense is included in "interest charges on borrowed money" in the Statement of Earnings.

## Minority Interest

For balance sheet purposes, minority interest represents the interests of noncontrolling shareholders in consolidated entities. For income statement purposes, minority interest expense represents such shareholders' interest in the earnings of those entities.

## Income Taxes

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

FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes (an interpretation of FASB Statement No. 109)" ("FIN 48") is effective for fiscal years beginning after December 15, 2006. FIN 48 sets forth criteria for recognition and measurement of tax positions taken or expected to be taken in a tax return. FIN 48 requires that companies recognize the impact of a tax position if that position is more likely than not of being sustained on audit, based on the technical merits of the position. FIN 48 also provides guidance on derecognition, classification, interest, penalties, accounting in interim periods and disclosure. Management is currently evaluating the impact of adopting this interpretation and anticipates that it will not have a significant impact on AFG's results of operations or financial condition.

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AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

## Stock-Based Compensation

Effective January 1, 2006, AFG implemented Statement of Financial Accounting Standards ("SFAS") No. 123(R), "Share-Based Payment" using the modified prospective method under



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which prior year amounts are not restated. Under SFAS No. 123(R), companies must recognize compensation expense for all new share-based awards (including employee stock options), and the nonvested portions of prior awards, based on their calculated "fair value" at the date of grant. Beginning in 2006, all share-based grants are recognized as compensation expense over the vesting period. AFG uses the Black-Scholes pricing model to measure the fair value of employee stock options.

Prior to the implementation of SFAS No. 123(R), AFG accounted for stock options and other stock-based compensation plans using the intrinsic value method prescribed by Accounting Principles Board Opinion ("APB") No. 25, "Accounting for Stock Issued to Employees." Under this method, no compensation expense for stock option grants was recognized because options were granted at exercise prices equal to the fair value of the shares at the dates of grant. See *Note I - "Shareholders' Equity"* for further information on stock options.

### Benefit Plans

AFG provides retirement benefits to qualified employees of participating companies through the AFG Retirement and Savings Plan, a defined contribution plan. AFG makes all contributions to the retirement fund portion of the plan and matches a percentage of employee contributions to the savings fund. Company contributions are expensed in the year for which they are declared.

AFG and many of its subsidiaries provide health care and life insurance benefits to eligible retirees. AFG also provides postemployment benefits to former or inactive employees (primarily those on disability) who were not deemed retired under other company plans. The projected future cost of providing these benefits is expensed over the period the 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 (i) deductions of \$1.4 million in 2006 and \$.6 million in 2005 from net earnings related to dilution of majority-owned subsidiaries and (ii) the following additions to average shares outstanding representing the dilutive effect of stock-based compensation plans: 2006 - 2.5 million shares; 2005 - 1.9 million shares; and 2004 - 1.8 million shares.

### Statement of Cash Flows

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

#### **B. Acquisitions and Sales of Operations**

##### Ceres Group, Inc.

In August 2006, GAFRI acquired Ceres Group, Inc. ("Ceres") for \$204.4 million in cash. In connection with the acquisition, Ceres reinsured 100% of its major medical business and 50% of its in-force senior business, which focuses primarily on sales of Medicare supplement and other supplemental insurance products to the senior market. As a result of the reinsurance, Ceres has exited the major medical business. Following the acquisition, Ceres paid a \$60 million return of

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capital distribution to GAFRI. Pro forma results of operations for AFG, assuming the acquisition of Ceres had taken place at the beginning of 2006 would not differ significantly from actual reported results.

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### AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

##### Chatham Bars Inn

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

##### Old Standard Life Fixed Annuity Business

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

##### Great American Life Assurance Company of Puerto Rico

In the fourth quarter of 2005, GAFRI reached an agreement to sell its subsidiary, Great American Life Assurance Company of Puerto Rico ("GAPR"), for \$37.5 million in cash and recorded an estimated \$3.4 million pretax loss. GAFRI completed the sale in January 2006 and recognized an additional \$463,000 loss offsetting a like amount of earnings recorded prior to the sale. GAFRI acquired GAPR in 1997 for approximately \$50 million. During 2005, GAFRI received \$100 million in dividends from GAPR.

##### Farmers Crop Insurance Alliance, Inc.

On September 30, 2005, AFG acquired the multi-peril crop insurance and the crop hail insurance business written through Farmers Crop Insurance Alliance, Inc. for \$17.5 million in cash. AFG will pay additional amounts of up to 10% of annual premiums through September 2008 based on certain customer retention criteria. Approximately \$16.5 million of the initial Farmers Crop purchase price was recorded as intangible renewal rights and is being amortized over an estimated retention period of four years on a straight-line basis. Additional payments totaling \$848,000 were made in 2006; any future payments (not expected to exceed \$20 million) based on customer retention will also be recorded as intangible renewal rights. There is some uncertainty as to the amount of premiums that ultimately will be retained due to the departure of several Farmers' employees in the months preceding the acquisition. This business generated gross written premiums of approximately \$200 million in 2006.

##### National Interstate Initial Public Offering

An AFG majority-owned subsidiary, National Interstate Corporation ("NATL"), issued 3.4 million of its common shares in a February 2005 initial public offering. NATL used \$15 million of the \$40.4 million in proceeds to repay a loan to an AFG subsidiary and the balance for general corporate purposes. At December 31, 2006, AFG owned approximately 53% of NATL's common stock compared to 66% prior to the offering.

##### Transport Insurance Company

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In November 2004, AFG completed the sale of Transport Insurance Company. See Note K - "Discontinued Operations."

### National Health Annuity Business

In May 2004, GAFRI acquired the fixed annuity business of National Health Insurance Company (over 30,000 policies). This transaction increased both annuity benefits accumulated and cash and investments by approximately \$750 million.

#### **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.

AFG reports its property and casualty insurance business in the following Specialty sub-segments: (i) Property and transportation, which includes inland and ocean marine, agricultural-related business and commercial automobile, (ii) Specialty casualty, which includes executive and professional liability, umbrella and excess liability and excess and surplus, (iii) Specialty financial, which includes fidelity and surety bonds and collateral protection and (iv) California workers' compensation. AFG's annuity and supplemental insurance business markets traditional fixed, indexed and variable annuities and a variety of supplemental insurance products. AFG's reportable segments and their

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### AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

components were determined based primarily upon similar economic characteristics, products and services.

In 2006, 2005, and 2004, just over 1% of AFG's revenues were derived from the sale of property and casualty insurance in Canada, Mexico and Europe. In 2005 and 2004, just over 2% of AFG's revenues were derived from the sale of life and supplemental health products in Puerto Rico. The Puerto Rico business was sold in January 2006.

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### 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.

|                                     | <u>2006</u> | <u>2005</u> | <u>2004</u> |
|-------------------------------------|-------------|-------------|-------------|
| Assets                              |             |             |             |
| Property and casualty insurance (a) | \$11,492.7  | \$10,501.4  | \$10,182.6  |
| Annuity and supplemental insurance  | 13,241.8    | 11,913.6    | 11,702.5    |

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|  |                   |                   |                   |
|--|-------------------|-------------------|-------------------|
| Other                                  | <u>366.6</u>      | <u>401.0</u>      | <u>674.4</u>      |
|  | <u>\$25,101.1</u> | <u>\$22,816.0</u> | <u>\$22,559.5</u> |
| Revenues                               |                   |                   |                   |
| Property and casualty insurance:       |                   |                   |                   |
| Premiums earned:                       |                   |                   |                   |
| Specialty                              |                   |                   |                   |
| Property and transportation            | \$ 983.9          | \$ 857.7          | \$ 611.3          |
| Specialty casualty                     | 803.9             | 733.9             | 717.1             |
| Specialty financial                    | 406.4             | 363.1             | 358.3             |
| California workers' compensation       | 292.1             | 347.4             | 338.5             |
| Other                                  | 75.1              | 60.7              | 71.4              |
| Other lines                            | <u>1.7</u>        | <u>3.7</u>        | <u>13.7</u>       |
|  | 2,563.1           | 2,366.5           | 2,110.3           |
| Investment income                      | 324.8             | 287.6             | 261.3             |
| Realized gains                         | 31.3              | 17.3              | 239.2             |
| Other                                  | <u>196.6</u>      | <u>242.3</u>      | <u>193.2</u>      |
|  | 3,115.8           | 2,913.7           | 2,804.0           |
| Annuity and supplemental insurance:    |                   |                   |                   |
| Investment income                      | 607.0             | 574.4             | 538.0             |
| Life, accident and health premiums     | 354.7             | 371.0             | 351.4             |
| Realized gains (losses)                | (1.7)             | 9.5               | 59.7              |
| Other                                  | <u>107.4</u>      | <u>81.7</u>       | <u>71.2</u>       |
|  | 1,067.4           | 1,036.6           | 1,020.3           |
| Other                                  | <u>66.9</u>       | <u>34.1</u>       | <u>43.5</u>       |
|  | <u>\$ 4,250.1</u> | <u>\$ 3,984.4</u> | <u>\$ 3,867.8</u> |
| Operating Earnings Before Income Taxes |                   |                   |                   |
| Property and casualty insurance:       |                   |                   |                   |
| Underwriting:                          |                   |                   |                   |
| Specialty                              |                   |                   |                   |
| Property and transportation            | \$ 174.2          | \$ 145.7          | \$ 118.5          |
| Specialty casualty                     | 120.9             | 63.4              | 1.5               |
| Specialty financial                    | (41.4)            | (77.1)            | (32.1)            |
| California workers' compensation       | 75.8              | 104.2             | 35.5              |
| Other (b)                              | (7.0)             | (28.4)            | (.5)              |

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|  |                 |                 |                 |
|--|-----------------|-----------------|-----------------|
| Other lines (c)                                | <u>(4.5)</u>    | <u>(182.8)</u>  | <u>(11.3)</u>   |
|  | )               | )               |                 |
|  | 318.0           | 25.0            | 111.6           |
| Investment income, realized gains<br>and other | <u>325.4</u>    | <u>312.5</u>    | <u>452.7</u>    |
|  | 643.4           | 337.5           | 564.3           |
| Annuity and supplemental insurance (d)         | 108.2           | 74.5            | 153.6           |
| Other (e)                                      | <u>(54.0)</u>   | <u>(77.1)</u>   | <u>(132.9)</u>  |
|  | )               | )               |                 |
|  | <u>\$ 697.6</u> | <u>\$ 334.9</u> | <u>\$ 585.0</u> |

(a) Not allocable to sub-segments.

(b) Includes a charge of \$19.9 million for adjustments related to deferred gains on retroactive reinsurance, and \$7.0 million in hurricane losses from assumed reinsurance in 2005.

(c) Includes a third quarter 2005 charge of \$179.3 million to increase asbestos, environmental and other mass tort reserves.

(d) Includes a third quarter 2005 charge of \$9.5 million related to environmental liabilities at GAFRI's former manufacturing operations.

(e) Includes holding company expenses and a third quarter 2004 charge of \$52 million resulting from the settlement of litigation.

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AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

**D. Investments**

Fixed maturities and other stocks classified as available for sale at December 31 consisted of the following (in millions):

| <u>2006</u> |              |                         |               | <u>2005</u> |              |                         |               |
|-------------|--------------|-------------------------|---------------|-------------|--------------|-------------------------|---------------|
| Amortized   | Fair         | <u>Gross Unrealized</u> |               | Amortized   | Fair         | <u>Gross Unrealized</u> |               |
| <u>Cost</u> | <u>Value</u> | <u>Gains</u>            | <u>Losses</u> | <u>Cost</u> | <u>Value</u> | <u>Gains</u>            | <u>Losses</u> |

Fixed maturities:  
United States

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|                            |                 |                 |                |                  |                 |                 |                |                  |
|----------------------------|-----------------|-----------------|----------------|------------------|-----------------|-----------------|----------------|------------------|
| Government                 |                 |                 |                |                  |                 |                 |                |                  |
| and government agencies    |                 |                 |                |                  |                 |                 |                |                  |
| and authorities            | \$ 1,041        | \$ 1,027        | \$ 3.0         | (\$ 16.4)        | \$ 1,016        | \$ 1,013        | \$ 13.2        | (\$ 17.1)        |
| States, municipalities and |                 |                 |                |                  |                 |                 |                |                  |
| political subdivisions     | 1,156           | 1,152           | 7.0            | (11.4)           | 1,192           | 1,193           | 10.7           | (10.0)           |
| Foreign government         | 163             | 164             | 2.0            | (0.6)            | 172             | 174             | 3.1            | (0.5)            |
| Public utilities           | 1,060           | 1,065           | 15.3           | (10.5)           | 1,006           | 1,029           | 27.1           | (3.9)            |
| Mortgage-backed            | 4,466           | 4,418           | 21.6           | (70.0)           | 4,567           | 4,513           | 16.2           | (70.7)           |
| securities                 |                 |                 |                |                  |                 |                 |                |                  |
| All other corporate        | 6,747           | 6,765           | 90.0           | (70.2)           | 6,271           | 6,356           | 138.9          | (54.5)           |
| Redeemable preferred       | <u>30</u>       | <u>33</u>       | <u>1.5</u>     | <u>-</u>         | <u>48</u>       | <u>49</u>       | <u>1.9</u>     | <u>(0.1)</u>     |
| stocks                     |                 |                 |                |                  |                 |                 |                |                  |
|                            |                 |                 |                |                  |                 |                 | )              |                  |
|                            | <u>\$14,663</u> | <u>\$14,624</u> | <u>\$140.4</u> | <u>(\$179.1)</u> | <u>\$14,272</u> | <u>\$14,327</u> | <u>\$211.1</u> | <u>(\$156.8)</u> |
| Other stocks               | <u>\$ 606</u>   | <u>\$ 729</u>   | <u>\$129.0</u> | <u>(\$ 6.0)</u>  | <u>\$ 502</u>   | <u>\$ 557</u>   | <u>\$ 73.3</u> | <u>(\$ 18.1)</u> |

The following tables show gross unrealized losses (in millions) on fixed maturities and other stocks by investment category and length of time that individual securities have been in a continuous unrealized loss position at December 31, 2006 and 2005.

|                            | <u>Twelve Months or Less</u> |                   |                      | <u>More Than Twelve Months</u> |                   |                      |
|----------------------------|------------------------------|-------------------|----------------------|--------------------------------|-------------------|----------------------|
|                            | <u>Unrealized</u>            | <u>Fair Value</u> | <u>Fair Value as</u> | <u>Unrealized</u>              | <u>Fair Value</u> | <u>Fair Value as</u> |
|                            | <u>Loss</u>                  | <u>Value</u>      | <u>% of Cost</u>     | <u>Loss</u>                    | <u>Value</u>      | <u>% of Cost</u>     |
| <u>2006</u>                |                              |                   |                      |                                |                   |                      |
| Fixed maturities:          |                              |                   |                      |                                |                   |                      |
| United States Government   |                              |                   |                      |                                |                   |                      |
| and government agencies    |                              |                   |                      |                                |                   |                      |
| and authorities            | (\$ 2.1)                     | \$ 321            | 99%                  | (\$ 14.4)                      | \$ 540            | 97%                  |
| States, municipalities and |                              |                   |                      |                                |                   |                      |
| political subdivisions     | (0.7)                        | 120               | 99%                  | (10.7)                         | 745               | 99%                  |
| Foreign government         | -                            | 9                 | 100%                 | (0.6)                          | 41                | 99%                  |
| Public utilities           | (4.7)                        | 284               | 98%                  | (5.8)                          | 239               | 98%                  |
| Mortgage-backed            | (5.3)                        | 778               | 99%                  | (64.6)                         | 2,726             | 98%                  |
| securities                 |                              |                   |                      |                                |                   |                      |
| All other corporate        | (14.6)                       | 1,395             | 99%                  | (55.6)                         | 2,119             | 97%                  |
| Redeemable preferred       | <u>-</u>                     | <u>3</u>          | 98%                  | <u>-</u>                       | <u>-</u>          | -                    |
| stocks                     |                              |                   |                      |                                |                   |                      |
|                            | <u>(\$ 27.4)</u>             | <u>\$2,910</u>    | 99%                  | <u>(\$151.7)</u>               | <u>\$6,410</u>    | 98%                  |

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|  |                  |                |     |                  |                |      |
|--|------------------|----------------|-----|------------------|----------------|------|
| Other stocks   | <u>(\$ 3.7)</u>  | <u>\$ 57</u>   | 94% | <u>(\$ 2.3)</u>  | <u>\$ 48</u>   | 95%  |
| <u>2005</u>  |                  |                |     |                  |                |      |
| Fixed maturities:  |                  |                |     |                  |                |      |
| United States Government and government agencies and authorities | (\$ 7.1)         | \$ 390         | 98% | (\$ 10.0)        | \$ 377         | 97%  |
| States, municipalities and political subdivisions                | (8.0)            | 721            | 99% | (2.0)            | 90             | 98%  |
| Foreign government   | (0.5)            | 49             | 99% | -                | 1              | 100% |
| Public utilities   | (3.1)            | 230            | 99% | (0.8)            | 30             | 97%  |
| Mortgage-backed securities                                       | (51.7)           | 3,186          | 98% | (19.0)           | 513            | 96%  |
| All other corporate  | (39.6)           | 2,204          | 98% | (14.9)           | 383            | 96%  |
| Redeemable preferred stocks                                      | <u>(0.1)</u>     | <u>10</u>      | 99% | <u>-</u>         | <u>-</u>       | - %  |
|  | )                |                |     |                  |                |      |
|  | <u>(\$110.1)</u> | <u>\$6,790</u> | 98% | <u>(\$ 46.7)</u> | <u>\$1,394</u> | 97%  |
| Other stocks   | <u>(\$ 13.4)</u> | <u>\$ 246</u>  | 95% | <u>(\$ 4.7)</u>  | <u>\$ 40</u>   | 90%  |

At December 31, 2006, the gross unrealized losses relate to nearly 1,500 securities with no single unrealized loss in excess of \$2.4 million. At that date, investment grade securities (as determined by nationally recognized rating agencies) represented about 96% of the total unrealized loss and fair value, respectively. Of the mortgage-backed securities, substantially all of the unrealized losses relate to AAA rated securities. Management believes that AFG will recover its cost basis in the securities having unrealized losses at December 31, 2006 and that AFG has the ability and intent to hold such securities until they recover in value or mature.

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AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

The table below sets forth the scheduled maturities of fixed maturities as of December 31, 2006 (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. Mortgage-backed securities had an average life of approximately six years at December 31, 2006.

| <u>Maturity</u>                    | Amortized    | <u>Fair Value</u> |          |
|------------------------------------|--------------|-------------------|----------|
|                                    | <u>Cost</u>  | <u>Amount</u>     | <u>%</u> |
| One year or less                   | \$ 629       | \$ 633            | 4%       |
| After one year through five years  | 3,700        | 3,700             | 26       |
| After five years through ten years | 4,826        | 4,820             | 33       |
| After ten years                    | <u>1,042</u> | <u>1,053</u>      | <u>7</u> |

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|                            |                 |                 |            |
|----------------------------|-----------------|-----------------|------------|
|                            | 10,197          | 10,206          | 70         |
| Mortgage-backed securities | <u>4,466</u>    | <u>4,418</u>    | <u>30</u>  |
| Total                      | <u>\$14,663</u> | <u>\$14,624</u> | <u>100</u> |

%

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 (other than U.S. Treasury Notes) that exceeded 10% of Shareholders' Equity at December 31, 2006 or 2005. At December 31, 2006, an AFG subsidiary held collateral of approximately \$159 million for securities on loan; fair value of securities lent was approximately \$156 million. There were no securities on loan at December 31, 2005.

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

|                                    | <u>Fixed<br/>Maturities</u> | <u>Equity<br/>Securities</u> | <u>Tax<br/>Effects</u> | <u>Total</u> |
|------------------------------------|-----------------------------|------------------------------|------------------------|--------------|
| <u>2006</u>                        |                             |                              |                        |              |
| Realized - Continuing operations   | (\$ 27.4)                   | \$ 56.4                      | (\$ 10.2)              | \$ 18.8      |
| Change in Unrealized               | (93.0)                      | 67.8                         | 7.6                    | (17.6)       |
| <u>2005</u>                        |                             |                              |                        |              |
| Realized - Continuing operations   | (15.4)                      | 39.3                         | (6.1)                  | 17.8         |
| Change in Unrealized               | (321.9)                     | (25.9)                       | 120.3                  | (227.5)      |
| <u>2004</u>                        |                             |                              |                        |              |
| Realized - Continuing operations   | 49.7                        | 252.2                        | (105.5)                | 196.4        |
| Realized - Discontinued operations | 2.7                         | -                            | (0.9)                  | 1.8          |
| Change in Unrealized               | (1.6)                       | (115.3)                      | 41.1                   | (75.8)       |

Gross gains and losses (excluding impairment writedowns) on available for sale fixed maturity investment transactions included in the Statement of Cash Flows consisted of the following (in millions):

|              | <u>2006</u> | <u>2005</u> | <u>2004</u> |
|--------------|-------------|-------------|-------------|
| Gross Gains  | \$19.8      | \$29.6      | \$91.9      |
| Gross Losses | (35.5)      | (33.4)      | (23.5)      |



## AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

## Unrealized Gain (Loss) on Marketable Securities, Net

In addition to adjusting equity securities and fixed maturity securities classified as "available for sale" to fair value, SFAS 115 requires that certain other balance sheet amounts be adjusted to the extent that unrealized gains and losses from securities would result in adjustments had those gains or losses actually been realized. The following table shows the components of the unrealized gain (loss) on marketable securities, and its effect on various balance sheet captions (in millions).

|   | <u>2006</u>    | <u>2005</u>   |
|---|----------------|---------------|
| <u>Increase (decrease) in assets</u>                            |                |               |
| Fixed maturities - available for sale                           | (\$ 38.7)      | \$54.3        |
| Other stocks  | 123.0          | 55.2          |
| Deferred policy acquisition costs                               | (1.2)          | (17.3)        |
| Deferred income taxes (included in other assets)                | (29.4)         | (31.0)        |
| <u>(Increase) decrease in liabilities and minority interest</u> |                |               |
| Minority interest   | (3.5)          | (10.0)        |
| Annuity benefits and other liabilities                          | <u>.5</u>      | <u>.4</u>     |
|   | )              |               |
|   | <u>\$ 50.7</u> | <u>\$50.8</u> |

**E. Deferred Policy Acquisition Costs**

Included in deferred policy acquisition costs in AFG's Balance Sheet are \$95.0 million and \$54.1 million at December 31, 2006 and 2005, respectively, representing the present value of future profits ("PVFP") related to acquisitions by AFG's annuity and supplemental insurance business. The PVFP amounts are net of \$70.5 million and \$82.5 million of accumulated amortization. The change in PVFP and related accumulated amortization reflects the August 2006 acquisition of Ceres, partially offset by the January 2006 sale of GAPR. Amortization of the PVFP was \$9.0 million in 2006, \$9.3 million in 2005 and \$7.4 million in 2004. During each of the next five years, the PVFP is expected to decrease at a rate of approximately one-eighth of the balance at the beginning of each respective year.

**F. Goodwill**

Changes in the carrying value of goodwill during 2005 and 2006, by reporting segment, are presented in the following table (in millions):

|                         | Property and<br><u>Casualty</u> | Annuity and<br><u>Supplemental</u> | <u>Total</u> |
|-------------------------|---------------------------------|------------------------------------|--------------|
| Balance January 1, 2005 | \$151.9                         | \$14.0                             | \$165.9      |

|                            |                |               |                |
|----------------------------|----------------|---------------|----------------|
| Goodwill from acquisition  | <u>-</u>       | <u>1.0</u>    | <u>1.0</u>     |
| Balance December 31, 2005  | 151.9          | 15.0          | 166.9          |
| Goodwill from acquisitions | -              | 5.3           | 5.3            |
| Impairment charge          | -              | (4.2)         | (4.2)          |
| Sale of business           | <u>-</u>       | <u>(.2)</u>   | <u>(.2)</u>    |
|                            | )              | )             |                |
| Balance December 31, 2006  | <u>\$151.9</u> | <u>\$15.9</u> | <u>\$167.8</u> |

The addition to goodwill in 2006 reflects the acquisition of Ceres. GAFRI recorded a goodwill impairment charge of \$4.2 million (included in "Other operating and general expenses") during the fourth quarter of 2006 related to an insurance agency subsidiary. A review for impairment was prompted by a decrease in estimated future earnings from this agency. Fair value of the agency was estimated using the present value of expected future cash flows.

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## AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

• **Long-Term Debt**

Long-term debt, consisted of the following at December 31 (in millions):

|   | <u>2006</u>  | <u>2005</u>  |
|---|--------------|--------------|
| Holding Company:  |              |              |
| AFG 7-1/8% Senior Debentures due April 2009,<br>less discount of \$388 and \$671<br>(imputed rate - 7.2%) | \$182.9      | \$226.0      |
| AFG Senior Convertible Notes due June 2033<br>(imputed rate - 4.0%)                                       | 189.7        | 189.9        |
| AFG 7-1/8% Senior Debentures due February 2034  | 115.0        | 115.0        |
| AFG 7-1/8% Senior Debentures due December 2007  | 59.5         | 59.5         |
| Other   | <u>3.8</u>   | <u>3.8</u>   |
|   | <u>550.9</u> | <u>594.2</u> |

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Subsidiaries:

|   |              |              |
|---|--------------|--------------|
| GAFRI 7-1/2% Senior Debentures due November 2033  | 112.5        | 112.5        |
| GAFRI 7-1/4% Senior Debentures due January 2034   | 86.3         | 86.3         |
| GAFRI 6-7/8% Senior Notes due June 2008   | 31.5         | 100.0        |
| Notes payable secured by real estate  | 67.8         | 33.1         |
| American Premier Underwriters, Inc. ("American Premier")  |              |              |
| 10-7/8% Subordinated Notes due May 2011,<br>including premium of \$343 and \$404<br>(imputed rate - 9.6%) | 8.1          | 8.1          |
| Other   | <u>6.9</u>   | <u>8.5</u>   |
|   | <u>313.1</u> | <u>348.5</u> |

Payable to Subsidiary Trusts:

|   |                |                |
|---|----------------|----------------|
| GAFRI 8-7/8% Subordinated Debentures due<br>January 2027                  | 22.0           | 22.0           |
| GAFRI 7.35% Subordinated Debentures due May 2033                          | 20.0           | 20.0           |
| National Interstate Variable Rate Subordinated<br>Debentures due May 2033 | <u>15.0</u>    | <u>15.0</u>    |
|   | <u>57.0</u>    | <u>57.0</u>    |
|   | <u>\$921.0</u> | <u>\$999.7</u> |

At December 31, 2006, scheduled principal payments on debt for the subsequent five years were as follows: 2007 - \$60.8 million, 2008 - \$32.2 million, 2009 - \$184.4 million, 2010 - \$2.9 million and 2011 - \$9.1 million.

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

|                                    |                |                |
|------------------------------------|----------------|----------------|
|                                    | <u>2006</u>    | <u>2005</u>    |
| Unsecured obligations              | \$853.2        | \$966.6        |
| Obligations secured by real estate | <u>67.8</u>    | <u>33.1</u>    |
|                                    | <u>\$921.0</u> | <u>\$999.7</u> |

On March 1, 2007, GAFRI will redeem its 8-7/8% Subordinated Debentures due 2027.

During 2006, AFG repurchased \$43.5 million of its 7-1/8% Debentures due 2009 for \$45.6 million in cash and GAFRI repurchased \$68.5 million of its 6-7/8% Notes for \$70.8 million in cash. In July 2006, an AFG subsidiary borrowed \$42 million under a 6.3% 10-year mortgage loan secured by one of its hotel properties.

During 2005, AFG repurchased \$15.6 million of its 7-1/8% Debentures due 2007 and \$71.2 million of its 7-1/8% Debentures due 2009 for \$92.6 million in cash.

In March 2006, AFG and GAFRI replaced their existing credit agreements with a five-year revolving credit facility under which they can borrow a combined

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## AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

\$500 million. AFG and GAFRI have agreed not to borrow more than \$325 million and \$200 million, respectively, under the credit facility and AFG has agreed to guarantee amounts borrowed by GAFRI. Amounts borrowed bear interest at rates ranging from 0.5% to 1.25% over LIBOR based on AFG's credit rating. No amounts were borrowed under these agreements at December 31, 2006 or 2005.

To achieve a desired balance between fixed and variable rate debt, GAFRI has entered into interest rate swaps that effectively convert its 6-7/8% fixed rate Senior Notes to a floating rate of 3-month LIBOR plus 2.9%. In connection with the 2006 debt repurchases discussed above, GAFRI paid an additional \$2 million to effectively terminate the portion of the interest rate swaps that covered the repurchased debt.

AFG's Senior Convertible Notes were issued at a price of 37.153% of the principal amount due at maturity. Interest is payable semiannually at a rate of 4% of issue price per year through June 2008, after which interest at 4% annually will be accrued and added to the carrying value of the Notes. The Notes are redeemable at AFG's option at any time on or after June 2, 2008, at accreted value ranging from \$371.53 per Note to \$1,000 per Note at maturity. Holders may require AFG to purchase all or a portion of their Notes on five year anniversaries beginning in 2008, at the accreted value. Generally, holders may convert each Note into 17.2524 shares of AFG Common Stock (at \$21.53 per share currently) (i) if the average market price of AFG Common Stock to be received upon conversion exceeds 120% of the accreted value (\$25.84 per share currently) for a specified period, (ii) if the credit rating of the Notes is significantly lowered, or (iii) if AFG calls the notes for redemption. Based upon the market price of AFG's Common Stock during the fourth quarter of 2006, the Notes are currently convertible through March 31, 2007. AFG has delivered cash in lieu of Common Stock upon conversion of the Notes and intends to continue to do so. Accordingly, shares issuable upon conversion are not treated as dilutive.

Cash interest payments on long-term debt were \$61 million in 2006, \$73 million in 2005 and \$75 million in 2004. 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: 2006 -\$9.2 million; 2005 - \$5.4 million; and 2004 - \$5.2 million.

- **Minority Interest**

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Minority interest expense represents the interest of non-controlling investors in the earnings or losses of consolidated subsidiaries. Included in minority interest expense in 2004 is \$3.5 million for the interest of minority holders in a collateralized debt obligation that AFG consolidated prior to its liquidation in 2005.

• **Shareholders' Equity**

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

AFG sold 4 million shares of its Common Stock through public offerings in the fourth quarter of 2004 at an average price of \$20.37 per share, net of commissions and fees. In addition, American Premier sold 2,042,567 previously issued and outstanding AFG common shares that it was holding for the benefit of certain creditors and other claimants pursuant to the 1978 plan of reorganization of its predecessor, The Penn Central Transportation Company. The \$41.5 million in proceeds were placed in escrow to be used to settle such claims.

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 2005 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. This plan became effective in the first quarter of 2006.

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## AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

At December 31, 2006, there were 15 million shares of AFG Common Stock reserved for issuance under AFG's stock incentive plan. 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:

|                                  | <u>Shares</u>    | <u>Average<br/>Exercise<br/>Price</u> | <u>Average<br/>Remaining<br/>Contractual<br/>Term</u> | <u>Aggregate<br/>Intrinsic<br/>Value<br/>(in millions)</u> |
|----------------------------------|------------------|---------------------------------------|---|--|
| Outstanding at January 1, 2006   | 9,583,986        | \$18.76                               |   |  |
| Granted                          | 1,457,193        | \$27.01                               |   |  |
| Exercised                        | (2,421,667)      | \$21.37                               |   |  |
|                                  | <u>(46,809)</u>  | \$22.07                               |   |  |
| Forfeited/Cancelled              |                  |                                       |   |  |
| Outstanding at December 31, 2006 | <u>8,572,703</u> | \$19.41                               | 6.0 years   | \$141.5  |

|                                    |                  |           |         |
|------------------------------------|------------------|-----------|---------|
| Options exercisable at             | <u>4,604,015</u> | 4.3 years | \$ 84.4 |
| December 31, 2006                  |                  | \$17.57   |         |
| Options and other awards available | <u>6,460,281</u> |           |         |
| for grant at December 31, 2006     |                  |           |         |

The total intrinsic value of options exercised during 2006, 2005 and 2004 was \$24.2 million, \$12.0 million and \$10.2 million, respectively. During 2006, 2005 and 2004, AFG received \$35.1 million, \$25.1 million and \$8.9 million in cash from the exercise of stock options. The total tax benefit related to the exercises was \$7.7 million, \$3.9 million and \$3.3 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 estimated term. AFG began using the SEC's simplified method of calculating expected term with its 2006 grants. The fair value of options granted in 2006, 2005 and 2004 was \$6.68 per share, \$6.44 per share and \$5.95 per share, respectively, based on the following assumptions:

|                          | <u>2006</u> | <u>2005</u> | <u>2004</u> |
|--------------------------|-------------|-------------|-------------|
| Expected dividend yield  | 1.5%        | 2%          | 2%          |
| Expected volatility      | 19%         | 28%         | 29%         |
| Expected term (in years) | 6.5         | 8.4         | 7.5         |
| Risk-free rate           | 4.6%        | 4.3%        | 3.7%        |

Total compensation expense related to stock incentive plans for 2006 was \$10.0 million. Related tax benefits totaled \$2.0 million for the year. Included in these totals are \$3.0 million for the year in compensation expense and \$472,000 for the year in tax benefits related to stock incentive plans of two AFG subsidiaries. As of December 31, 2006, there was a total of \$17.6 million of total unrecognized compensation expense related to nonvested stock options granted under AFG's plans. That cost is expected to be recognized over a weighted average of 3.3 years.

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AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

The following table illustrates the effect on net earnings (in millions) and earnings per share for the years ended 2004 and 2005, had compensation cost been recognized and determined based on the "fair values" at grant dates consistent with the method used beginning in 2006.

2005                      2004

|  |                |                |
|--|----------------|----------------|
| Net earnings as reported                   | \$206.6        | \$359.9        |
| Pro forma stock option expense, net of tax | <u>(7.1)</u>   | <u>(6.7)</u>   |
|  | )              | )              |
| Adjusted net earnings                      | <u>\$199.5</u> | <u>\$353.2</u> |
| Earnings per share (as reported):          |                |                |
| Basic                                      | \$1.78         | \$3.26         |
| Diluted                                    | \$1.75         | \$3.21         |
| Earnings per share (adjusted):             |                |                |
| Basic                                      | \$1.72         | \$3.20         |
| Diluted                                    | \$1.70         | \$3.16         |

#### Accumulated Other Comprehensive Income, Net of Tax

Comprehensive income is defined as all changes in Shareholders' Equity except those arising from transactions with shareholders. Comprehensive income includes net income and other comprehensive income, which consists of changes in net unrealized gains or losses on available for sale securities and foreign currency translation. The components of accumulated other comprehensive income (loss) were as follows (in millions):

|   | Pretax<br>Net Unrealized<br>Gains (Losses)<br><u>on Securities</u> | Foreign<br>Currency<br>Translation<br><u>Adjustment</u> | Other (a) | Tax<br>Effects | Minority<br>Interest | Accumulated<br>Other<br>Comprehensive<br>Income(Loss) |
|---|--|---|-----------|----------------|----------------------|---|
| Balance at January 1, 2004                                      | \$506.6  |   |           | (\$175.0)      | (\$29.0)             | \$302.6   |
| Unrealized holding gains on securities arising during the year  | 202.9  |   |           | (70.7)         | (12.2)               | 120.0   |
| Realized gains included in net income                           | (304.7)  |   |           | 106.6          | 7.0                  | (191.1)   |
| Unrealized losses of subsidiary sold                            | <u>.3</u>  |   |           | <u>(.1)</u>    | <u>-</u>             | <u>.2</u>   |
|   |  |   | )         |                |                      |   |
| Balance at December 31, 2004                                    | 405.1  |   |           | (139.2)        | (34.2)               | 231.7   |
| Unrealized holding losses on securities arising during the year | (289.4)  |   |           | 102.1          | 22.1                 | (165.2)   |
| Realized gains included in net income                           | <u>(23.9)</u>  |   |           | <u>6.1</u>     | <u>2.1</u>           | <u>(15.7)</u>   |
|   |  |   | )         |                |                      |   |
| Balance at December 31, 2005                                    | 91.8   | -   | -         | (31.0)         | (10.0)               | 50.8  |

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|  |                |               |              |                  |                 |                |
|--|----------------|---------------|--------------|------------------|-----------------|----------------|
| Unrealized holding gains on securities arising during the year | 29.2           | -             | -            | (8.6)            | 4.8             | 25.4           |
| Realized gains included in net income                          | (29.0)         | -             | -            | 10.2             | .1              | (18.7)         |
| Unrealized gains of subsidiary sold                            | (8.4)          | -             | -            | -                | 1.6             | (6.8)          |
| Foreign currency translation gains                             | -              | 4.3           | -            | -                | -               | 4.3            |
| Other  | -              | -             | .8           | (.3)             | -               | .5             |
|  |                |               |              | )                |                 |                |
| Balance at December 31, 2006                                   | <u>\$ 83.6</u> | <u>\$ 4.3</u> | <u>\$ .8</u> | <u>(\$ 29.7)</u> | <u>(\$ 3.5)</u> | <u>\$ 55.5</u> |

(a) Net unrealized defined benefit pension and other postretirement plan costs.

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AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

• **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):

|                                      | <u>2006</u>    | <u>2005</u>    | <u>2004</u>    |
|--------------------------------------|----------------|----------------|----------------|
| Earnings (loss) before income taxes: |                |                |                |
| Operating                            | \$697.6        | \$334.9        | \$585.0        |
| Minority interest expense            | (31.6)         | (25.4)         | (31.9)         |
| Equity in net losses of investee     | (3.2)          | (7.8)          | (4.8)          |
| Discontinued operations              | 41.9           | 17.4           | .2             |
| Accounting changes                   | <u>-</u>       | <u>-</u>       | <u>(8.8)</u>   |
|                                      |                | )              |                |
| Total                                | <u>\$704.7</u> | <u>\$319.1</u> | <u>\$539.7</u> |
| Income taxes at statutory rate       | \$246.6        | \$111.7        | \$188.9        |
| Effect of:                           |                |                |                |
| Adjustment to prior year taxes       | (8.0)          | 2.3            | (2.6)          |
| Minority interest                    | 13.1           | 9.8            | 9.9            |
| Subsidiaries not in AFG's tax return | 6.1            | 5.6            | -              |
| Tax exempt interest                  | (8.6)          | (7.9)          | (6.3)          |
| Effect of foreign operations         | .1             | (6.7)          | (4.2)          |
| Other                                | <u>2.0</u>     | <u>(2.3)</u>   | <u>(5.9)</u>   |
|                                      | )              | )              |                |
| Total Provision                      | 251.3          | 112.5          | 179.8          |



Amounts applicable to:

|                                  |          |          |            |
|----------------------------------|----------|----------|------------|
| Equity in net losses of investee | 1.1      | 2.7      | 1.7        |
| Discontinued operations          | (16.7)   | (6.9)    | (.2)       |
| Accounting changes               | <u>-</u> | <u>-</u> | <u>3.2</u> |

Provision for income taxes as shown  
on the Statement of Earnings

|                |                |                |
|----------------|----------------|----------------|
| <u>\$235.7</u> | <u>\$108.3</u> | <u>\$184.5</u> |
|----------------|----------------|----------------|

Total earnings before income taxes include income (losses) subject to tax in foreign jurisdictions of \$24.4 million in 2006, (\$33.8 million) in 2005 and \$26.6 million in 2004.

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

|                 | <u>2006</u>    | <u>2005</u>    | <u>2004</u>    |
|-----------------|----------------|----------------|----------------|
| Current taxes:  |                |                |                |
| Federal         | \$241.2        | \$ 66.3        | \$ 64.0        |
| Foreign         | 1.2            | .8             | 1.9            |
| State           | (.2)           | 3.0            | 2.2            |
| Deferred taxes: |                |                |                |
| Federal         | 9.1            | 44.9           | 112.5          |
| Foreign         | <u>-</u>       | <u>(2.5)</u>   | <u>(.8)</u>    |
|                 | )              | )              |                |
|                 | <u>\$251.3</u> | <u>\$112.5</u> | <u>\$179.8</u> |

For income tax purposes, AFG and its subsidiaries had the following carryforwards available at December 31, 2006 (in millions):

|                     | <u>Expiring</u> | <u>Amount</u> |
|---------------------|-----------------|---------------|
| Operating Loss      | 2007 - 2010     | \$ .2         |
|                     | 2011 - 2020     | 74.0          |
|                     | 2021 - 2025     | 78.6          |
| Capital Loss        | 2007 - 2011     | 2.7           |
| Other - Tax Credits |                 | .1            |

## AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

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):

|   | <u>2006</u>    | <u>2005</u>    |
|---|----------------|----------------|
| Deferred tax assets:                        |                |                |
| Net operating loss carryforwards            | \$ 53.5        | \$ 50.5        |
| Capital loss carryforwards                  | .9             | 1.1            |
| Insurance claims and reserves               | 346.9          | 310.8          |
| Other, net                                  | <u>162.1</u>   | <u>179.0</u>   |
|   | 563.4          | 541.4          |
| Valuation allowance for deferred tax assets | <u>(53.2)</u>  | <u>(50.0)</u>  |
|   | ) )            |                |
|   | 510.2          | 491.4          |
| Deferred tax liabilities:                   |                |                |
| Deferred acquisition costs                  | (338.4)        | (334.9)        |
| Investment securities                       | <u>(46.7)</u>  | <u>(23.2)</u>  |
|   | ) )            |                |
|   | <u>(385.1)</u> | <u>(358.1)</u> |
|   | ) )            |                |
| Net deferred tax asset                      | <u>\$125.1</u> | <u>\$133.3</u> |

The gross deferred tax asset has been reduced by a valuation allowance including \$50 million 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 increase in the valuation allowance in 2006 relates to the NOL of an acquired subsidiary. The likelihood of realizing this asset will be reviewed periodically; any adjustments required to the valuation allowance will be made in the period in the developments on which they are based become known.

The American Jobs Creation Act of 2004 provides a special one-time dividends received deduction on the repatriation of certain foreign earnings. AFG subsidiaries paid \$91.8 million in dividends that qualified for this special tax treatment during 2005. Since deferred taxes had previously been accrued on most of these earnings, only \$846,000 in additional income tax was recognized in 2005 on the earnings remitted.

Cash payments for income taxes, net of refunds, were \$213.6 million, \$91.9 million and \$55.1 million for 2006, 2005 and 2004, respectively.

**K. Discontinued Operations**

In the second quarter of 2006, GAFRI sold Chatham Bars Inn, its resort-hotel property located on Cape Cod for \$166 million. The results of operations of this investment property and the gain on sale are presented as discontinued operations in the Statement of Earnings. Operating results for a smaller hotel property that was sold in the fourth quarter of 2005 have been reclassified as discontinued operations to conform to the current year's presentation. Balance Sheet amounts prior to the hotel sale have not been reclassified.

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AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

A summary of the discontinued hotel operations sold follows (in millions):

|  | <u>2006</u>   | <u>2005</u>   | <u>2004</u>   |
|--|---------------|---------------|---------------|
| Assets:                                      |               |               |               |
| Investment in real estate                    | -             | \$38.5        | -             |
| Operations:                                  |               |               |               |
| Revenue                                      | \$ 3.9        | \$37.3        | \$38.4        |
| Pretax earnings (loss)                       | (1.0)         | 5.4           | 4.5           |
| Provision (benefit) for income taxes         | (.3)          | 1.8           | 1.6           |
| Minority interest                            | <u>.1</u>     | <u>(.6)</u>   | <u>(.5)</u>   |
|  | )             | )             |               |
| Earnings (loss) from discontinued operations | (.6)          | 3.0           | 2.4           |
| Gain on sale, net of tax (*)                 | <u>25.8</u>   | <u>8.8</u>    | <u>-</u>      |
| Discontinued operations, net of tax          | <u>\$25.2</u> | <u>\$11.8</u> | <u>\$ 2.4</u> |

(\*) After transaction costs, contingencies, the write-off of certain deferred annuity acquisition costs associated with the gain recognition and minority interest.

In the fourth quarter of 2004, AFG completed the sale of Transport Insurance Company, an inactive property and casualty subsidiary with only run-off liabilities. In December 2003, AFG recorded a \$55 million impairment charge to reduce its investment in Transport for its estimated loss on sale, which was determined based on negotiations with potential buyers.

Transport's results are reflected as discontinued for all periods presented in the Statement of Earnings. A summary of Transport's discontinued operations follows (in millions):

|  | <u>2005</u>    | <u>2004</u>    |
|--|----------------|----------------|
| Operations:                                  |                |                |
| Revenue                                      | \$ -           | \$5.4          |
| Pretax earnings (loss)                       | -              | (1.5)          |
| Provision (benefit) for income taxes         | <u>-</u>       | <u>(.6)</u>    |
|  | )              |                |
| Earnings (loss) from discontinued operations | -              | (.9)           |
| Loss on sale, net of tax                     | <u>(1.3)</u>   | <u>(1.5)</u>   |
|  | )              |                |
| Discontinued operations                      | <u>(\$1.3)</u> | <u>(\$2.4)</u> |

The operations of GAPR (sold in 2006) are not reported as discontinued because they were not material to AFG.

**L. Equity in Net Losses of Investee**

Equity in net earnings (losses) of investees includes AFG's share of the losses from a manufacturing business (\$2.1 million in 2006, \$1.2 million in 2005 and \$3.1 million in 2004). In addition, equity in net earnings (losses) of investee for 2005 includes a \$3.9 million after tax impairment writedown related to this business.

**M. Commitments and Contingencies**

In December 2006, AFG subsidiaries recognized a pretax gain of \$44.6 million on the sale of certain New York assets, primarily transferable development rights and assets under long-term leases. The buyer of the assets has the right to require AFG to repurchase the assets if a contingency (considered remote by AFG) is not resolved within six months of the sale.

Loss 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"), prior to its bankruptcy reorganization in 1978 and certain manufacturing operations disposed of by American Premier.

In 2004, American Premier reached an agreement with two other responsible parties on the allocation of environmental clean-up costs at a former railroad site in Paoli, Pennsylvania. Based on the settlement, American Premier recorded a charge (included in "Other operating and general expenses") of \$52 million to increase its liabilities for environmental exposures. Although American Premier has been advised by counsel that it should be able to recover a significant amount of these costs from a financially viable third party, no recovery asset has been recorded for its Paoli Yard costs.

At December 31, 2006, American Premier had liabilities for environmental and personal injury claims aggregating \$76 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. Management expects to conduct a comprehensive review of these liabilities in conjunction with the property and casualty group's asbestos and environmental reserve study in 2007.

In the second half of 2005, GAFRI completed an in-depth review of projected costs associated with its former manufacturing operations. Based upon information provided by environmental and other consultants, GAFRI recorded a pretax charge of \$9.5 million in the third quarter of 2005. At December 31, 2006, GAFRI had a liability of approximately \$13 million for environmental costs and certain other matters associated with the sales of these former operations.

AFG's insurance subsidiaries continue to receive claims related to environmental exposures, asbestos and other mass tort claims. As more fully described in Item 7, establishing reserves for these claims is subject to uncertainties that are significantly greater than those presented by other types of claims. The liability for asbestos and environmental reserves at December 31, 2006 and 2005, respectively, was \$518 million and \$540 million; related recoverables from reinsurers (net of allowances for doubtful accounts) at those dates were \$85 million and \$79 million, respectively. The liability for other mass tort reserves at December 31, 2006 and 2005, respectively, was \$19 million and \$21 million; related recoverables from reinsurers (net of allowances for doubtful accounts) at those dates were \$4 million and \$3 million, respectively.

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.

• **Quarterly Operating Results (Unaudited)**

The operations of certain of AFG's 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. Quarterly results necessarily rely heavily on estimates. These estimates and certain other factors, such as the nature of investees' operations and discretionary sales of assets, cause the quarterly results not to be necessarily indicative of results for longer periods of time.

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AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

The following are quarterly results of consolidated operations for the two years ended December 31, 2006 (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<br><u>Quarter</u> | 2nd<br><u>Quarter</u> | 3rd<br><u>Quarter</u> | 4th<br><u>Quarter</u> | Total<br><u>Year</u> |
|--|-----------------------|-----------------------|-----------------------|-----------------------|----------------------|
|--|-----------------------|-----------------------|-----------------------|-----------------------|----------------------|

| <u>2006</u>                                    |         |         |           |           |           |
|--|---------|---------|-----------|-----------|-----------|
| Revenues                                       | \$996.1 | \$995.0 | \$1,136.5 | \$1,122.5 | \$4,250.1 |
| Earnings (loss) from:                          |         |         |           |           |           |
| Continuing operations                          | 101.9   | 97.2    | 93.5      | 135.6     | 428.2     |
| Discontinued operations                        | (0.4)   | 25.6    | -         | -         | 25.2      |
| Net earnings                                   | 101.5   | 122.8   | 93.5      | 135.6     | 453.4     |
| Basic earnings per common share:               |         |         |           |           |           |
| Continuing operations                          | \$0.86  | \$0.83  | \$0.79    | \$1.14    | \$3.63    |
| Discontinued operations                        | -       | 0.21    | -         | -         | 0.21      |
| Net earnings available to Common Shares        | \$0.86  | \$1.04  | \$0.79    | \$1.14    | \$3.84    |
| Diluted earnings per common share:             |         |         |           |           |           |
| Continuing operations                          | \$0.85  | \$0.81  | \$0.77    | \$1.11    | \$3.54    |
| Discontinued operations                        | -       | .21     | -         | -         | 0.21      |
| Net earnings available to Common Shares        | \$0.85  | \$1.02  | \$0.77    | \$1.11    | \$3.75    |
| Average number of Common Shares:               |         |         |           |           |           |
| Basic  | 117.4   | 117.8   | 118.1     | 118.9     | 118.0     |
| Diluted  | 119.4   | 120.4   | 120.6     | 121.6     | 120.5     |
| <u>2005</u>                                    |         |         |           |           |           |
| Revenues                                       | \$926.1 | \$984.0 | \$1,075.9 | \$998.4   | \$3,984.4 |
| Earnings (loss) from:                          |         |         |           |           |           |
| Continuing operations                          | 63.0    | 80.9    | (28.7)    | 80.9      | 196.1     |
| Discontinued operations                        | (0.1)   | 0.7     | 2.3       | 7.6       | 10.5      |
| Net earnings (loss)                            | 62.9    | 81.6    | (26.4)    | 88.5      | 206.6     |
| Basic earnings (loss) per common share:        |         |         |           |           |           |
| Continuing operations                          | \$0.55  | \$0.70  | (\$0.25)  | \$0.69    | \$1.69    |
| Discontinued operations                        | -       | 0.01    | 0.02      | 0.07      | 0.09      |
| Net earnings (loss) available to Common Shares | \$0.55  | \$0.71  | (\$0.23)  | \$0.76    | \$1.78    |
| Diluted earnings (loss) per common share:      |         |         |           |           |           |
| Continuing operations                          | \$0.54  | \$0.69  | (\$0.24)  | \$0.69    | \$1.66    |
| Discontinued operations                        | -       | 0.01    | 0.02      | 0.06      | 0.09      |
| Net earnings (loss) available to Common Shares | \$0.54  | \$0.70  | (\$0.22)  | \$0.75    | \$1.75    |
| Average number of Common Shares:               |         |         |           |           |           |
| Basic  | 115.1   | 115.7   | 116.0     | 116.5     | 115.8     |
| Diluted  | 116.7   | 117.3   | 118.1     | 118.8     | 117.8     |

Results for the fourth quarter of 2006 include a \$44.6 million pretax gain on the sale of certain New York City assets.

Discontinued operations for the second quarter of 2006 includes a \$25.8 million after tax gain from the sale of Chatham Bars Inn, a resort hotel.

Results for the fourth quarter of 2005 include pretax charges of (i) \$45.0 million associated with the residual value business, (ii) \$29.4 million to deferred acquisition costs and insurance liabilities related to the annuity and run-off life operations, (iii) \$18.3 million for adjustments to deferred gains on retroactive reinsurance, and (iv) \$12.6 million in

hurricane losses. These items were partially offset by pretax gains of \$42.6 million from the sales of Ohio and Pennsylvania coal properties and a Texas hotel.

Results for the third quarter of 2005 include a \$179.3 million pretax charge to strengthen asbestos, environmental and other mass tort insurance reserves, \$40 million in pretax losses related to hurricanes and a \$30.9 million pretax gain on the sale of Illinois coal reserves.

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AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

AFG has realized gains (losses) on sales of subsidiaries in recent years (see *Note B - "Acquisitions and Sales of Operations"*). Realized gains (losses) on securities and subsidiaries amounted to (in millions):

|      | <u>1st</u><br><u>Quarter</u> | <u>2nd</u><br><u>Quarter</u> | <u>3rd</u><br><u>Quarter</u> | <u>4th</u><br><u>Quarter</u> | <u>Total</u><br><u>Year</u> |
|------|------------------------------|------------------------------|------------------------------|------------------------------|-----------------------------|
| 2006 | \$29.8                       | (\$ 7.5)                     | (\$ 2.5)                     | \$8.7                        | \$28.5                      |
| 2005 | ( 5.5)                       | 22.1                         | 10.7                         | (6.8)                        | 20.5                        |

• **Insurance**

Securities owned by insurance subsidiaries having a carrying value of approximately \$1.2 billion at December 31, 2006, were on deposit as required by regulatory authorities.

**Insurance Reserves**

The liability for losses and loss adjustment expenses ("LAE") for long-term scheduled payments under certain workers' compensation insurance has been discounted at about 7%, an approximation of long-term investment yields. As a result, the total liability for losses and loss adjustment expenses at December 31, 2006, has been reduced by \$35 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 on a GAAP basis (in millions). In 2006, favorable development in specialty property and transportation, specialty casualty and California workers' compensation was slightly offset by unfavorable development in the specialty financial sub-segment. In addition to the asbestos, environmental and other mass tort charge in 2005, adverse development in the specialty casualty sub-segment was offset by positive development in the property and transportation and California workers' compensation sub-segments. Adverse development in 2004 was primarily due to the specialty casualty segment.

|   | <u>2006</u> | <u>2005</u> | <u>2004</u> |
|---|-------------|-------------|-------------|
| Balance at beginning of period                                  | \$3,548     | \$3,103     | \$2,850     |
| Provision for losses and LAE occurring in the current year      | 1,537       | 1,490       | 1,282       |
| Net increase (decrease) in provision for claims of prior years: |             |             |             |
| 2005 special A&E and other mass tort charge                     | -           | 179         | -           |

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|  |   |                |                |                |
|--|---|----------------|----------------|----------------|
| Other  |   | <u>(59)</u>    | <u>2</u>       | <u>140</u>     |
|  | ) |                |                |                |
| Total losses and LAE incurred (*)                            |   | 1,478          | 1,671          | 1,422          |
| Payments for losses and LAE of:                              |   |                |                |                |
| Current year   |   | (456)          | (423)          | (377)          |
| Prior years  |   | <u>(852)</u>   | <u>(803)</u>   | <u>(726)</u>   |
|  | ) |                |                |                |
| Total payments   | ) | (1,308)        | (1,226)        | (1,103)        |
| Reserves of businesses acquired (sold)                       |   | <u>1</u>       | <u>-</u>       | <u>(66)</u>    |
|  | ) |                |                |                |
| Balance at end of period                                     |   | 3,719          | 3,548          | 3,103          |
| Add back reinsurance recoverables, net<br>of allowance       |   | <u>2,309</u>   | <u>2,243</u>   | <u>2,234</u>   |
| Gross unpaid losses and LAE included<br>in the Balance Sheet |   | <u>\$6.028</u> | <u>\$5.791</u> | <u>\$5.337</u> |

(\*) Before adjustments for deferred gains on retroactive reinsurance of \$2 million in 2006, \$18 million in 2005 and \$1 million in 2004. Includes \$7 million in losses of Transport Insurance Company in 2004 which are classified as discontinued operations.

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AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

Net Investment Income

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

|                                    | <u>2006</u> | <u>2005</u> | <u>2004</u> |
|------------------------------------|-------------|-------------|-------------|
| Insurance group investment income: |             |             |             |
| Fixed maturities                   | \$904.5     | \$842.5     | \$774.9     |
| Equity securities                  | 16.7        | 18.6        | 23.1        |
| Other                              | <u>4.6</u>  | <u>.5</u>   | <u>.7</u>   |
|                                    | 925.8       | 861.6       | 798.7       |



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|   |                |                |                |
|---|----------------|----------------|----------------|
| Insurance group investment expenses (*) | <u>(25.7)</u>  | <u>(23.8)</u>  | <u>(27.2)</u>  |
|   | )              | )              | )              |
|   | <u>\$900.1</u> | <u>\$837.8</u> | <u>\$771.5</u> |

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

Statutory Information

AFG's 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 and policyholders' surplus on a statutory basis for the insurance subsidiaries were as follows (in millions):

|                                 | <u>Net Earnings</u> |             |             | <u>Policyholders' Surplus</u> |             |
|---------------------------------|---------------------|-------------|-------------|-------------------------------|-------------|
|                                 | <u>2006</u>         | <u>2005</u> | <u>2004</u> | <u>2006</u>                   | <u>2005</u> |
| Property and casualty companies | \$475               | \$178       | \$390       | \$2,425                       | \$2,187     |
| Life insurance companies        | 186                 | 114         | 122         | 737                           | 651         |
| 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 deducted from losses and loss adjustment expenses.

|                         | <u>2006</u>    | <u>2005</u>    | <u>2004</u>    |
|-------------------------|----------------|----------------|----------------|
| Direct premiums written | \$3,745        | \$3,634        | \$3,675        |
| Reinsurance assumed (*) | 189            | 65             | 62             |
| Reinsurance ceded       | <u>(1,276)</u> | <u>(1,251)</u> | <u>(1,508)</u> |
|                         | )              | )              | )              |
| Net written premiums    | <u>\$2,658</u> | <u>\$2,448</u> | <u>\$2,229</u> |
| Direct premiums earned  | \$3,712        | \$3,592        | \$3,643        |

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|                         |                |                |                |
|-------------------------|----------------|----------------|----------------|
| Reinsurance assumed (*) | 211            | 66             | 77             |
| Reinsurance ceded       | <u>(1,360)</u> | <u>(1,292)</u> | <u>(1,610)</u> |
|                         | )              | )              | )              |
| Net earned premiums     | <u>\$2,563</u> | <u>\$2,366</u> | <u>\$2,110</u> |
| Reinsurance recoveries  | <u>\$ 912</u>  | <u>\$ 874</u>  | <u>\$1,203</u> |

(\*) The increase in reinsurance assumed is due primarily to the Farmers' crop acquisition.

GAFRI has reinsured approximately \$23 billion in face amount of life insurance (excluding GAPR) as of both December 31, 2006 and 2005. Life premiums ceded (excluding GAPR) were \$65 million, \$68 million and \$86 million for 2006, 2005 and 2004, respectively.

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AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

• **Additional Information**

Total rental expense for various leases of office space and equipment was \$34 million, \$31 million and \$35 million for 2006, 2005 and 2004, respectively.

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, 2006, were as follows: 2007 - \$31 million; 2008 - \$28 million; 2009 - \$24 million; 2010 - \$19 million; 2011 - \$17 million; and \$23 million thereafter.

Other operating and general expenses included charges for possible losses on agents' balances, other receivables and other assets in the following amounts: 2006 - \$0.4 million; 2005 - \$11.1 million; and 2004 - \$15.1 million. Losses and loss adjustment expenses included charges for possible losses on reinsurance recoverables of \$12.8 million in 2006, \$0.4 million in 2005 and \$12.7 million in 2004. The aggregate allowance for all such losses amounted to approximately \$39 million and \$35 million at December 31, 2006 and 2005, respectively.

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.

|  | <u>2006</u>     |              | <u>2005</u>     |
|--|-----------------|--------------|-----------------|
|  | <u>Carrying</u> | <u>Fair</u>  | <u>Carrying</u> |
|  | <u>Value</u>    | <u>Value</u> | <u>Value</u>    |
|  |                 |              | <u>Fair</u>     |
|  |                 |              | <u>Value</u>    |

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|                              |          |          |          |          |
|------------------------------|----------|----------|----------|----------|
| Assets:                      |          |          |          |          |
| Fixed maturities             | \$14,901 | \$14,901 | \$14,598 | \$14,598 |
| Other stocks                 | 729      | 729      | 557      | 557      |
| Liabilities:                 |          |          |          |          |
| Annuity benefits accumulated | \$ 9,457 | \$ 8,969 | \$ 8,417 | \$ 8,060 |
| Long-term debt               | 921      | 1,070    | 1,000    | 1,071    |
| Shareholders' Equity         | \$ 2,929 | \$ 4,284 | \$ 2,458 | \$ 2,991 |

Fair values are based on prices quoted in the most active market for each security. If quoted prices are not available, fair value is estimated based on discounted cash flow models, fair value of comparable securities, or similar methods. The fair value of the liability for annuities in the payout phase is assumed to be the present value of the anticipated cash flows, discounted at current interest rates. Fair value of annuities in the accumulation phase is assumed to be the policyholders' cash surrender amount. Fair value of shareholders' equity is based on the quoted market price of AFG's Common Stock.

#### 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, 2006, AFG and its subsidiaries had commitments to fund credit facilities and contribute limited partnership capital totaling up to \$67 million.

#### Managed Investment Entity

From 1999 to mid-2005, AFG had an investment in, and acted as investment manager for, a collateralized debt obligation ("CDO") of which AFG was determined to be the "primary beneficiary." Accordingly, AFG was required to consolidate this CDO beginning in 2003. Other income includes \$0.7 million in 2005 and \$23.8 million in 2004 in revenues from this entity; other operating and general expenses includes expenses of \$0.8 million in 2005 and \$20.2 million in 2004.

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## AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

AFG is the investment manager and has investments in five other CDOs with an aggregate carrying value of \$24 million at December 31, 2006 (included in fixed maturities), which are not required to be consolidated. These CDOs were formed between 2004 and 2006 and had approximately \$2.1 billion in investments at December 31, 2006.

#### 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 2007 from its insurance subsidiaries without seeking regulatory clearance is

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approximately \$484 million. Additional amounts of dividends, loans and advances require regulatory approval.

### Benefit Plans

AFG expensed approximately \$18 million in 2006 and \$20 million in 2005 and \$17 million in 2004 for its retirement and employee savings plans.

### Transactions With Affiliates

In 2006, AFG sold to an unrelated party its 29% interest in an aircraft that it had jointly owned with AFG's Chairman and his two brothers. AFG received proceeds of approximately \$597,000 and recorded a loss of \$117,000 on the sale. Prior to the sale, costs of operating the aircraft were borne proportionately.

AFG had an obligation for a line of credit to a company that was 100% owned by AFG's Chairman. In 2004, AFG's Chairman assumed AFG's obligation; AFG no longer has any interest or investment in the company.

In December 2004, AFG's Chairman and one of his brothers purchased 900,000 and 300,000 shares, respectively, of AFG's Common Stock as part of a public offering.

#### • **Subsequent Event (unaudited)**

On February 22, 2007, AFG announced that it has proposed that GAFRI (an 81%-owned subsidiary) engage in a merger transaction that would increase AFG's ownership of GAFRI's common stock to 100%. Under the proposed merger transaction, GAFRI would acquire for cash all the outstanding shares not currently held by AFG at a price of \$23.50 per share for an aggregate amount of approximately \$215 million. The proposed transaction is subject to the negotiation of a merger agreement with GAFRI's special committee of independent directors, and would be subject to customary conditions and regulatory approvals. If an agreement is reached, AFG proposes that GAFRI use excess capital plus borrowings from AFG to fund the transaction and anticipates that it would close in the third quarter of 2007.

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## PART III

The information required by the following Items will be included in AFG's definitive Proxy Statement for the 2007 Annual Meeting of Shareholders which will be filed with the Securities and Exchange Commission within 120 days after the end of Registrant's fiscal year and is incorporated herein by reference.

|         |   |
|---------|---|
| ITEM 10 | <u>Directors, Executive Officers of the Registrant and Corporate Governance</u>                       |
| ITEM 11 | <u>Executive Compensation</u>   |
| ITEM 12 | <u>Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u> |
| ITEM 13 | <u>Certain Relationships and Related Transactions, and Director Independence</u>                      |
| ITEM 14 | <u>Principal Accountant Fees and Services</u>   |

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 2006, 2005 and 2004:

|   | <u>Page</u> |
|---|-------------|
| I - Condensed Financial Information of Registrant                                 | S-2         |
| V - Supplemental Information Concerning<br>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.

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AMERICAN FINANCIAL GROUP, INC. - PARENT ONLY

SCHEDULE I - CONDENSED FINANCIAL INFORMATION OF REGISTRANT

(In Millions)

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Condensed Balance Sheet

December 31

2006

2005

Assets:

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|  |                  |                  |
|--|------------------|------------------|
| Cash and cash equivalents                                | \$ 146.0         | \$ 20.9          |
| Investment in securities                                 | 75.3             | 141.8            |
| Investment in subsidiaries (a)                           | 3,412.0          | 2,812.3          |
| Other investments  | 2.3              | 34.8             |
| Other assets   | <u>12.7</u>      | <u>121.3</u>     |
|  | <u>\$3,648.3</u> | <u>\$3,131.1</u> |
| <b>Liabilities and Shareholders' Equity:</b>             |                  |                  |
| Accounts payable, accrued expenses and other liabilities | \$ 168.5         | \$ 79.3          |
| Long-term debt   | 550.9            | 594.2            |
| Shareholders' equity                                     | <u>2,928.9</u>   | <u>2,457.6</u>   |
|  | <u>\$3,648.3</u> | <u>\$3,131.1</u> |

(a) Investment in subsidiaries includes intercompany receivables and payables.

Condensed Statement of Earnings

|  | <u>Year Ended December 31,</u> |             |             |
|--|--------------------------------|-------------|-------------|
|  | <u>2006</u>                    | <u>2005</u> | <u>2004</u> |
| <b>Income:</b>                                   |                                |             |             |
| Dividends from subsidiaries                      | \$531.5                        | \$271.0     | \$ 65.0     |
| Equity in undistributed earnings of subsidiaries | 249.2                          | 161.9       | 590.5       |
| Realized gains (losses) on investments           | (.9)                           | (6.3)       | 3.0         |
| Investment and other income                      | <u>6.3</u>                     | <u>2.9</u>  | <u>.7</u>   |
|  | 786.1                          | 429.5       | 659.2       |
| <b>Costs and Expenses:</b>                       |                                |             |             |
| Interest charges on intercompany borrowings      | 39.1                           | 44.2        | 31.9        |
| Interest charges on other borrowings             | 35.5                           | 42.4        | 44.6        |
| Loss on retirement of debt                       | 2.5                            | 6.2         | .6          |
| Other operating and general expenses             | <u>46.2</u>                    | <u>35.1</u> | <u>33.8</u> |

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|   |                |                |                |
|---|----------------|----------------|----------------|
|   | <u>123.3</u>   | <u>127.9</u>   | <u>110.9</u>   |
| Earnings from continuing operations<br>before income taxes and accounting changes | 662.8          | 301.6          | 548.3          |
| Provision for income taxes  | <u>234.6</u>   | <u>105.5</u>   | <u>182.8</u>   |
| Earnings from continuing operations   | 428.2          | 196.1          | 365.5          |
| Discontinued operations, net of tax   | 25.2           | 10.5           | -              |
| Cumulative effect of accounting changes, net of tax                               | <u>-</u>       | <u>-</u>       | <u>(5.6)</u>   |
|   |                | )              |                |
| Net Earnings  | <u>\$453.4</u> | <u>\$206.6</u> | <u>\$359.9</u> |

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AMERICAN FINANCIAL GROUP, INC. - PARENT ONLY

SCHEDULE I - CONDENSED FINANCIAL INFORMATION OF REGISTRANT - CONTINUED

(In Millions)

—

Condensed Statement of Cash Flows

|   | <u>Year Ended December 31,</u> |             |             |
|---|--------------------------------|-------------|-------------|
|   | <u>2006</u>                    | <u>2005</u> | <u>2004</u> |
| Operating Activities:                           |                                |             |             |
| Net earnings                                    | \$453.4                        | \$206.6     | \$359.9     |
| Adjustments:                                    |                                |             |             |
| Cumulative effect of accounting changes         | -                              | -           | 5.6         |
| Equity in earnings of subsidiaries              | (514.4)                        | (288.1)     | (430.0)     |
| Depreciation and amortization                   | 1.6                            | 3.3         | 3.7         |
| Realized (gains) losses on investing activities | 1.0                            | 6.2         | (3.3)       |
| Loss on retirement of debt                      | 2.5                            | 6.2         | .6          |

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|  |                |                |                |
|--|----------------|----------------|----------------|
| Change in balances with affiliates                   | (47.0)         | (29.3)         | (118.6)        |
| Decrease in other assets                             | 2.0            | 21.5           | 148.8          |
| Increase in other liabilities                        | 84.5           | 8.4            | 2.9            |
| Dividends from subsidiaries                          | 102.5          | 90.0           | 65.0           |
| Other  | <u>6.8</u>     | <u>4.0</u>     | <u>4.0</u>     |
| Net cash provided by operating activities            | <u>92.9</u>    | <u>28.8</u>    | <u>38.6</u>    |
| Investing Activities                                 |                |                |                |
| :  |                |                |                |
| Capital contributions to subsidiaries                | (2.5)          | (10.4)         | (10.1)         |
| Purchases of investments                             | (1.8)          | (4.4)          | (1.0)          |
| Sales of investments                                 | 62.0           | .1             | 4.9            |
| Maturities and redemptions                           | 21.9           | -              | -              |
| Other  | <u>(0.2)</u>   | <u>(.3)</u>    | <u>(.3)</u>    |
| Net cash provided by (used in) investing activities  | <u>79.4</u>    | <u>(15.0)</u>  | <u>(6.5)</u>   |
| Financing Activities:                                |                |                |                |
| Additional long-term borrowings                      | -              | .1             | 111.3          |
| Reductions of long-term debt                         | (46.0)         | (97.6)         | (101.4)        |
| Issuances of Common Stock                            | 37.1           | 30.3           | 95.4           |
| Cash dividends paid                                  | (38.2)         | (33.1)         | (35.1)         |
| Other  | <u>(0.1)</u>   | <u>-</u>       | <u>-</u>       |
| Net cash provided by (used in) financing activities  | <u>(47.2)</u>  | <u>(100.3)</u> | <u>70.2</u>    |
| Net Increase (Decrease) in Cash and Cash Equivalents | 125.1          | (86.5)         | 102.3          |
| Cash and cash equivalents at beginning of period     | <u>20.9</u>    | <u>107.4</u>   | <u>5.1</u>     |
| Cash and cash equivalents at end of period           | <u>\$146.0</u> | <u>\$ 20.9</u> | <u>\$107.4</u> |



AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES  
SCHEDULE V - SUPPLEMENTAL INFORMATION CONCERNING

PROPERTY-CASUALTY INSURANCE OPERATIONS

THREE YEARS ENDED DECEMBER 31, 2006

(IN MILLIONS)

| COLUMN A                    | COLUMN B                          | COLUMN C   | COLUMN D                             | COLUMN E                 | COLUMN F        | COLUMN G              |            |
|-----------------------------|-----------------------------------|--|--------------------------------------|--------------------------|-----------------|-----------------------|------------|
| AFFILIATION WITH REGISTRANT | DEFERRED POLICY ACQUISITION COSTS | (a)<br>RESERVES FOR UNPAID CLAIMS AND CLAIMS ADJUSTMENT EXPENSES | (b)<br>DISCOUNT DEDUCTED IN COLUMN C | (c)<br>UNEARNED PREMIUMS | EARNED PREMIUMS | NET INVESTMENT INCOME | CUMULATIVE |

CONSOLIDATED PROPERTY-CASUALTY ENTITIES

|      |              |                |             |                |                |                |                |                |                |                |                |
|------|--------------|----------------|-------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|
| 2006 | <u>\$321</u> | <u>\$6,028</u> | <u>\$35</u> | <u>\$1,654</u> | <u>\$2,563</u> | <u>\$304</u>   | <u>\$1,537</u> | <u>(\$ 59)</u> | <u>\$612</u>   | <u>\$1,308</u> | <u>\$2,658</u> |
| 2005 | <u>\$304</u> | <u>\$5,791</u> | <u>\$34</u> | <u>\$1,644</u> | <u>\$2,366</u> | <u>\$270</u>   | <u>\$1,490</u> | <u>\$181</u>   | <u>\$504</u>   | <u>\$1,226</u> | <u>\$2,448</u> |
| 2004 |              |                |             | <u>\$2,110</u> | <u>\$237</u>   | <u>\$1,282</u> | <u>\$140</u>   | <u>\$451</u>   | <u>\$1,103</u> | <u>\$2,229</u> |                |

(a) Grossed up for reinsurance recoverables of \$2,309 and \$2,243 at December 31, 2006 and 2005, respectively.

(b) Discounted at approximately 7%.

(c) Grossed up for prepaid reinsurance premiums of \$394 and \$479 at December 31, 2006 and 2005, respectively.

(d) Includes \$7 million recorded in discontinued operations in 2004.

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 27, 2007

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

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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:

| <u>Signature</u>                                     | <u>Capacity</u>                       | <u>Date</u>       |
|--|---------------------------------------|-------------------|
| <u>/s/CARL H. LINDNER</u><br>Carl H. Lindner         | Chairman of the Board<br>of Directors | February 27, 2007 |
| <u>/s/CARL H. LINDNER III</u><br>Carl H. Lindner III | Director                              | February 27, 2007 |
| <u>/s/S. CRAIG LINDNER</u><br>S. Craig Lindner       | Director                              | February 27, 2007 |

|  |   |                   |
|--|---|-------------------|
| <u>/s/THEODORE H. EMMERICH</u><br>Theodore H. Emmerich | Director*   | February 27, 2007 |
| <u>/s/JAMES E. EVANS</u><br>James E. Evans             | Director  | February 27, 2007 |
| <u>/s/TERRY S. JACOBS</u><br>Terry S. Jacobs           | Director*   | February 27, 2007 |
| <u>/s/WILLIAM R. MARTIN</u><br>William R. Martin       | Director*   | February 27, 2007 |
| <u>/s/KENNETH C. AMBRECHT</u><br>Kenneth C. Ambrecht   | Director  | February 27, 2007 |
| <u>/s/WILLIAM W. VERITY</u><br>William W. Verity       | Director  | February 27, 2007 |
| <u>/s/KEITH A. JENSEN</u><br>Keith A. Jensen           | Senior Vice President<br>(principal financial and accounting officer) | February 27, 2007 |

\* Member of the Audit Committee

#### INDEX TO EXHIBITS

#### AMERICAN FINANCIAL GROUP, INC.

| <u>Number</u> | <u>Exhibit Description</u>   |  |
|---------------|--|--|
| 3(a)          | Amended and Restated Articles of Incorporation, filed as Exhibit 3(a) to AFG's Form 10-K for 1997. | (*)  |
| 3(b)          | Code of Regulations, filed as Exhibit 3(b) to AFG's Form 10-K for 1997.                            | (*)  |
| 4             | Instruments defining the rights of security holders.   | Registrant has no outstanding debt issues exceeding 10% of the assets of Registrant and consolidated subsidiaries. |

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Material Contracts:

- |       |   |     |
|-------|---|-----|
| 10(a) | 2005 Stock Incentive Plan included in AFG's 2005 Proxy.   | (*) |
| 10(b) | Stock Option Plan, filed as Exhibit 10(a) to AFG's Form 10-K for 1998.  | (*) |
| 10(c) | Form of stock option agreements, filed as Exhibit 10(b) to AFG's Form 10-K for 1998.  | (*) |
| 10(d) | Amended and Restated Deferred Compensation Plan.  |     |
| 10(e) | 2006 Co-Chief Executive Officer Bonus Plan, filed as Exhibit 99.1 to AFG's Form 8-K filed on March 2, 2006.   | (*) |
| 10(f) | 2006 Senior Executive Bonus Plan, filed as Exhibit 99.2 to AFG's Form 8-K filed on March 2, 2006.   | (*) |
| 10(g) | Amended and restated Nonqualified Auxiliary RASP, filed as Exhibit 10(d) to AFG's Form 10-K for 2003.   | (*) |
| 10(h) | Keith E. Lindner Salary Continuation Agreement, filed as Exhibit 10(c) to AFG's March 31, 2004 Form 10-Q.   | (*) |
| 10(i) | Fred J. Runk Separation Agreement, filed as Exhibit 99.2 to AFG's Form 8-K filed on November 30, 2004.  | (*) |
| 10(j) | Retirement program for outside directors, filed as Exhibit 10(e) to AFG's Form 10-K<br>for 1995.  | (*) |
| 10(k) | Directors' Compensation Plan, included in AFG's 2004 Proxy Statement.   | (*) |
| 10(l) | Amended Equity Distribution Agreement, dated March 27, 2006, among American Financial Group, Inc., as seller, and UBS Securities LLC, filed as Exhibit 1.2 to AFG's Registration Statement on Form S-3 on March 27, 2006. | (*) |
| 10(m) | 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.       | (*) |

(\*) Incorporated herein by reference.

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INDEX TO EXHIBITS - CONTINUED

AMERICAN FINANCIAL GROUP, INC.

| <u>Number</u> | <u>Exhibit Description</u>                           |
|---------------|--|
|               | Computation of ratios of earnings                    |
| <u>12</u>     | to fixed charges.                                    |
|               | Subsidiaries of the Registrant.                      |
| <u>21</u>     |  |
|               | Consent of independent auditors.                     |
| <u>23</u>     |  |
|               | Sarbanes-Oxley Section 302(a) Certification of       |
| <u>31 (a)</u> | Co-Chief Executive Officer.                          |
|               | Sarbanes-Oxley Section 302(a) Certification of       |
| <u>31 (b)</u> | Co-Chief Executive Officer.                          |
|               | Sarbanes-Oxley Section 302(a) Certification of       |
| <u>31 (c)</u> | Chief Financial Officer.                             |
|               | Sarbanes-Oxley Section 906 Certification of Co-Chief |
| <u>32</u>     | Executive Officers and Chief Financial Officer.      |