AMERICAN FINANCIAL GROUP INC
Form 10-Q
May 09, 2012
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

Quarterly Report Pursuant to Section 13 or 15(d) of

the Securities Exchange Act of 1934

For the Quarterly Period Ended March 31, 2012

Commission File No. 1-13653

AMERICAN FINANCIAL GROUP, INC.

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

301 East Fourth Street, Cincinnati, Ohio 45202

(513) 579-2121

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

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

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

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

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

As of May 1, 2012, there were 96,887,372 shares of the Registrant s Common Stock outstanding, excluding 14.9 million shares owned by subsidiaries.

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PART I

ITEM I FINANCIAL STATEMENTS

AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEET (UNAUDITED)

(Dollars In Millions)

	March 31, 2012	December 31, 2011 (as adjusted)
Assets:		
Cash and cash equivalents	$ 1,422	$ 1,324
Investments:		
Fixed maturities, available for sale at fair value (amortized cost $20,994 and $20,562)	22,371	21,807
Fixed maturities, trading at fair value	457	440
Equity securities, at fair value (cost $800 and $744)	1,054	928
Mortgage loans	438	401
Policy loans	249	252
Real estate and other investments	487	425
Total cash and investments	26,478	25,577
Recoverables from reinsurers	2,678	2,942
Prepaid reinsurance premiums	415	409
Agents balances and premiums receivable	550	565
Deferred policy acquisition costs	916	901
Assets of managed investment entities	2,952	3,058
Other receivables	625	895
Variable annuity assets (separate accounts)	601	548
Other assets	810	757
Goodwill	186	186
Total assets	$ 36,211	$ 35,838
Liabilities and Equity:		
Unpaid losses and loss adjustment expenses	$ 6,117	$ 6,520
Unearned premiums	1,496	1,484
Annuity benefits accumulated	16,064	15,420
Life, accident and health reserves	1,739	1,727
Payable to reinsurers	292	475
Liabilities of managed investment entities	2,672	2,787
Long-term debt	931	934
Variable annuity liabilities (separate accounts)	601	548
Other liabilities	1,567	1,386
Total liabilities	31,479	31,281
Shareholders equity:		
Common Stock, no par value		
- 200,000,000 shares authorized		

- 97,177,820 and 97,846,402 shares outstanding	97	98
Capital surplus	1,126	1,121
Retained earnings:		
Appropriated managed investment entities	145	173
Unappropriated	2,498	2,439
Accumulated other comprehensive income, net of tax	714	580
Total shareholders equity	4,580	4,411
Noncontrolling interests	152	146
Total equity	4,732	4,557
Total liabilities and equity	$ 36,211	$ 35,838

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AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF EARNINGS (UNAUDITED)

(In Millions, Except Per Share Data)

	Three months ended March 31,	
	2012	2011 (as adjusted)
Revenues:		
Property and casualty insurance premiums	$ 603	$ 599
Life, accident and health premiums	105	110
Investment income	322	300
Realized gains (losses) on:		
Securities (*)	44	
Subsidiaries		(3)
Income (loss) of managed investment entities:		
Investment income	29	25
Loss on change in fair value of assets/liabilities	(29)	(33)
Other income	39	41
Total revenues	1,113	1,039
Costs and Expenses:		
Property and casualty insurance:		
Losses and loss adjustment expenses	344	341
Commissions and other underwriting expenses	211	203
Annuity benefits	130	116
Life, accident and health benefits	92	96
Annuity and supplemental insurance acquisition expenses	47	50
Interest charges on borrowed money	21	21
Expenses of managed investment entities	19	18
Other operating and general expenses	103	92
Total costs and expenses	967	937
Operating earnings before income taxes	146	102
Provision for income taxes	58	48
Net earnings, including noncontrolling interests	88	54
Less: Net earnings (loss) attributable to noncontrolling interests	(25)	(34)
Net Earnings Attributable to Shareholders	$ 113	$ 88
Earnings Attributable to Shareholders per Common Share:		
Basic	$ 1.16	$ .84
Diluted	$ 1.14	$ .83
Average number of Common Shares:		
Basic	97.7	104.6

Diluted	99.4	106.2
Cash dividends per Common Share	$ .175	$ .1625

(*) Consists of the following:		
Realized gains before impairments	$ 48	$ 10
Losses on securities with impairment	(5)	(7)
Non-credit portion recognized in other comprehensive income (loss)	1	(3)
Impairment charges recognized in earnings	(4)	(10)
Total realized gains on securities	$ 44	$

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AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME (UNAUDITED)

(In Millions)

	Three months ended March 31,	
	2012	2011
Net earnings, including noncontrolling interests	$ 88	$ 54
Other comprehensive income, net of tax:		
Net unrealized gains on securities:		
Unrealized holding gains on securities arising during the period	158	18
Reclassification adjustment for realized gains included in net earnings	(28)	
Total net unrealized gains on securities	130	18
Foreign currency translation adjustments	7	7
Pension and other postretirement plans adjustments	1	
Other comprehensive income, net of tax	138	25
Total comprehensive income, net of tax	226	79
Less: Comprehensive income (loss) attributable to noncontrolling interests	(21)	(34)
Comprehensive income attributable to shareholders	$ 247	$ 113

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AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF CHANGES IN EQUITY (UNAUDITED)

(Dollars in Millions)

		Shareholders Equity						
		Common Stock and	Retained Earnings		Accum.		Noncon-	
	Common Shares	Capital Surplus	Appro.	Unappro.	Other Comp Inc.(Loss)	Total	trolling Interests	Total Equity
Balance at December 31, 2011, as adjusted	97,846,402	$ 1,219	$ 173	$ 2,439	$ 580	$ 4,411	$ 146	$ 4,557
Net earnings				113		113	(25)	88
Other comprehensive income					134	134	4	138
Allocation of losses of managed investment entities			(28)			(28)	28	
Dividends on Common Stock				(17)		(17)		(17)
Shares issued:								
Exercise of stock options	551,219	14				14		14
Other benefit plans	250,072	5				5		5
Dividend reinvestment plan	3,916							
Stock-based compensation expense		4				4		4
Shares acquired and retired	(1,473,789)	(19)		(37)		(56)		(56)
Other							(1)	(1)
Balance at March 31, 2012	97,177,820	$ 1,223	$ 145	$ 2,498	$ 714	$ 4,580	$ 152	$ 4,732
Balance at December 31, 2010	105,168,366	$ 1,271	$ 197	$ 2,523	$ 479	$ 4,470	$ 150	$ 4,620
Cumulative effect of accounting change				(155)	16	(139)		(139)
Balance at December 31, 2010, as adjusted	105,168,366	1,271	197	2,368	495	4,331	150	4,481
Net earnings				88		88	(34)	54
Other comprehensive income					25	25		25
Allocation of losses of managed investment entities			(35)			(35)	35	
Dividends on Common Stock				(17)		(17)		(17)
Shares issued:								
Exercise of stock options	436,127	11				11		11
Other benefit plans	332,337	7				7		7
Dividend reinvestment plan	4,043							
Stock-based compensation expense		3				3		3
Shares acquired and retired	(2,457,721)	(30)		(54)		(84)		(84)
Other							(2)	(2)
Balance at March 31, 2011	103,483,152	$ 1,262	$ 162	$ 2,385	$ 520	$ 4,329	$ 149	$ 4,478

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AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF CASH FLOWS (UNAUDITED)

(In Millions)

	Three months ended March 31,	
	2012	2011 (as adjusted)
Operating Activities:		
Net earnings, including noncontrolling interests	$ 88	$ 54
Adjustments:		
Depreciation and amortization	46	49
Annuity benefits	130	116
Realized (gains) losses on investing activities	(44)	3
Net purchases of trading securities	(13)	(5)
Deferred annuity and life policy acquisition costs	(60)	(51)
Change in:		
Reinsurance and other receivables	535	446
Other assets	(30)	15
Insurance claims and reserves	(373)	(202)
Payable to reinsurers	(183)	(92)
Other liabilities	(3)	59
Managed investment entities assets/liabilities	(86)	(12)
Other operating activities, net	3	9
Net cash provided by operating activities	10	389
Investing Activities:		
Purchases of:		
Fixed maturities	(951)	(1,044)
Equity securities	(59)	(34)
Mortgage loans	(39)	(91)
Real estate, property and equipment	(44)	(20)
Proceeds from:		
Maturities and redemptions of fixed maturities	514	590
Repayments of mortgage loans	2	10
Sales of fixed maturities	131	291
Sales of equity securities	65	6
Managed investment entities:		
Purchases of investments	(566)	(352)
Proceeds from sales and redemptions of investments	774	400
Other investing activities, net	(10)	(13)
Net cash used in investing activities	(183)	(257)
Financing Activities:		
Annuity receipts	804	672
Annuity surrenders, benefits and withdrawals	(348)	(311)
Reductions of long-term debt	(3)	(3)
Issuances of managed investment entities liabilities	359	

Retirement of managed investment entities liabilities	(489)	(4)
Issuances of Common Stock	14	11
Repurchases of Common Stock	(56)	(84)
Cash dividends paid on Common Stock	(17)	(16)
Other financing activities, net	7	3
Net cash provided by financing activities	271	268
Net Change in Cash and Cash Equivalents	98	400
Cash and cash equivalents at beginning of period	1,324	1,099
Cash and cash equivalents at end of period	$ 1,422	$ 1,499

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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D.	**Investments**	**K.**	**Income Taxes**
E.	**Derivatives**	**L.**	**Contingencies**
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Accounting Policies

A. Accounting Policies

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

Certain reclassifications have been made to prior periods to conform to the current year s presentation. All significant intercompany balances and transactions have been eliminated. The results of operations of companies since their formation or acquisition are included in the consolidated financial statements. Events or transactions occurring subsequent to March 31, 2012, and prior to the filing date of this Form 10-Q, have been evaluated for potential recognition or disclosure herein.

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

Accounting Standards Adopted in 2012 Effective January 1, 2012, AFG retrospectively adopted Accounting Standards Update (ASU) 2010-26 that addresses which costs related to issuing or renewing insurance contracts qualify for deferral. To qualify for deferral, the guidance specifies that a cost must be directly related to the successful acquisition of an insurance contract. The financial statements for prior periods have been adjusted to reflect the adoption of the new standard.

The impact of adoption on amounts previously reported is shown in the table below (in millions, except per share data):

	December 31, 2011
Deferred policy acquisition costs	
As previously reported	$ 1,105
As adjusted	901
Net deferred tax liability (included in other liabilities)	
As previously reported	$ 203
As adjusted	133
Shareholders equity	
As previously reported	$ 4,545
As adjusted	4,411

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

	2011				
	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter	Total Year
Net earnings attributable to shareholders					
As previously reported	$ 83	$ 55	$ 96	$ 109	$ 343
As adjusted	88	48	97	109	342
Diluted earnings per Common Share					
As previously reported	$ .79	$ .52	$ .94	$ 1.10	$ 3.33
As adjusted	.83	.46	.95	1.09	3.32

Effective January 1, 2012, AFG retrospectively adopted ASU 2011-05, which eliminates the option to report other comprehensive income in the Statement of Changes in Equity. As permitted by the standard, comprehensive income is presented herein in a separate statement immediately following the Statement of Earnings. This new presentation does not change the measurement of net earnings, other comprehensive income or earnings per share, and accordingly, had no impact on AFG s results of operations or financial position.

Effective January 1, 2012, AFG adopted ASU 2011-04, which clarifies the application of existing fair value measurement and amends certain disclosure requirements. Disclosures required by the guidance are included in Note C. The impact of adoption was not material to AFG s results of operations or financial position.

Fair Value Measurements Accounting standards define fair value as the price that would be received to sell an asset or paid to transfer a liability (an exit price) in an orderly transaction between market participants on the measurement date. The standards establish a hierarchy of valuation techniques based on whether the assumptions that market participants would use in pricing the asset or liability (inputs) are observable or unobservable. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect AFG s assumptions about the assumptions market participants would use in pricing the asset or liability. AFG did not have any significant nonrecurring fair value measurements of nonfinancial assets and liabilities in the first quarter of 2012 or 2011.

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

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

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

Gains or losses on securities are determined on the specific identification basis. When a decline in the value of a specific investment is considered to be other-than-temporary at the balance sheet date, a provision for impairment is charged to earnings (included in realized gains (losses)) and the cost basis of that investment is reduced. If management can assert that it does not intend to sell an impaired fixed maturity security and it is not more likely than not that it will have to sell the security before recovery of its amortized cost basis, then the other-than-temporary impairment is separated into two components: 1) the amount related to credit losses (recorded in earnings) and 2) the amount related to all other factors (recorded in other comprehensive income). The credit-related portion of an other-than-temporary impairment is measured by comparing a security s amortized cost to the present value of its current expected cash flows discounted at its effective yield prior to the impairment charge. Both components are shown in the Statement of Earnings. If management intends to sell an impaired security, or it is more likely than not that it will be required to sell the security before recovery, an impairment charge to earnings is recorded to reduce the amortized cost of that security to fair value.

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

Goodwill Goodwill represents the excess of cost of subsidiaries over AFG s equity in their underlying net assets. Goodwill is not amortized, but is subject to an impairment test at least annually. Under guidance adopted in 2011, an entity is only required to complete the quantitative annual goodwill impairment test on a reporting unit if the entity determines (through qualitative analysis) that it is more likely than not that the reporting unit s fair value is less than its carrying amount.

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

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

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED

Deferred Policy Acquisition Costs (DPAC) Policy acquisition costs (principally commissions, premium taxes and certain policy issuance costs) directly related to the successful acquisition of an insurance contract are deferred. DPAC also includes capitalized costs associated with sales inducements offered to fixed annuity policyholders such as enhanced interest rates and premium and persistency bonuses. As discussed above under Accounting Standards Adopted in 2012, AFG s accounting for DPAC changed effective January 1, 2012, and amounts previously reported have been adjusted retrospectively.

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

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

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

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

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

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

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED

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

Because AFG has no right to use the CLO assets and no obligation to pay the CLO liabilities, the assets and liabilities of the CLOs are shown separately in AFG s Balance Sheet. AFG has elected the fair value option for reporting on the CLO assets and liabilities to improve the transparency of financial reporting related to the CLOs. The excess of fair value of the CLOs assets over the fair value of the liabilities is recorded in AFG s Balance Sheet as appropriated retained earnings managed investment entities, representing amounts that ultimately will inure to the benefit of the CLO debt holders.

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

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

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

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

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

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

Annuity benefits accumulated also includes amounts advanced from the Federal Home Loan Bank of Cincinnati.

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

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

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

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

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

Income Taxes Deferred income taxes are calculated using the liability method. Under this method, deferred income tax assets and liabilities are determined based on differences between financial reporting and tax bases and are measured using enacted tax rates. A valuation allowance is established to reduce total deferred tax assets to an amount that will more likely than not be realized.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED

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

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

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

Earnings Per Share Basic earnings per share is calculated using the weighted average number of shares of common stock outstanding during the period. The calculation of diluted earnings per share includes adjustments to weighted average common shares of 1.7 million for the first quarter of 2012 and 1.6 million for the first quarter of 2011 related to stock-based compensation plans.

AFG s weighted average diluted shares outstanding excludes 1.5 million for the first quarter of 2012 and 1.8 million for the first quarter of 2011 in anti-dilutive potential common shares related to stock compensation plans. Adjustments to net earnings attributable to shareholders in the calculation of diluted earnings per share were nominal in the 2012 and 2011 periods.

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

Segments of Operations

B. Segments of Operations

AFG manages its business as three segments: (i) property and casualty insurance, (ii) annuity and supplemental insurance and (iii) other, which includes holding company costs and amounts attributable to the noncontrolling interests of the managed investment entities.

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

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

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

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

	Three months ended March 31,	
	2012	2011
Revenues		
Property and casualty insurance:		
Premiums earned:		
Specialty		
Property and transportation	$ 263	$ 255
Specialty casualty	220	216
Specialty financial	103	112
Other	17	16
Total premiums earned	603	599
Investment income	71	75
Realized gains	31	
Other income	13	15
Total property and casualty insurance	718	689
Annuity and supplemental insurance:		
Investment income	252	228
Life, accident and health premiums	105	110
Realized gains (losses)	13	(3)
Other income	26	24
Total annuity and supplemental insurance	396	359
Other	(1)	(9)
Total revenues	$ 1,113	$ 1,039
Operating Earnings Before Income Taxes		
Property and casualty insurance:		
Underwriting:		
Specialty		
Property and transportation	$ 27	$ 36
Specialty casualty	4	1
Specialty financial	16	16
Other	1	2
Total underwriting	48	55
Investment and other income, net	55	69

Realized gains	31	
Total property and casualty insurance	134	124
Annuity and supplemental insurance:		
Operations	67	54
Realized gains (losses)	13	(3)
Total annuity and supplemental insurance	80	51
Other (*)	(68)	(73)
Total operating earnings before income taxes	$ 146	$ 102

(*) Includes holding company expenses and $28 million and $35 million in losses of managed investment entities attributable to noncontrolling interests for the first quarter of 2012 and 2011, respectively.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

Fair Value Measurements

C. Fair Value Measurements

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

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

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

Level 3 Valuations derived from market valuation techniques generally consistent with those used to estimate the fair values of Level 2 financial instruments in which one or more significant inputs are unobservable or when the market for a security exhibits significantly less liquidity relative to markets supporting Level 2 fair value measurements. The unobservable inputs may include management s own assumptions about the assumptions market participants would use based on the best information available in the circumstances. AFG s Level 3 is comprised of financial instruments, including liabilities of managed investment entities, whose fair value is estimated based on non-binding broker quotes or internally developed using significant inputs not based on, or corroborated by, observable market information.

AFG s management is responsible for the valuation process and uses data from outside sources (including nationally recognized pricing services and broker/dealers) in establishing fair value. AFG s internal investment professionals are a group of approximately 20 analysts whose primary responsibility is to manage AFG s investment portfolio. These professionals monitor individual investments as well as overall industries and are active in the financial markets on a daily basis. The group is led by AFG s chief investment officer, who reports directly to one of the Co-CEOs. Valuation techniques utilized by pricing services and prices obtained from external sources are reviewed by AFG s internal investment professionals who are familiar with the securities being priced and the markets in which they trade to ensure the fair value determination is representative of an exit price. To validate the appropriateness of the prices obtained, these investment managers consider widely published indices (as benchmarks), recent trades, changes in interest rates, general economic conditions and the credit quality of the specific issuers. In addition, the Company communicates directly with the pricing service regarding the methods and assumptions used in pricing, including verifying, on a test basis, the inputs used by the service to value specific securities.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

Assets and liabilities measured and carried at fair value in the financial statements are summarized below (in millions):

	Level 1	Level 2	Level 3	Total
March 31, 2012				
Assets:				
Available for sale (AFS) fixed maturities:				
U.S. Government and government agencies	$ 235	$ 155	$	$ 390
States, municipalities and political subdivisions		3,844	72	3,916
Foreign government		260		260
Residential MBS		3,804	314	4,118
Commercial MBS		2,880	20	2,900
All other corporate	8	10,264	515	10,787
Total AFS fixed maturities	243	21,207	921	22,371
Trading fixed maturities		456	1	457
Equity securities	955	75	24	1,054
Assets of managed investment entities (MIE)	245	2,643	64	2,952
Variable annuity assets (separate accounts) (a)		601		601
Other investments		142		142
Total assets accounted for at fair value	$ 1,443	$ 25,124	$ 1,010	$ 27,577
Liabilities:				
Liabilities of managed investment entities	$ 118	$	$ 2,554	$ 2,672
Derivatives in annuity benefits accumulated			483	483
Other liabilities derivatives		22		22
Total liabilities accounted for at fair value	$ 118	$ 22	$ 3,037	$ 3,177
December 31, 2011				
Assets:				
Available for sale (AFS) fixed maturities:				
U.S. Government and government agencies	$ 248	$ 134	$	$ 382
States, municipalities and political subdivisions		3,794	83	3,877
Foreign government		254		254
Residential MBS		3,487	361	3,848
Commercial MBS		2,821	19	2,840
All other corporate	9	10,078	519	10,606
Total AFS fixed maturities	257	20,568	982	21,807
Trading fixed maturities		439	1	440
Equity securities	888	29	11	928
Assets of managed investment entities (MIE)	290	2,724	44	3,058
Variable annuity assets (separate accounts) (a)		548		548
Other investments		71		71

Total assets accounted for at fair value	$ 1,435	$ 24,379	$ 1,038	$ 26,852
Liabilities:				
Liabilities of managed investment entities	$ 194	$	$ 2,593	$ 2,787
Derivatives in annuity benefits accumulated			395	395
Other liabilities derivatives		23		23
Total liabilities accounted for at fair value	$ 194	$ 23	$ 2,988	$ 3,205

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

At March 31, 2012, six preferred stocks with an aggregate fair value of $35 million were transferred from Level 1 to Level 2. The transfers were due to decreases in trade frequency, resulting in lack of available trade data sufficient to warrant classification in Level 1. Approximately 4% of the total assets measured at fair value on March 31, 2012, were Level 3 assets. Approximately 94% ($949 million) of the Level 3 assets were priced using non-binding broker quotes, for which there is a lack of transparency as to the inputs used to determine fair value. Details as to the quantitative inputs are neither provided by the brokers nor otherwise reasonably obtainable by AFG. Since internally developed Level 3 asset fair values represent less than one-half of 1% of the total assets measured at fair value and less than 2% of AFG s shareholders equity, changes in unobservable inputs used to determine internally developed fair values would not have a material impact on AFG s financial position.

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The fair values of the liabilities of managed investment entities were determined using primarily non-binding broker quotes, which were reviewed by AFG s investment professionals. AFG s investment professionals are familiar with the cash flow models used by the brokers to determine the fair value of these liabilities and review the broker quotes based on their knowledge of the CLO market and the market for the underlying assets. Their review includes consideration of expected reinvestment, default and recovery rates on the assets supporting the CLO liabilities, as well as surveying general CLO liability fair values and analysis provided by third parties.

The only significant Level 3 assets or liabilities carried at fair value in the financial statements that were not measured using broker quotes are the derivatives embedded in AFG s indexed annuity liabilities, which are measured using a discounted cash flow approach and had a fair value of $483 million at March 31, 2012. The following table presents information about the unobservable inputs used by management in determining fair value of these embedded derivatives. See *Note E Derivatives.*

Unobservable Input	Range
Adjustment for insurance subsidiary s credit risk	0.5% - 2.1% over the risk free rate
Risk margin for uncertainty in cash flows	0.3% reduction in the discount rate
Surrenders	4% - 25% of indexed account value
Partial surrenders	3% - 5% of indexed account value
Annuitizations	1% - 2% of indexed account value
Deaths	1% - 2.5% of indexed account value
Budgeted option costs	2.5% - 4.0% of indexed account value

Increasing the budgeted option cost or risk margin for uncertainty in cash flows assumptions in the table above would increase the fair value of the indexed annuity embedded derivatives, while increasing any of the other unobservable inputs in the table above would decrease the fair value of the embedded derivatives.

Changes in balances of Level 3 financial assets and liabilities carried at fair value during the first quarter of 2012 and 2011 are presented below (in millions). The transfers into and out of Level 3 were due to changes in the availability of market observable inputs. All transfers are reflected in the table at fair value as of the end of the reporting period.

	Balance at December 31, 2011	Total realized/unrealized gains (losses) included in Net income	Total realized/unrealized gains (losses) included in Other comp. income (loss)	Purchases and issuances	Sales and Settlements	Transfer into Level 3	Transfer out of Level 3	Balance at March 31, 2012
AFS fixed maturities:								
State and municipal	$ 83	$	$	$ 10	$	$	($ 21)	$ 72
Residential MBS	361	1		8	(10)	60	(106)	314
Commercial MBS	19		1					20
All other corporate	519	2	3	26	(16)	21	(40)	515

Trading fixed maturities	1						1
Equity securities	11		9		4		24
Assets of MIE	44		12	(3)	14	(3)	64
Liabilities of MIE (*)	(2,593)	(84)	(366)	489			(2,554)
Embedded derivatives	(395)	(62)	(34)	8			(483)

(*) Total realized/unrealized loss included in net income includes losses of $39 million related to liabilities outstanding as of March 31, 2012. See *Note G Managed Investment Entities*.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED

	Balance at December 31, 2010	Net income	Total realized/unrealized gains (losses) included in Other comp. income (loss)	Purchases and Issuances	Sales and Settlements	Transfer into Level 3	Transfer out of Level 3	Balance at March 31, 2011
AFS fixed maturities:								
State and municipal	$ 20	$	$ 1	$	$	$	$	$ 21
Residential MBS	312	1			(13)	7	(36)	271
Commercial MBS	6					3		9
All other corporate	436	(2)		45	(11)	22	(66)	424
Trading fixed maturities	3						(2)	1
Equity securities	21		2		(2)			21
Assets of MIE	48	(1)		7	(4)	6	(2)	54
Liabilities of MIE (*)	(2,258)	(62)			4			(2,316)
Embedded derivatives	(190)	(19)		(30)	5			(234)

(*) Total realized/unrealized loss included in net income includes losses of $61 million related to liabilities outstanding as of March 31, 2011. See *Note G Managed Investment Entities*.

The carrying value and fair value of financial instruments that are not carried at fair value in the financial statements are summarized below (in millions):

March 31, 2012	Carrying Value	Fair Value	Level 1	Level 2	Level 3
Financial assets:					
Cash and cash equivalents	$ 1,422	$ 1,422	$ 1,422	$	$
Mortgage loans	438	441			441
Policy loans	249	249			249
Total financial assets not accounted for at fair value	$ 2,109	$ 2,112	$ 1,422	$	$ 690
Financial liabilities:					
Annuity benefits accumulated (*)	$ 15,864	$ 15,788	$	$	$ 15,788
Long-term debt	931	1,033		918	115
Total financial liabilities not accounted for at fair value	$ 16,795	$ 16,821	$	$ 918	$ 15,903

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

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

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Investments

D. Investments

Available for sale fixed maturities and equity securities at March 31, 2012, and December 31, 2011, consisted of the following (in millions):

	March 31, 2012				December 31, 2011			
	Amortized Cost	Fair Value	Gross Unrealized Gains	Gross Unrealized Losses	Amortized Cost	Fair Value	Gross Unrealized Gains	Gross Unrealized Losses
Fixed maturities:								
U.S. Government and government agencies	$ 374	$ 390	$ 16	$	$ 363	$ 382	$ 19	$
States, municipalities and political subdivisions	3,683	3,916	239	(6)	3,613	3,877	267	(3)
Foreign government	243	260	17		236	254	18	
Residential MBS	4,069	4,118	192	(143)	3,858	3,848	170	(180)
Commercial MBS	2,651	2,900	250	(1)	2,628	2,840	218	(6)
All other corporate	9,974	10,787	836	(23)	9,864	10,606	802	(60)
Total fixed maturities	$ 20,994	$ 22,371	$ 1,550	($ 173)	$ 20,562	$ 21,807	$ 1,494	($ 249)
Common stocks	$ 643	$ 892	$ 258	($ 9)	$ 610	$ 797	$ 207	($ 20)
Perpetual preferred stocks	$ 157	$ 162	$ 8	($ 3)	$ 134	$ 131	$ 5	($ 8)

The non-credit related portion of other-than-temporary impairment charges are included in other comprehensive income. Cumulative charges taken for residential MBS still owned at March 31, 2012 and December 31, 2011, respectively were $229 million and $227 million.

The following tables show gross unrealized losses (in millions) on fixed maturities and equity securities by investment category and length of time that individual securities have been in a continuous unrealized loss position at March 31, 2012 and December 31, 2011.

	Less Than Twelve Months			Twelve Months or More		
	Unrealized Loss	Fair Value	Fair Value as % of Cost	Unrealized Loss	Fair Value	Fair Value as % of Cost
March 31, 2012						
Fixed maturities:						
U.S. Government and government agencies	$	$ 27	100%	$	$	%
States, municipalities and political subdivisions	(5)	250	98%	(1)	22	96%
Foreign government			%			%
Residential MBS	(36)	846	96%	(107)	502	82%

Commercial MBS	(1)	38	97%		2	100%
All other corporate	(12)	602	98%	(11)	112	91%
Total fixed maturities	($ 54)	$ 1,763	97%	($ 119)	$ 638	84%
Common stocks	($ 8)	$ 70	90%	($ 1)	$ 4	80%
Perpetual preferred stocks	$	$ 2	100%	($ 3)	$ 22	88%
December 31, 2011						
Fixed maturities:						
U.S. Government and government agencies	$	$ 2	100%	$	$	%
States, municipalities and political subdivisions	(2)	120	98%	(1)	59	98%
Foreign government		1	100%			%
Residential MBS	(59)	1,141	95%	(121)	473	80%
Commercial MBS	(6)	183	97%		18	100%
All other corporate	(43)	940	96%	(17)	114	87%
Total fixed maturities	($ 110)	$ 2,387	96%	($ 139)	$ 664	83%
Common stocks	($ 19)	$ 169	90%	($ 1)	$ 4	80%
Perpetual preferred stocks	($ 1)	$ 23	96%	($ 7)	$ 31	82%

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED

At March 31, 2012, the gross unrealized losses on fixed maturities of $173 million relate to approximately 725 securities. Investment grade securities (as determined by nationally recognized rating agencies) represented approximately 28% of the gross unrealized loss and 55% of the fair value.

AFG analyzes its MBS securities for other-than-temporary impairment each quarter based upon expected future cash flows. Management estimates expected future cash flows based upon its knowledge of the MBS market, cash flow projections (which reflect loan to collateral values, subordination, vintage and geographic concentration) received from independent sources, implied cash flows inherent in security ratings and analysis of historical payment data. For the first three months of 2012, AFG recorded in earnings $4 million in other-than-temporary impairment charges related to its residential MBS.

A progression of the credit portion of other-than-temporary impairments on fixed maturity securities for which the non-credit portion of an impairment has been recognized in other comprehensive income is shown below (in millions).

	2012	2011
Balance at January 1	$ 187	$ 143
Additional credit impairments on:		
Previously impaired securities	3	7
Securities without prior impairments		1
Balance at March 31	$ 190	$ 151

The table below sets forth the scheduled maturities of available for sale fixed maturities as of March 31, 2012 (in millions). Asset-backed securities and other securities with sinking funds are reported at average maturity. Actual maturities may differ from contractual maturities because certain securities may be called or prepaid by the issuers. MBS had an average life of approximately 4 years at March 31, 2012.

	Amortized Cost	Fair Value	
Maturity		Amount	%
One year or less	$ 634	$ 648	3%
After one year through five years	5,265	5,599	25
After five years through ten years	6,425	7,001	31
After ten years	1,950	2,105	10
	14,274	15,353	69
MBS	6,720	7,018	31
Total	$ 20,994	$ 22,371	100%

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

declining interest rates.

There were no investments in individual issuers that exceeded 10% of Shareholders Equity at March 31, 2012 or December 31, 2011.

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

	Pre-tax	Deferred Tax and Amounts Attributable to Noncontrolling Interests	Net
March 31, 2012			
Unrealized gain on:			
Fixed maturity securities	$ 1,377	($ 492)	$ 885
Equity securities	254	(90)	164
Deferred policy acquisition costs	(539)	189	(350)
Annuity benefits and other liabilities	10	(4)	6
	$ 1,102	($ 397)	$ 705
December 31, 2011			
Unrealized gain on:			
Fixed maturity securities	$ 1,245	($ 444)	$ 801
Equity securities	184	(65)	119
Deferred policy acquisition costs	(537)	188	(349)
Annuity benefits and other liabilities	10	(3)	7
	$ 902	($ 324)	$ 578

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

	Fixed Maturities	Equity Securities	Mortgage Loans and Other Investments	Other (a)	Tax Effects	Noncon-trolling Interests	Total
Quarter ended March 31, 2012							
Realized before impairments	$ 14	$ 35	$ 1	($ 2)	($ 17)	$	$ 31
Realized impairments	(4)	(2)		2	1		(3)
Change in unrealized	132	70		(2)	(70)	(3)	127

Quarter ended March 31, 2011							
Realized before impairments	$ 13	$ 1	($ 2)	($ 2)	($ 3)	$	$ 7
Realized impairments	(11)		(3)	4	3		(7)
Change in unrealized	37	13		(22)	(10)		18

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

Realized gains (losses) on securities includes net gains of $4 million in the first quarter of 2012 compared to net losses of $3 million in the first quarter of 2011 from the mark-to-market of certain MBS, primarily interest-only securities with interest rates that float inversely with short-term rates. Gross realized gains and losses (excluding impairment writedowns and mark-to-market of derivatives) on available for sale fixed maturity and equity security investment transactions included in the Statement of Cash Flows consisted of the following (in millions):

	Three months ended March 31,	
	2012	2011
Fixed maturities:		
Gross gains	$ 10	$ 17
Gross losses		(1)
Equity securities:		
Gross gains	35	1
Gross losses		

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED

Derivatives

E. Derivatives

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

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

		March 31, 2012		December 31, 2011	
Derivative	Balance Sheet Line	Asset	Liability	Asset	Liability
MBS with embedded derivatives	Fixed maturities	$ 102	$	$ 99	$
Interest rate swaptions	Other investments	5		5	
Indexed annuities (embedded derivative)	Annuity benefits accumulated		483		395
Equity index call options	Other investments	137		66	
Reinsurance contracts (embedded derivative)	Other liabilities		22		23
		$ 244	$ 505	$ 170	$ 418

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

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

AFG s indexed annuities, which represented approximately one-third of annuity benefits accumulated at March 31, 2012, provide policyholders with a crediting rate tied, in part, to the performance of an existing stock market index. AFG attempts to mitigate the risk in the index-based component of these products through the purchase of call options on the appropriate index. AFG s strategy is designed so that an increase in the liabilities, due to an increase in the market index, will be generally offset by unrealized and realized gains on the call options purchased by AFG. Both the index-based component of the annuities and the related call options are considered derivatives.

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

The following table summarizes the gain (loss) included in the Statement of Earnings for changes in the fair value of these derivatives for the first quarter of 2012 and 2011 (in millions):

Derivative	Statement of Earnings Line	2012	2011
MBS with embedded derivatives	Realized gains	$ 4	($ 3)
Interest rate swaptions	Realized gains		(2)
Indexed annuities (embedded derivative)	Annuity benefits	(62)	(19)
Equity index call options	Annuity benefits	57	18
Reinsurance contracts (embedded derivative)	Investment income	1	
		$	($ 6)

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED

Deferred Policy Acquisition Costs

F. Deferred Policy Acquisition Costs

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

	March 31, 2012	December 31, 2011
Property and casualty insurance	$ 191	$ 189
Annuity and supplemental insurance:		
Policy acquisition costs	922	898
Policyholder sales inducements	203	207
Present value of future profits (PVFP)	139	144
Impact of unrealized gains and losses on securities	(539)	(537)
Total annuity and supplemental	725	712
	$ 916	$ 901

See *Accounting Standards Adopted in 2012 under Note A Accounting Policies.* The PVFP amounts in the table above are net of $200 million and $195 million of accumulated amortization at March 31, 2012 and December 31, 2011, respectively. Amortization of the PVFP was $5 million in the first quarter of 2012 and $6 million in the first quarter of 2011.

Managed Investment Entities

G. Managed Investment Entities

AFG is the investment manager and has investments ranging from 7.5% to 51.2% of the most subordinate debt tranche of eight collateralized loan obligation entities or CLOs, which are considered variable interest entities. Upon formation between 2004 and 2012, these entities issued securities in various senior and subordinate classes and invested the proceeds primarily in secured bank loans, which serve as collateral for the debt securities issued by each particular CLO. None of the collateral was purchased from AFG. AFG s investments in the subordinate debt tranches of these entities receive residual income from the CLOs only after the CLOs pay operating expenses (including management fees to AFG), interest on and returns of capital to senior levels of debt securities. There are no contractual requirements for AFG to provide additional funding for these entities. AFG has not provided and does not intend to provide any financial support to these entities.

AFG s maximum ultimate exposure to economic loss on its CLOs is limited to its investment in the CLOs, which had an aggregate fair value of $135 million at March 31, 2012, and $98 million at December 31, 2011.

In February 2012, one of the AFG CLOs was substantially liquidated at the instruction of the holder of the majority of the most subordinate debt tranche, as permitted by the CLO indentures. In March 2012, AFG formed a new CLO, which issued $410 million face amount of liabilities (including $39 million face amount purchased by subsidiaries of AFG).

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED

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

	Three months ended March 31,	
	2012	2011
Gains (losses) on change in fair value of assets/liabilities (a):		
Assets	$ 55	$ 29
Liabilities	(84)	(62)
Management fees paid to AFG	4	3
CLO earnings (losses) attributable to:		
AFG shareholders (b)	5	6
Noncontrolling interests (b)	(28)	(35)

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

The aggregate unpaid principal balance of the CLOs fixed maturity investments exceeded the fair value of the investments by $65 million and $120 million at March 31, 2012 and December 31, 2011. The aggregate unpaid principal balance of the CLOs debt exceeded its fair value by $227 million and $306 million at those dates. The CLO assets include $6 million and $2 million in loans (aggregate unpaid principal balance of $17 million and $7 million, respectively) at March 31, 2012 and December 31, 2011, for which the CLOs are not accruing interest because the loans are in default.

Goodwill and Other Intangibles

H. Goodwill and Other Intangibles

There were no changes in the goodwill balance of $186 million during the three months ended March 31, 2012. Included in other assets in AFG s Balance Sheet is $38 million at March 31, 2012 and $41 million at December 31, 2011, in amortizable intangible assets related to property and casualty insurance acquisitions. These amounts are net of accumulated amortization of $51 million and $47 million, respectively. Amortization of these intangibles was $4 million and $3 million for the first three months of 2012 and 2011, respectively. Other assets also include $8 million in non-amortizable intangible assets related to property and casualty insurance acquisitions.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED

Long-Term Debt

I. Long-Term Debt

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

	March 31, 2012	December 31, 2011
Direct obligations of AFG:		
9-7/8% Senior Notes due June 2019	$ 350	$ 350
7% Senior Notes due September 2050	132	132
7-1/8% Senior Debentures due February 2034	115	115
Other	3	3
	600	600
Subsidiaries:		
Obligations of AAG Holding (guaranteed by AFG):		
7-1/2% Senior Debentures due November 2033	112	112
7-1/4% Senior Debentures due January 2034	86	86
Notes payable secured by real estate due 2012 through 2016	64	64
Secured borrowings ($16 and $17 guaranteed by AFG)	27	30
National Interstate bank credit facility	22	22
	311	314
Payable to Subsidiary Trusts:		
AAG Holding Variable Rate Subordinated Debentures due May 2033	20	20
	$ 931	$ 934

Scheduled principal payments on debt for the balance of 2012 and the subsequent five years were as follows: 2012 $31 million; 2013 $20 million; 2014 $2 million; 2015 $14 million; 2016 $45 million and 2017 none.

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

	March 31, 2012	December 31, 2011

Unsecured obligations	$	840	$	840
Obligations secured by real estate		64		64
Other secured borrowings		27		30
	$	931	$	934

AFG can borrow up to $500 million under its revolving credit facility which expires in August 2013. Amounts borrowed under this agreement bear interest at rates ranging from 1.75% to 3.00% (currently 2%) over LIBOR based on AFG s credit rating. No amounts were borrowed under this facility at March 31, 2012.

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AMERICAN FINANCIAL GROUP, INC. 10-Q

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED

Shareholders' Equity

J. Shareholders Equity

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

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

	AOCI Beginning Balance	OCI Pre-tax	OCI Tax	OCI Non-controlling interests	OCI Net	AOCI Ending Balance
Three Months ended March 31, 2012						
Net unrealized gains on securities	$ 578(a)	$ 200	($ 70)	($ 3)	$ 127	$ 705(a)
Foreign currency translation adjustments	10	7		(1)	6	16
Pension and other postretirement plans adjustments	(8)	1			1	(7)
Total	$ 580	$ 208	($ 70)	($ 4)	$ 134	$ 714
Three Months ended March 31, 2011						
Net unrealized gains on securities	$ 491	$ 28	($ 10)	$	$ 18	$ 509
Foreign currency translation adjustments	12	7			7	19
Pension and other postretirement plans adjustments	(8)					(8)
Total	$ 495	$ 35	($ 10)	$	$ 25	$ 520

(a) Includes net unrealized losses of $8 million at March 31, 2012 and $15 million at December 31, 2011 related to securities for which only the credit portion of an other-than-temporary impairment has been recorded in earnings.

Stock Based Compensation Under AFG s Stock Incentive Plan, employees of AFG and its subsidiaries are eligible to receive equity awards in the form of stock options, stock appreciation rights, restricted stock awards, restricted stock units and stock awards. In the first three months of 2012, AFG issued 131,731 shares of restricted Common Stock (fair value of $38.11 per share) and granted stock options for 1.1 million shares of Common Stock (at an average exercise price of $38.11) under the Stock Incentive Plan. In addition, AFG issued 111,270 shares of Common Stock (fair value of $38.38 per share) in the first quarter of 2012 under its Annual Co-CEO Equity Bonus Plan.

AFG uses the Black-Scholes option pricing model to calculate the fair value of its option grants. Expected volatility is based on historical volatility over a period equal to the expected term. The expected term was estimated based on historical exercise patterns and post vesting cancellations. The weighted average fair value of options granted during 2012 was $13.03 per share based on the following assumptions:

expected dividend yield 1.8%; expected volatility 39%; expected term 7.3 years; risk-free rate 1.4%.

Total compensation expense related to stock incentive plans of AFG and its subsidiaries was $6 and $5 million, respectively, in the first quarter of 2012 and 2011.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED

Income Taxes

K. Income Taxes

Income (losses) attributable to noncontrolling interests related to AFG s managed investment entities are non-taxable (non-deductible). For the first three months of 2012 and 2011, respectively, AFG s operating earnings before income taxes included $28 million and $35 million of such non-deductible losses, thereby increasing AFG s effective tax rate.

AFG is involved in litigation with the IRS regarding the calculation of tax reserves for certain annuity reserves pursuant to Actuarial Guideline 33. In 2010, the U.S. District Court in Southern Ohio issued a final summary judgment in favor of AFG. The IRS appealed the District Court decision to the Sixth Circuit Court of Appeals, which heard oral arguments on March 7, 2012. Ultimate resolution may require revised tax calculations for the years 1996-2005, possibly requiring a revised application of tax attribute carryovers or carrybacks, both capital and ordinary, to the affected years, and is contingent upon formal review and acceptance by the IRS. Resolution of the case could result in a decrease in the liability for unrecognized tax benefits by up to $36 million and a decrease in related accrued interest of $15 million. These amounts do not include tax and interest paid to the IRS in 2005 and 2006, for which the suit was filed, totaling $17 million. See Note N *Subsequent Event.*

During the first quarter of 2012, there were no material changes to AFG s liability for uncertain tax positions, which is discussed in *Note L Income Taxes,* to AFG s 2011 Form 10-K.

Contingencies

L. Contingencies

There have been no significant changes to the matters discussed and referred to in *Note M Contingencies* of AFG s 2011 Form 10-K covering property and casualty insurance reserves for claims related to environmental exposures, asbestos and other mass tort claims as well as environmental and occupational injury and disease claims of former subsidiary railroad and manufacturing operations.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED

Condensed Consolidating Information

M. **Condensed Consolidating Information** AFG has guaranteed all of the outstanding public debt of Great American Financial Resources, Inc. (GAFRI) and GAFRI s wholly-owned subsidiary, AAG Holding Company, Inc. In addition, GAFRI guarantees AAG Holding s public debt. The AFG and GAFRI guarantees are full and unconditional and joint and several. Condensed consolidating financial statements for AFG are as follows:

CONDENSED CONSOLIDATING BALANCE SHEET

(In millions)

	AFG	GAFRI	AAG Holding	All Other Subs	Consol. Entries	Consolidated
MARCH 31, 2012						
Assets:						
Cash and investments	$ 419	$ 25	$	$ 26,035	($ 1)	$ 26,478
Recoverables from reinsurers and prepaid reinsurance premiums				3,093		3,093
Agents balances and premiums receivable				550		550
Deferred policy acquisition costs				916		916
Assets of managed investment entities				2,952		2,952
Other assets	120	8	8	2,121	(35)	2,222
Investment in subsidiaries and affiliates	4,931	2,169	2,254	640	(9,994)	
Total assets	$ 5,470	$ 2,202	$ 2,262	$ 36,307	($ 10,030)	$ 36,211
Liabilities and Equity:						
Unpaid losses and loss adjustment expenses and unearned premiums	$	$	$	$ 7,613	$	$ 7,613
Annuity, life, accident and health benefits and reserves				17,815	(12)	17,803
Liabilities of managed investment entities				2,672		2,672
Long-term debt	600		219	112		931
Other liabilities	290	20	109	2,247	(206)	2,460
Total liabilities	890	20	328	30,459	(218)	31,479
Total shareholders equity	4,580	2,182	1,934	5,696	(9,812)	4,580
Noncontrolling interests				152		152
Total liabilities and equity	$ 5,470	$ 2,202	$ 2,262	$ 36,307	($ 10,030)	$ 36,211
DECEMBER 31, 2011						
Assets:						
Cash and investments	$ 456	$ 32	$	$ 25,090	($ 1)	$ 25,577
Recoverables from reinsurers and prepaid reinsurance premiums				3,351		3,351
Agents balances and premiums receivable				565		565
Deferred policy acquisition costs				901		901
Assets of managed investment entities				3,058		3,058
Other assets	105	5	5	2,309	(38)	2,386

Investment in subsidiaries and affiliates	4,732	2,015	2,107	643	(9,497)	
Total assets	$ 5,293	$ 2,052	$ 2,112	$ 35,917	($ 9,536)	$ 35,838
Liabilities and Equity:						
Unpaid losses and loss adjustment expenses and unearned premiums	$	$	$	$ 8,004	$	$ 8,004
Annuity, life, accident and health benefits and reserves				17,148	(1)	17,147
Liabilities of managed investment entities				2,787		2,787
Long-term debt	600		220	115	(1)	934
Other liabilities	282	20	109	2,196	(198)	2,409
Total liabilities	882	20	329	30,250	(200)	31,281
Total shareholders equity	4,411	2,032	1,783	5,521	(9,336)	4,411
Noncontrolling interests				146		146
Total liabilities and equity	$ 5,293	$ 2,052	$ 2,112	$ 35,917	($ 9,536)	$ 35,838

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AMERICAN FINANCIAL GROUP, INC. 10-Q

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED

CONDENSED CONSOLIDATING STATEMENT OF EARNINGS

(In millions)

	AFG	GAFRI	AAG Holding	All Other Subs	Consol. Entries	Consolidated
FOR THE THREE MONTHS ENDED MARCH 31, 2012						
Revenues:						
Property and casualty insurance premiums	$	$	$	$ 603	$	$ 603
Life, accident and health premiums				105		105
Realized gains (losses)				45	(1)	44
Income of managed investment entities						
Investment and other income	2	2		362	(5)	361
Equity in earnings of subsidiaries	203	78	84		(365)	
Total revenues	205	80	84	1,115	(371)	1,113
Costs and Expenses:						
Insurance benefits and expenses				824		824
Interest charges on borrowed money	16		6	4	(5)	21
Expenses of managed investment entities				19		19
Other operating and general expenses	18	4	2	80	(1)	103
Total costs and expenses	34	4	8	927	(6)	967
Operating earnings before income taxes	171	76	76	188	(365)	146
Provision (credit) for income taxes	58	27	27	72	(126)	58
Net earnings, including noncontrolling interests	113	49	49	116	(239)	88
Less: Net earnings (loss) attributable to noncontrolling interests				(25)		(25)
Net Earnings Attributable to Shareholders	$ 113	$ 49	$ 49	$ 141	($ 239)	$ 113

	AFG	GAFRI	AAG Holding	All Other Subs	Consol. Entries	Consolidated
FOR THE THREE MONTHS ENDED MARCH 31, 2011						
Revenues:						
Property and casualty insurance premiums	$	$	$	$ 599	$	$ 599
Life, accident and health premiums				110		110
Realized gains (losses)				(3)		(3)
Income of managed investment entities				(8)		(8)
Investment and other income	2	3		343	(7)	341
Equity in earnings of subsidiaries	167	47	55		(269)	

Total revenues	169	50	55	1,041	(276)	1,039
Costs and Expenses:						
Insurance benefits and expenses				806		806
Interest charges on borrowed money	16		6	4	(5)	21
Expenses of managed investment entities				18		18
Other operating and general expenses	17	3	1	72	(1)	92
Total costs and expenses	33	3	7	900	(6)	937
Operating earnings before income taxes	136	47	48	141	(270)	102
Provision (credit) for income taxes	48	17	17	60	(94)	48
Net earnings, including noncontrolling interests	88	30	31	81	(176)	54
Less: Net earnings (loss) attributable to noncontrolling interests				(34)		(34)
Net Earnings Attributable to Shareholders	$ 88	$ 30	$ 31	$ 115	($ 176)	$ 88

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AMERICAN FINANCIAL GROUP, INC. 10-Q

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED

CONDENSED CONSOLIDATING STATEMENT OF COMPREHENSIVE INCOME

(In millions)

	AFG	GAFRI	AAG Holding	All Other Subs	Consol. Entries	Consolidated
FOR THE THREE MONTHS ENDED MARCH 31, 2012						
Net earnings, including noncontrolling interests	$ 113	$ 49	$ 49	$ 116	($ 239)	$ 88
Other comprehensive income, net of tax	134	119	117	138	(370)	138
Total comprehensive income, net of tax	247	168	166	254	(609)	226
Less: Comprehensive income (loss) attributable to noncontrolling interests				(21)		(21)
Comprehensive income attributable to shareholders	$ 247	$ 168	$ 166	$ 275	($ 609)	$ 247

	AFG	GAFRI	AAG Holding	All Other Subs	Consol. Entries	Consolidated
FOR THE THREE MONTHS ENDED MARCH 31, 2011						
Net earnings, including noncontrolling interests	$ 88	$ 30	$ 31	$ 81	($ 176)	$ 54
Other comprehensive income, net of tax	25	18	18	24	(60)	25
Total comprehensive income, net of tax	113	48	49	105	(236)	79
Less: Comprehensive income (loss) attributable to noncontrolling interests				(34)		(34)
Comprehensive income attributable to shareholders	$ 113	$ 48	$ 49	$ 139	($ 236)	$ 113

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED

CONDENSED CONSOLIDATING STATEMENT OF CASH FLOWS

(In millions)

	AFG	GAFRI	AAG Holding	All Other Subs	Consol. Entries	Consolidated
FOR THE THREE MONTHS ENDED MARCH 31, 2012						
Operating Activities:						
Net earnings, including noncontrolling interests	$ 113	$ 49	$ 49	$ 116	($ 239)	$ 88
Adjustments:						
Equity in net earnings of subsidiaries	(134)	(51)	(54)		239	
Dividends from subsidiaries	55				(55)	
Other operating activities, net		(2)	(3)	(73)		(78)
Net cash provided by (used in) operating activities	34	(4)	(8)	43	(55)	10
Investing Activities:						
Purchases of investments, property and equipment	(8)			(1,085)		(1,093)
Capital contributions to subsidiaries	(4)	(8)			12	
Proceeds from maturities and redemptions of investments				516		516
Proceeds from sales of investments, property and equipment				196		196
Managed investment entities:						
Purchases of investments				(566)		(566)
Proceeds from sales and redemptions of investments				774		774
Other investing activities, net				(10)		(10)
Net cash provided by (used in) investing activities	(12)	(8)		(175)	12	(183)
Financing Activities:						
Annuity receipts				804		804
Annuity surrenders, benefits and withdrawals				(348)		(348)
Issuances of managed investment entities liabilities				359		359
Retirement of managed investment entities liabilities				(489)		(489)
Issuances of Common Stock	14					14
Capital contributions from parent		4	8		(12)	
Repurchases of Common Stock	(56)					(56)
Cash dividends paid	(17)			(55)	55	(17)
Other financing activities, net				4		4
Net cash provided by (used in) financing activities	(59)	4	8	275	43	271
Net change in cash and cash equivalents	(37)	(8)		143		98
Cash and cash equivalents at beginning of period	415	19		890		1,324

Cash and cash equivalents at end of period	$ 378	$ 11	$	$ 1,033	$	$ 1,422

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED

CONDENSED CONSOLIDATING STATEMENT OF CASH FLOWS

(In millions)

	AFG	GAFRI	AAG Holding	All Other Subs	Consol. Entries	Consolidated
FOR THE THREE MONTHS ENDED MARCH 31, 2011						
Operating Activities:						
Net earnings, including noncontrolling interests	$ 88	$ 30	$ 31	$ 81	($ 176)	$ 54
Adjustments:						
Equity in net earnings of subsidiaries	(110)	(30)	(36)		176	
Dividends from subsidiaries	105				(105)	
Other operating activities, net	(23)	(2)	(2)	362		335
Net cash provided by (used in) operating activities	60	(2)	(7)	443	(105)	389
Investing Activities:						
Purchases of investments, property and equipment	(7)			(1,182)		(1,189)
Capital contributions to subsidiaries	(5)	(8)	(1)		14	
Proceeds from maturities and redemptions of investments	2	2		596		600
Proceeds from sales of investments, property and equipment				297		297
Managed investment entities:						
Purchases of investments				(352)		(352)
Proceeds from sales and redemptions of investments				400		400
Other investing activities, net				(13)		(13)
Net cash provided by (used in) investing activities	(10)	(6)	(1)	(254)	14	(257)
Financing Activities:						
Annuity receipts				672		672
Annuity surrenders, benefits and withdrawals				(311)		(311)
Retirement of managed investment entities liabilities				(4)		(4)
Issuances of Common Stock	10			1		11
Capital contributions from parent		4	8	2	(14)	
Repurchases of Common Stock	(84)					(84)
Cash dividends paid	(16)			(105)	105	(16)
Net cash provided by (used in) financing activities	(90)	4	8	255	91	268
Net change in cash and cash equivalents	(40)	(4)		444		400
Cash and cash equivalents at beginning of period	370	20		709		1,099
Cash and cash equivalents at end of period	$ 330	$ 16	$	$ 1,153	$	$ 1,499

Subsequent Event

N. **Subsequent Event** As discussed in *Note K Income Taxes,* AFG has been involved in litigation with the IRS regarding the calculation of tax reserves for certain annuity reserves for the years 1996 through 2001. On May 4, 2012, the Sixth Circuit Court of Appeals affirmed the Summary Judgment of the District Court in favor of AFG. As a result, unless the IRS determines to seek a discretionary appeal of this decision within 90 days, the decision will become final, and AFG will record net earnings of approximately $27 million. As discussed in Note K, AFG continues to hold discussions with the IRS involving subsequent tax years.

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AMERICAN FINANCIAL GROUP, INC. 10-Q

ITEM 2

Management s Discussion and Analysis

of Financial Condition and Results of Operations

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FORWARD-LOOKING STATEMENTS

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

Actual results and/or financial condition could differ materially from those contained in or implied by such forward-looking statements for a variety of reasons including but not limited to:

- changes in financial, political and economic conditions, including changes in interest and inflation rates, currency fluctuations and extended economic recessions or expansions in the U.S. and abroad;
- performance of securities markets;
- AFG s ability to estimate accurately the likelihood, magnitude and timing of any losses in connection with investments in the non-agency residential mortgage market;

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

the availability of capital;

regulatory actions (including changes in statutory accounting rules);

changes in the legal environment affecting AFG or its customers;

tax law and accounting changes;

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

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

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

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

trends in persistency, mortality and morbidity;

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

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

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

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AMERICAN FINANCIAL GROUP, INC. 10-Q

Management s Discussion and Analysis

of Financial Condition and Results of Operations Continued

OVERVIEW

Financial Condition

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

Results of Operations

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

Net earnings attributable to AFG s shareholders for the first three months of 2012 were $113 million ($1.14 per share, diluted) compared to $88 million ($.83 per share, diluted) reported in the same period of 2011. Improved operating results in the annuity and supplemental insurance group and realized gains in 2012 compared to realized losses in 2011 more than offset lower underwriting profit and lower investment income in AFG s property and casualty insurance operations.

CRITICAL ACCOUNTING POLICIES

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

- the establishment of insurance reserves, especially asbestos and environmental-related reserves and reserves for AFG s closed block of long-term care business,
- the recoverability of reinsurance,
- the recoverability of deferred acquisition costs,
- the establishment of asbestos and environmental reserves of former railroad and manufacturing operations, and
- the valuation of investments, including the determination of other-than-temporary impairments.

For a discussion of these policies, see *Management s Discussion and Analysis Critical Accounting Policies* in AFG s 2011 Form 10-K.

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AMERICAN FINANCIAL GROUP, INC. 10-Q

Management s Discussion and Analysis

of Financial Condition and Results of Operations Continued

LIQUIDITY AND CAPITAL RESOURCES

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

	March 31, 2012	December 31, 2011	2010
Long-term debt	$ 931	$ 934	$ 952
Total capital	4,977	4,860	4,894
Ratio of debt to total capital:			
Including debt secured by real estate	18.7%	19.2%	19.5%
Excluding debt secured by real estate	17.7%	18.2%	18.4%

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

AFG s ratio of earnings to fixed charges, including annuity benefits as a fixed charge, was 2.12 for the three months ended March 31, 2012 and 1.95 for the entire year of 2011. Excluding annuity benefits, this ratio was 7.80 and 6.59, respectively. Although the ratio excluding annuity benefits is not required or encouraged to be disclosed under Securities and Exchange Commission rules, it is presented because interest credited to annuity policyholder accounts is not always considered a borrowing cost for an insurance company.

Parent and Subsidiary Liquidity

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

AFG can borrow up to $500 million under its revolving credit facility which expires in August 2013. There were no borrowings under this agreement, or under any other parent company short-term borrowing arrangements, during 2012.

During the first three months of 2012, AFG repurchased 1.5 million shares of its Common Stock for $56 million. In April 2012, AFG repurchased approximately 357,000 additional shares of its Common Stock for $14 million. During 2011, AFG repurchased 9.3 million shares of its Common Stock for $315 million.

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

Subsidiary Liquidity Great American Life Insurance Company (GALIC), a wholly-owned annuity and supplemental insurance subsidiary, is a member of the Federal Home Loan Bank of Cincinnati (FHLB). The FHLB makes advances and provides other banking services to member institutions, which provides the annuity and supplemental insurance operations with a substantial additional source of liquidity. In the fourth quarter of 2011 the FHLB advanced GALIC $240 million at interest rates ranging from .02% to .03% over LIBOR (average rate of .26% at March 31, 2012). These advances must be repaid within 5 to 7 years but GALIC has the option to prepay all or a portion of the advances on a monthly basis. GALIC has invested the proceeds from the advances in fixed maturity securities for the purpose of earning a spread over the interest payments due to the FHLB.

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National Interstate Corporation, a 52%-owned property and casualty insurance subsidiary, can borrow up to $75 million, subject to certain conditions, under an unsecured credit agreement expiring in December 2012. Amounts borrowed bear interest at rates ranging from .45% to .9% (currently .65%) over LIBOR based on National Interstate s credit rating. There was $22 million outstanding under this agreement at March 31, 2012. National Interstate expects to successfully replace this credit agreement prior to its expiration, although potentially at a higher cost.

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

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

In the annuity business, where profitability is largely dependent on earning a spread between invested assets and annuity liabilities, the duration of investments is generally maintained close to that of liabilities. In a rising interest rate environment, significant protection from withdrawals exists in the form of temporary and permanent surrender charges on AFG s annuity products. With declining rates, AFG receives some protection (from spread compression) due to the ability to lower crediting rates, subject to contractually guaranteed minimum interest rates (GMIRs). AFG began selling new policies with GMIRs below 2% in 2003; almost all new business since late 2010 has been issued with a 1% GMIR. At March 31, 2012, the average crediting rate on AFG s annuities was approximately 3.0%, while the average GMIR was approximately 2.4%. This margin provides AFG the flexibility to lower its crediting rates by up to 60 basis points on average in the future should market interest rates continue to remain low for a long period of time.

AFG believes its insurance subsidiaries maintain sufficient liquidity to pay claims and benefits and operating expenses. In addition, these subsidiaries have sufficient capital to meet commitments in the event of unforeseen events such as reserve deficiencies, inadequate premium rates or reinsurer insolvencies. Nonetheless, changes in statutory accounting rules, significant declines in the fair value of the insurance subsidiaries investment portfolios or significant ratings downgrades on these investments, could create a need for additional capital.

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Investments AFG s investment portfolio at March 31, 2012, contained $22.4 billion in Fixed maturities classified as available for sale and $1.1 billion in Equity securities, all carried at fair value with unrealized gains and losses included in a separate component of shareholders equity on an after-tax basis. In addition, $457 million in fixed maturities were classified as trading with changes in unrealized holding gains or losses included in investment income.

Fair values for AFG s portfolio are determined by AFG s internal investment professionals using data from nationally recognized pricing services as well as non-binding broker quotes. Fair values of equity securities are generally based on closing prices obtained from the pricing services. For mortgage-backed securities (MBS), which comprise approximately 31% of AFG s fixed maturities, prices for each security are generally obtained from both pricing services and broker quotes. For the remainder of AFG s fixed maturity portfolio, approximately 92% are priced using pricing services and the balance is priced primarily by using non-binding broker quotes. When prices obtained for the same security vary, AFG s internal investment professionals select the price they believe is most indicative of an exit price.

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

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

In general, the fair value of AFG s fixed maturity investments is inversely correlated to changes in interest rates. The following table demonstrates the sensitivity of such fair values to reasonably likely changes in interest rates by illustrating the estimated effect on AFG s fixed maturity portfolio that an immediate increase of 100 basis points in the interest rate yield curve would have at March 31, 2012 (dollars in millions). Increases or decreases from the 100 basis points illustrated would be approximately proportional.

Fair value of fixed maturity portfolio	$ 22,828
Pretax impact on fair value of 100 bps increase in interest rates	($ 1,027)
Pretax impact as % of total fixed maturity portfolio	(4.5%)

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Approximately 88% of the fixed maturities held by AFG at March 31, 2012, were rated investment grade (credit rating of AAA to BBB) by nationally recognized rating agencies. Investment grade securities generally bear lower yields and lower degrees of risk than those that are unrated and noninvestment grade. Management believes that the high quality investment portfolio should generate a stable and predictable investment return.

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

Summarized information for AFG s MBS (including those classified as trading) at March 31, 2012, is shown (in millions) in the table below. Agency-backed securities are those issued by a U.S. government-backed agency; Alt-A mortgages are those with risk profiles between prime and subprime. The majority of the Alt-A securities and substantially all of the subprime securities are backed by fixed-rate mortgages. The average life of the residential and commercial MBS is approximately 4 and 5 years, respectively.

Collateral type	Amortized Cost	Fair Value	Fair Value as % of Cost	Unrealized Gain (Loss)	% Rated Investment Grade
Residential:					
Agency-backed	$ 298	$ 311	104%	$ 13	100%
Non-agency prime	2,248	2,328	104	80	57
Alt-A	820	790	96	(30)	41
Subprime	716	699	98	(17)	26
Commercial	2,684	2,933	109	249	99
Other	21	24	114	3	50
	$ 6,787	$ 7,085	104%	$ 298	71%

The National Association of Insurance Commissioners (NAIC) assigns creditworthiness designations on a scale of 1 to 6 with 1 being the highest quality and 6 being the lowest quality. The NAIC retained a third-party investment management firm to assist in the determination of appropriate NAIC designations for mortgage-backed securities based not only on the probability of loss (which is the primary basis of ratings by the major ratings firms), but also on the severity of loss and statutory carrying value. At March 31, 2012, 97% (based on statutory carrying value of $6.7 billion) of AFG s MBS securities had an NAIC designation of 1 or 2.

Municipal bonds represented approximately 17% of AFG s fixed maturity portfolio at March 31, 2012. AFG s municipal bond portfolio is high quality, with 99% of the securities rated investment grade at that date. The portfolio is well diversified across the states of issuance and individual issuers. At March 31, 2012, approximately 80% of the municipal bond portfolio was held in revenue bonds, with the remaining 20% held in general obligation bonds. State general obligation securities of California, Illinois, New Jersey and New York collectively represented only 2% of this portfolio.

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Summarized information for the unrealized gains and losses recorded in AFG s Balance Sheet at March 31, 2012, is shown in the following table (dollars in millions). Approximately $141 million of available for sale Fixed maturities and $74 million of Equity securities had no unrealized gains or losses at March 31, 2012.

	Securities With Unrealized Gains	Securities With Unrealized Losses
Available for Sale Fixed Maturities		
Fair value of securities	$ 19,829	$ 2,401
Amortized cost of securities	$ 18,279	$ 2,574
Gross unrealized gain (loss)	$ 1,550	($ 173)
Fair value as % of amortized cost	108%	93%
Number of security positions	3,948	725
Number individually exceeding $2 million gain or loss	142	3
Concentration of gains (losses) by type or industry (exceeding 5% of unrealized):		
Mortgage-backed securities	$ 442	($ 144)
States and municipalities	239	(6)
Gas and electric services	160	(1)
Banks, savings and credit institutions	104	(6)
Percentage rated investment grade	91%	55%
Equity Securities		
Fair value of securities	$ 882	$ 98
Cost of securities	$ 616	$ 110
Gross unrealized gain (loss)	$ 266(*)	($ 12)
Fair value as % of cost	143%	89%
Number of security positions	188	48
Number individually exceeding $2 million gain or loss	20	2

(*) Includes $113 million on AFG s investment in Verisk Analytics, Inc.

The table below sets forth the scheduled maturities of AFG s available for sale fixed maturity securities at March 31, 2012, based on their fair values. Asset-backed securities and other securities with sinking funds are reported at average maturity. Actual maturities may differ from contractual maturities because certain securities may be called or prepaid by the issuers.

	Securities With Unrealized Gains	Securities With Unrealized Losses
Maturity		
One year or less	3%	1%
After one year through five years	27	14
After five years through ten years	33	16

After ten years	9	11
	72	42
Mortgage-backed securities (average life of approximately four years)	28	58
	100%	100%

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

	Aggregate Fair Value	Aggregate Unrealized Gain (Loss)	Fair Value as % of Cost Basis
Fixed Maturities at March 31, 2012			
Securities with unrealized gains:			
Exceeding $500,000 (888 issues)	$ 10,808	$ 1,127	112%
$500,000 or less (3,060 issues)	9,021	423	105
	$ 19,829	$ 1,550	108%
Securities with unrealized losses:			
Exceeding $500,000 (104 issues)	$ 553	($ 112)	83%
$500,000 or less (621 issues)	1,848	(61)	97
	$ 2,401	($ 173)	93%

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

	Aggregate Fair Value	Aggregate Unrealized Loss	Fair Value as % of Cost Basis
Securities with Unrealized Losses at March 31, 2012			
Investment grade fixed maturities with losses for:			
Less than one year (243 issues)	$ 1,027	($ 21)	98%
One year or longer (112 issues)	284	(27)	91
	$ 1,311	($ 48)	96%
Non-investment grade fixed maturities with losses for:			
Less than one year (192 issues)	$ 736	($ 33)	96%
One year or longer (178 issues)	354	(92)	79
	$ 1,090	($ 125)	90%
Common equity securities with losses for:			
Less than one year (31 issues)	$ 70	($ 8)	90%

One year or longer (4 issues)	4	(1)	80
	$ 74	($ 9)	89%
Perpetual preferred equity securities with losses for:			
Less than one year (8 issues)	$ 2	$	100%
One year or longer (5 issues)	22	(3)	88
	$ 24	($ 3)	89%

When a decline in the value of a specific investment is considered to be other-than-temporary, a provision for impairment is charged to earnings (accounted for as a realized loss) and the cost basis of that investment is reduced by the amount of the charge. The determination of whether unrealized losses are other-than-temporary requires judgment based on subjective as well as objective factors as detailed in AFG s 2011 Form 10-K under *Management s Discussion and Analysis Investments.*

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Based on its analysis, management believes (i) AFG will recover its cost basis in the securities with unrealized losses and (ii) that AFG has the ability and intent to hold the securities until they recover in value and had no intent to sell them at March 31, 2012. Although AFG has the ability to continue holding its investments with unrealized losses, its intent to hold them may change due to deterioration in the issuers creditworthiness, decisions to lessen exposure to a particular issuer or industry, asset/liability management decisions, market movements, changes in views about appropriate asset allocation or the desire to offset taxable realized gains. Should AFG s ability or intent change with regard to a particular security, a charge for impairment would likely be required. While it is not possible to accurately predict if or when a specific security will become impaired, charges for other-than-temporary impairment could be material to results of operations in future periods. Significant declines in the fair value of AFG s investment portfolio could have a significant adverse effect on AFG s liquidity.

Uncertainties Management believes that the areas posing the greatest risk of material loss are the adequacy of its insurance reserves and contingencies arising out of its former railroad and manufacturing operations. See *Management s Discussion and Analysis Uncertainties* in AFG s 2011 Form 10-K. AFG conducts comprehensive studies of its asbestos and environmental reserves with the aid of outside actuarial and engineering firms and specialty outside counsel every two years with an in-depth internal review during the intervening years. See *Management s Discussion and Analysis Results of Operations Asbestos and Environmental Reserve Charges* in AFG s 2011 Form 10-K.

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MANAGED INVESTMENT ENTITIES

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

CONDENSED CONSOLIDATING BALANCE SHEET

March 31, 2012	Before CLO Consolidation	Managed Investment Entities	Consol. Entries	Consolidated As Reported
Assets:				
Cash and investments	$ 26,613	$	($ 135)(a)	$ 26,478
Assets of managed investment entities		2,952		2,952
Other assets	6,781			6,781
Total assets	$ 33,394	$ 2,952	($ 135)	$ 36,211
Liabilities:				
Unpaid losses and loss adjustment expenses and unearned premiums	$ 7,613	$	$	$ 7,613
Annuity, life, accident and health benefits and reserves	17,803			17,803
Liabilities of managed investment entities		2,807	($ 135)(a)	2,672
Long-term debt and other liabilities	3,391			3,391
Total liabilities	28,807	2,807	($ 135)	31,479
Shareholders Equity:				
Common Stock and Capital surplus	1,223			1,223
Retained earnings:				
Appropriated - managed investment entities		145		145
Unappropriated	2,498			2,498
Accumulated other comprehensive income	714			714
Total shareholders equity	4,435	145		4,580
Noncontrolling interests	152			152
Total equity	4,587	145		4,732
Total liabilities and equity	$ 33,394	$ 2,952	($ 135)	$ 36,211
December 31, 2011				
Assets:				
Cash and investments	$ 25,675	$	($ 98)(a)	$ 25,577
Assets of managed investment entities		3,058		3,058

Other assets	7,203			7,203
Total assets	$ 32,878	$ 3,058	($ 98)	$ 35,838
Liabilities:				
Unpaid losses and loss adjustment expenses and unearned premiums	$ 8,004	$	$	$ 8,004
Annuity, life, accident and health benefits and reserves	17,147			17,147
Liabilities of managed investment entities		2,885	(98)(a)	2,787
Long-term debt and other liabilities	3,343			3,343
Total liabilities	28,494	2,885	(98)	31,281
Shareholders equity:				
Common Stock and Capital surplus	1,219			1,219
Retained earnings:				
Appropriated - managed investment entities		173		173
Unappropriated	2,439			2,439
Accumulated other comprehensive income	580			580
Total shareholders equity	4,238	173		4,411
Noncontrolling interests	146			146
Total equity	4,384	173		4,557
Total liabilities and equity	$ 32,878	$ 3,058	($ 98)	$ 35,838

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

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CONDENSED CONSOLIDATING STATEMENT OF EARNINGS

	Before CLO Consolidation(a)	Managed Investment Entities	Consol. Entries	Consolidated As Reported
Three months ended March 31, 2012				
Revenues:				
Insurance premiums	$ 708	$	$	$ 708
Investment income	327		(5)(b)	322
Realized gains (losses) on securities	44			44
Income (loss) of managed investment entities:				
Investment income		29		29
Loss on change in fair value of assets/liabilities		(31)	2(b)	(29)
Other income	43		(4)(c)	39
Total revenues	1,122	(2)	(7)	1,113
Costs and Expenses:				
Insurance benefits and expenses	824			824
Expenses of managed investment entities		26	(7)(b)(c)	19
Interest on borrowed money and other expenses	124			124
Total costs and expenses	948	26	(7)	967
Operating earnings before income taxes	174	(28)		146
Provision for income taxes	58			58
Net earnings, including noncontrolling interests	116	(28)		88
Less: Net earnings (loss) attributable to noncontrolling interests	3		(28)(d)	(25)
Net Earnings Attributable to Shareholders	$ 113	($ 28)	$ 28	$ 113
Three months ended March 31, 2011				
Revenues:				
Insurance premiums	$ 709	$	$	$ 709
Investment income	306		(6)(b)	300
Realized gains (losses) on subsidiaries	(3)			(3)
Income (loss) of managed investment entities:				
Investment income		25		25
Loss on change in fair value of assets/liabilities		(36)	3(b)	(33)
Other income	44		(3)(c)	41
Total revenues	1,056	(11)	(6)	1,039
Costs and Expenses:				
Insurance benefits and expenses	806			806
Expenses of managed investment entities		24	(6)(b)(c)	18

Interest on borrowed money and other expenses	113			113
Total costs and expenses	919	24	(6)	937
Operating earnings before income taxes	137	(35)		102
Provision for income taxes	48			48
Net earnings, including noncontrolling interests	89	(35)		54
Less: Net earnings (loss) attributable to noncontrolling interests	1		(35)(d)	(34)
Net Earnings Attributable to Shareholders	$ 88	($ 35)	$ 35	$ 88

(a) Includes $5 million and $6 million for the first three months of 2012 and 2011, respectively, in investment income representing the change in fair value of AFG s CLO investments plus $4 million and $3 million for each of the same periods in CLO management fees earned.
(b) Elimination of the change in fair value of AFG s investments in the CLOs, including $3 million in both the first three months of 2012 and 2011 in distributions recorded as interest expense by the CLOs.
(c) Elimination of management fees earned by AFG.
(d) Allocate losses of CLOs attributable to other debt holders to noncontrolling interests.

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RESULTS OF OPERATIONS

General Results of operations as shown in the accompanying financial statements are prepared in accordance with U.S. generally accepted accounting principles (GAAP).

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

	Three months ended March 31,	
	2012	2011
Core net operating earnings	$ 85	$ 91
Realized gains (losses)(*)	28	(3)
Net earnings attributable to shareholders	$ 113	$ 88
Diluted per share amounts:		
Core net operating earnings	$ .86	$ .85
Realized gains (losses)	.28	(.02)
Net earnings attributable to shareholders	$ 1.14	$ .83

(*) Realized gains (losses) are shown net of taxes of $16 million in the first quarter of 2012.

Core net operating earnings decreased in the first quarter of 2012 compared to the same period in 2011. Increased earnings in the annuity and supplemental insurance operations were more than offset by lower underwriting profit and lower investment income in the Specialty property and casualty insurance operations. Net earnings attributable to shareholders increased due to realized gains recorded in the first quarter of 2012 compared to realized losses in the comparable 2011 period. Both periods reflect the effect of share repurchases.

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

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 B Segments of Operations* for detail of AFG s operating profit by significant business segment.

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

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

	Three months ended March 31,	
	2012	2011
Gross Written Premiums		
Property and transportation	$ 328	$ 318
Specialty casualty	366	319
Specialty financial	129	116
Other		
	$ 823	$ 753
Net Written Premiums		
Property and transportation	$ 250	$ 254
Specialty casualty	247	214
Specialty financial	93	98
Other	17	18
	$ 607	$ 584
Combined Ratios		
Property and transportation	89.7%	85.8%
Specialty casualty	98.1	99.4
Specialty financial	85.0	85.7
Total Specialty	91.9	90.9
Aggregate (including discontinued lines)	92.1%	90.9%
Favorable (Unfavorable) Prior Year Development		
Property and transportation	$ 10	$ 22
Specialty casualty	1	
Specialty financial	7	(4)
Other specialty	1	3
	19	21
Other (primarily asbestos and environmental charges)		
Aggregate (including discontinued lines)	$ 19	$ 21

Gross and net written premiums increased in the first quarter of 2012 compared to the same 2011 period due primarily to higher premiums in the Specialty casualty segment. Overall average renewal rates increased approximately 3% during the first quarter of 2012.

The Specialty insurance operations generated an underwriting profit of $48 million in the 2012 first quarter compared to $55 million in the first quarter of 2011. Lower profits in the Property and transportation segment were partially offset by improved results in the Specialty casualty segment. Catastrophe losses were $4 million for the first quarter of 2012 compared to $8 million in the first quarter of 2011.

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Property and transportation gross written premiums increased during the first quarter of 2012 compared to 2011 due primarily to higher winter wheat commodity prices and market firming in the property and inland marine businesses, which were partially offset by lower gross written premiums in the transportation businesses. Increased cessions of the winter wheat business contributed to lower net written premiums for the 2012 first quarter. This group reported an underwriting profit of $27 million in the first quarter of 2012, compared to $36 million in the first quarter of 2011. Improved results in the crop insurance operations were more than offset by lower underwriting profits in the property and inland marine and transportation businesses, primarily the result of lower favorable prior year reserve development. Average renewal rates for this group were up approximately 2% for the quarter.

Specialty casualty gross and net written premiums increased during the first quarter of 2012 when compared to 2011 due primarily to higher premiums in the workers compensation and excess and surplus businesses. Increased business opportunities and general market hardening contributed to the growth in premiums. This group reported an underwriting profit of $4 million in the first quarter of 2012, compared to $1 million in the first quarter of 2011. Higher profitability in the international, general liability and workers compensation businesses was largely offset by lower favorable reserve development in the excess and surplus and executive liability businesses. Average renewal rates for this group were up approximately 4% for the quarter.

Specialty financial gross written premiums increased during the first quarter of 2012 when compared to 2011 primarily as a result of a service contracts business initiated in the second quarter of 2011 where all of the premiums were ceded under a reinsurance agreement. Additionally, planned reductions in coastal and near-coastal property exposures in the financial institutions business contributed to decreases in both gross and net written premiums for the quarter. This group reported an underwriting profit of $16 million in both the first quarter of 2012 and the first quarter of 2011.

Annuity and Supplemental Insurance Operations Operating earnings before income taxes for the annuity and supplemental insurance segment increased $13 million (24%) in the first quarter due to higher earnings in the fixed annuity operations as well as improved results in the supplemental insurance lines. The higher profitability in the fixed annuity operations was due primarily to higher invested assets resulting from growth in the business. In the supplemental insurance lines, Medicare supplement results were significantly higher than the 2011 first quarter due primarily to improved loss experience and lower policy lapses. In addition, the significant stock market increase in the first quarter of 2012 had a positive impact on results in the variable and fixed indexed annuity businesses.

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Statutory Annuity Premiums The following table summarizes AFG s annuity sales (in millions):

	Three months ended March 31,	
	2012	2011
403(b) Fixed and Indexed Annuities:		
First Year	$ 3	$ 6
Renewal	40	42
Single Sum	19	17
Subtotal	62	65
Non-403(b) Indexed Annuities	409	257
Non-403(b) Fixed Annuities	42	60
Bank Annuities	275	271
Variable Annuities	15	19
Total Annuity Premiums	$ 803	$ 672

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

The increase in annuity premiums for the first quarter of 2012 compared to the same period in 2011 is attributable to increased sales of indexed annuities in the non-403(b) single premium market. This increase reflects the industry trend towards indexed annuities and away from traditional fixed annuities, as well as AFG s introduction of new indexed products and features.

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

	Three months ended March 31,	
	2012	2011
Premiums		
Supplemental insurance operations		
First year	$ 8	$ 11
Renewal	92	92
Life operations (in run-off)	5	7
	$ 105	$ 110
Benefits		
Supplemental insurance operations	$ 82	$ 85
Life operations (in run-off)	10	11

	$ 92	$ 96

Investment Income In recent years, yields available in the financial markets on fixed maturity securities have generally declined, placing downward pressure on AFG s investment portfolio yield. The $22 million increase in investment income for the first quarter of 2012 compared to the same period in 2011 reflects higher average invested assets, primarily related to growth in the annuity business.

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

	Three months ended March 31,	
	2012	2011
Realized gains (losses) before impairments:		
Disposals	$ 46	$ 17
Change in the fair value of derivatives	4	(5)
Adjustments to annuity deferred policy acquisition costs and related items	(2)	(2)
	48	10
Impairment charges:		
Securities	(6)	(14)
Adjustments to annuity deferred policy acquisition costs and related items	2	4
	(4)	(10)
	$ 44	$

Realized gains on disposals for the first quarter of 2012 includes $27 million in gains on sales of shares of Verisk Analytics, Inc.

The change in fair value of derivatives includes net gains of $4 million in the 2012 quarter and net losses of $3 million in the 2011 quarter from the mark-to-market of MBS, primarily interest-only securities with interest rates that float inversely with short-term rates. See *Note E Derivatives.*

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

The $14 million increase in annuity benefits in the first quarter of 2012 compared to the first quarter of 2011 reflects growth in the annuity business.

Annuity and Supplemental Insurance Acquisition Expenses Annuity and supplemental insurance acquisition expenses include amortization of annuity, supplemental insurance and life business deferred policy acquisition costs (DPAC) as well as a portion of commissions on sales of insurance products. Annuity and supplemental insurance acquisition expenses also include amortization of the present value of future profits of businesses acquired (PVFP).

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

Other Operating and General Expenses The $11 million (12%) increase in other operating and general expenses for the first quarter of 2012 compared to the first quarter of 2011 reflects the impact of a $10 million recovery in the first quarter of 2011 on a prior property and casualty extracontractual obligation claim.

ITEM 3

Quantitative and Qualitative Disclosure of Market Risk

As of March 31, 2012, there were no material changes to the information provided in Item 7A Quantitative and Qualitative Disclosure of Market Risk of AFG s 2011 Form 10-K.

ITEM 4

Controls and Procedures

AFG s management, with participation of its Co-Chief Executive Officers and its principal financial officer, has evaluated AFG s disclosure controls and procedures (as defined in Exchange Act Rule 13a-15) as of the end of the period covered by this report. Based on that evaluation, AFG s Co-CEOs and principal financial officer concluded that the controls and procedures are effective. There have been no changes in AFG s internal control over financial reporting during the first fiscal quarter of 2012 that materially affected, or are reasonably likely to materially affect, AFG s internal control over financial reporting.

In the ordinary course of business, AFG and its subsidiaries routinely enhance their information systems by either upgrading current systems or implementing new systems such as the new investment accounting software system implemented in the first quarter of 2012. There has been no change in AFG s business processes and procedures during the first fiscal quarter of 2012 that has materially affected, or is reasonably likely to materially affect, AFG s internal controls over financial reporting.

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PART II

OTHER INFORMATION

ITEM 2

Unregistered Sales of Equity Securities and Use of Proceeds

Issuer Purchases of Equity Securities AFG repurchased shares of its Common Stock during the first three months of 2012 as follows:

	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares that May Yet be Purchased Under the Plans or Programs (a)
January	7,000	$ 36.42	7,000	3,420,041
February	521,500	$ 37.74	521,500	7,898,541
March	945,289	$ 38.01	945,289	6,953,252

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

ITEM 6

Exhibits

Number	Exhibit Description
12	Computation of ratios of earnings to fixed charges.
31(a)	Certification of the Co-Chief Executive Officer pursuant to section 302(a) of the Sarbanes-Oxley Act of 2002.
31(b)	Certification of the Co-Chief Executive Officer pursuant to section 302(a) of the Sarbanes-Oxley Act of 2002.
31(c)	Certification of the Chief Financial Officer pursuant to section 302(a) of the Sarbanes-Oxley Act of 2002.
32	Certification of the Co-Chief Executive Officers and Chief Financial Officer pursuant to section 906 of the Sarbanes-Oxley Act of 2002.
101	The following financial information from American Financial Group s Form 10-Q for the quarter ended March 31, 2012 formatted in XBRL (Extensible Business Reporting Language):
	(i) Consolidated Balance Sheet
	(ii) Consolidated Statement of Earnings
	(iii) Consolidated Statement of Comprehensive Income
	(iv) Consolidated Statement of Changes in Equity
	(v) Consolidated Statement of Changes in Cash Flows

(vi) Notes to Consolidated Financial Statements

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Signature

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

American Financial Group, Inc.

May 9, 2012

BY: /s/ Keith A. Jensen
Keith A. Jensen

Senior Vice President

(principal financial and accounting officer)