

AMERICAN FINANCIAL GROUP INC  
Form 10-K  
February 27, 2009

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

FORM 10-K

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

For the Fiscal Year Ended December 31, 2008

Commission File No. 1-13653

AMERICAN FINANCIAL GROUP

**, INC.**

Incorporated under the Laws of Ohio

IRS Employer I.D. No. 31-1544320

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

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

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

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

None

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

None

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

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

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements

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incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. [X]

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

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

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

State the aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was last sold, or the average bid and asked price of such common equity, as of the last business day of the Registrant's most recently completed second fiscal quarter: \$2.3 billion.

Indicate the number of shares outstanding of each of the Registrant's classes of common stock, as of the latest practicable date: 115,623,410 shares (excluding 14.9 million shares owned by subsidiaries) as of February 1, 2009.

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Documents Incorporated by Reference:

Proxy Statement for 2009 Annual Meeting of Stockholders (portions of which are incorporated by reference into Part III hereof).

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AMERICAN FINANCIAL GROUP, INC.

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**Part IV**

**FORWARD-LOOKING STATEMENTS**

This Form 10-K, chiefly in Items 1, 3, 5, 7 and 8, contains certain forward-looking statements that are subject to numerous assumptions, risks or uncertainties. The Private Securities Litigation Reform Act of 1995 provides a safe harbor for forward-looking statements. Some of the forward-looking statements can be identified by the use of words such as "anticipates", "believes", "expects", "estimates", "intends", "plans", "seeks", "could", "may", "should", "will" or the negative version of those words or other comparable terminology. Such forward-looking statements include statements relating to: expectations concerning market and other conditions and their effect on future premiums, revenues, earnings and investment activities; recoverability of asset values; expected losses and the adequacy of reserves for asbestos, environmental pollution and mass tort claims; rate changes; and improved loss experience.

Actual results or financial condition could differ materially from those contained in or implied by such forward-looking statements for a variety of factors including the following and those discussed in Item 1A - "Risk Factors."

- *changes in financial, political and economic conditions, including changes in interest rates and extended economic recessions or expansions;*
- *performance of securities markets;*
- *our ability to estimate accurately the likelihood, magnitude and timing of any losses in connection with investments in the non-agency residential mortgage market, especially in the subprime and Alt-A sectors;*
- *new legislation or declines in credit quality or credit ratings that could have a material impact on the valuation of securities in our investment portfolio, including mortgage-backed securities;*
- *the availability of capital;*
- *regulatory actions;*
- *changes in legal environment affecting AFG or its customers;*
- *tax law and accounting changes;*
- *levels of natural catastrophes, terrorist activities (including any nuclear, biological, chemical or radiological events), incidents of war and other major losses;*
- *development of insurance loss reserves and establishment of other reserves, particularly with respect to amounts associated with asbestos and environmental claims;*
- *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 the ability to obtain adequate rates; and*
- *changes in AFG's credit ratings or the financial strength ratings assigned by major ratings agencies to our operating subsidiaries.*

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

ITEM 1

Business

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

Introduction

American Financial Group, Inc. ("AFG") is a holding company that, through subsidiaries, is engaged primarily in property and casualty insurance, focusing on specialized commercial products for businesses, and in the sale of traditional fixed, indexed and variable annuities and a variety of supplemental insurance products. AFG was incorporated as an Ohio corporation in 1997. Its address is One East Fourth Street, Cincinnati, Ohio 45202; its phone number is (513) 579-2121. SEC filings, news releases, AFG's Code of Ethics applicable to directors, officers and employees and other information may be accessed free of charge through AFG's Internet site at: [www.afginc.com](http://www.afginc.com). (Information on AFG's Internet site is not part of this Form 10-K.)

At February 1, 2009, AFG's Chairman of the Board (Carl H. Lindner) and its Co-CEOs (Carl H. Lindner III and S. Craig Lindner, sons of the Chairman) beneficially owned 6.6%, 10.2% and 9.3%, respectively, of AFG's outstanding Common Stock.

Property and Casualty Insurance Operations

The property and casualty group reports to a single senior executive and is comprised of multiple business units that operate autonomously but with certain central controls and accountability. The decentralized approach allows each unit the autonomy necessary to respond to local and specialty market conditions while capitalizing on the efficiencies of centralized investment and administrative support functions. AFG's property and casualty insurance operations employed approximately 5,600 persons as of December 31, 2008.

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

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

AFG's statutory combined ratio averaged 87.5% for the period 2006 to 2008 as compared to 97.6% for the property and casualty industry over the same period (Source: "A.M. Best's U.S. Property/Casualty - Review & Preview" - February 2009 Edition). AFG believes that its specialty niche focus, product line diversification and underwriting discipline have contributed to the Company's ability to consistently outperform the industry's underwriting results. Management's philosophy is to refrain from writing business that is not expected to produce an underwriting profit even if it is necessary to limit premium growth to do so.

Financial data is reported in accordance with U.S. generally accepted accounting principles ("GAAP") for shareholder and other investment purposes and reported on a statutory basis for insurance regulatory purposes. In general, statutory accounting results in lower capital and surplus and lower net earnings than result from

application of GAAP. Major differences for statutory accounting include charging policy acquisition costs to expense as incurred rather than spreading the costs over the periods covered by the policies; reporting investment grade bonds and redeemable preferred stocks at amortized cost rather than fair value; netting of reinsurance recoverables and prepaid reinsurance premiums against the corresponding liabilities; and charging to surplus certain assets, such as certain deferred tax assets, furniture and fixtures and agents' balances over 90 days old.

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

Performance measures such as underwriting profit or loss and related combined ratios are often used by property and casualty insurers to help users of their financial statements better understand the company's performance. See *Note C - "Segments of Operations"* to the financial statements for the reconciliation of AFG's operating profit by significant business segment to the Statement of Earnings.

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

	<u>2008</u>	<u>2007</u>	<u>2006</u>
Gross written premiums	\$4,267	\$3,980	\$3,934
Ceded reinsurance	<u>(1,381)</u>	<u>(1,268)</u>	<u>(1,276)</u>
Net written premiums	<u>\$2,886</u>	<u>\$2,712</u>	<u>\$2,658</u>
Net earned premiums	\$2,867	\$2,703	\$2,563
Loss and LAE	1,611	1,389	1,480
Special asbestos, environmental and other mass tort charges	12	44	-
Underwriting expenses	<u>889</u>	<u>820</u>	<u>765</u>
Underwriting gain	<u>\$ 355</u>	<u>\$ 450</u>	<u>\$ 318</u>
GAAP ratios:			
Loss and LAE ratio	56.6%	52.9%	57.7%
Underwriting expense ratio	<u>31.0</u>	<u>30.4</u>	<u>29.9</u>
Combined ratio	<u>87.6</u>	<u>83.3</u>	<u>87.6</u>
	%	%	%



Provides coverage for all types of vehicles in a broad range of businesses and customized insurance programs for various transportation operations (such as buses and trucks), and a specialized physical damage product for the trucking industry.

#### Specialty Casualty

Executive and Professional Liability	Markets coverage for directors and officers of businesses and non-profit organizations and provides non-U.S. medical malpractice insurance.
Umbrella and Excess Liability	Provides higher layer liability coverage in excess of primary layers.
Excess and Surplus	Provides liability, umbrella and excess coverage for unique, volatile or hard to place risks, using rates and forms that generally do not have to be approved by state insurance regulators.
General Liability	Provides coverage for contractor-related businesses and energy development and production risks.
Targeted Programs	Includes coverage (primarily liability and, in certain cases, workers' compensation) for social service agencies, leisure, entertainment and non-profit organizations, customized solutions for other targeted markets and alternative risk programs using agency captives.
Specialty Financial	
Fidelity and Surety	Provides fidelity and crime coverage for government, mercantile and financial institutions and surety coverage for various types of contractors and public and private corporations.
Lease and Loan Services	Provides coverage for insurance risk management programs for lending and leasing institutions, including vehicle and equipment leasing and collateral and mortgage protection.
California Workers' Compensation	
Workers' Compensation	Writes coverage for prescribed benefits payable to employees (principally in California) who are injured on the job.

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Management believes specialization is the key element to the underwriting success of these business units. Each unit has separate management with significant operating autonomy to oversee the important operational functions of its business such as underwriting, pricing, marketing, policy processing and claims service. These specialty businesses are opportunistic and their premium volume will vary based on prevailing market conditions. AFG continually evaluates expansion in existing markets and opportunities in new specialty markets that meet its profitability objectives. For example, in January 2008, AFG acquired a majority interest in Marketform Group Limited, a United Kingdom-based Lloyd's insurer that is a leader in the non-U.S. medical malpractice market, and all of Strategic Comp Holdings, LLC, a provider of workers' compensation programs in the United States. Likewise, AFG will withdraw from markets that do not meet its profit objectives.

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The geographic distribution of statutory direct written premiums by AFG's U.S.-based insurers in 2008 compared to 2004 is shown below. Amounts exclude business written under special arrangements on behalf of, and fully reinsured to, the purchasers of the divisions sold. Less than 4% of AFG's direct written premiums were derived from non U.S.-based insurers, primarily Marketform.

	<u>2008</u>	<u>2004</u>		<u>2008</u>	<u>2004</u>
California	12.8%	21.2%	Missouri	2.4%	2.2%
Illinois	7.4	4.5	Ohio	2.4	2.9
Texas	7.3	7.7	Pennsylvania	2.4	2.5
Florida	6.0	6.0	Michigan	2.3	2.1
New York	4.4	4.5	South Dakota	2.3	*
Kansas	3.8	*	New Jersey	2.2	2.8
Indiana	3.0	2.0	North Dakota	2.2	*
Iowa	2.6	2.0	Georgia	2.1	2.1
Nebraska	2.6	*	Minnesota	*	2.0
Oklahoma	2.6	2.8	Other	<u>29.2</u>	<u>32.7</u>
				<u>100.0</u>	<u>100.0</u>
				%	%

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

The following table shows the distribution of statutory net written premiums for AFG's U.S.-based insurers by statutory annual statement line for 2008 compared to 2004.

	<u>2008</u>	<u>2004</u>
Other liability	19.7%	25.3%
Allied lines	18.6	5.1
Inland marine	9.9	8.8
Workers' compensation	9.2	17.8
Auto liability	8.5	8.4
Commercial multi-peril	8.5	6.5
Auto physical damage	6.6	5.9
Fidelity and surety	5.7	5.2
Collateral protection	4.6	7.0
Product liability	2.7	3.7
Ocean marine	2.7	2.9
Other	<u>3.3</u>	<u>3.4</u>
	<u>100.0</u>	<u>100.0</u>
	%	%

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

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The following table shows independent ratings and 2008 net written premiums (in millions) of AFG's major property and casualty insurance subsidiaries. Such ratings are generally based on concerns for policyholders and agents and are not directed toward the protection of investors. AFG believes that maintaining a Standard & Poor's ("S&P") rating of at least "A-" is important to compete successfully in certain lines of business.

<u>Company</u>	<u>Ratings</u>		<u>Net Written</u>
	<u>AM Best</u>	<u>S&amp;P</u>	<u>Premiums</u>
Great American Pool(*)	A	A	\$1,950
Mid-Continent	A	A	219
Republic Indemnity	A	A	213
American Empire Surplus Lines	A+	A	60
National Interstate	A	not rated	298
Marketform Lloyd's Syndicate	A	A+	104
Other			<u>42</u>
			<u>\$2,886</u>

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

#### Reinsurance

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

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

AFG has taken steps to limit its exposure to wind and earthquake losses by purchasing catastrophe reinsurance. In addition, AFG purchases catastrophe reinsurance for its workers' compensation businesses. Although market

availability at reasonable prices for such reinsurance has become more difficult over the past few years, AFG has been able to obtain reinsurance coverage in adequate amounts at acceptable rates due to management's decision to limit overall exposure to catastrophe losses through individual risk selection (including minimizing coastal exposures) and the Company's limited historical catastrophe losses.

In addition to the large line capacity and catastrophe reinsurance programs discussed above, AFG purchases reinsurance on a line-by-line basis. AFG regularly reviews the financial strength of its current and potential reinsurers. These reviews include consideration of credit ratings, available capital, claims paying history and expertise. This process periodically results in the transfer of risks to more financially secure reinsurers. Substantially all reinsurance is ceded to companies with investment grade or better S&P ratings or is secured by "funds withheld" or other collateral. Under "funds withheld" arrangements, AFG retains ceded premiums to fund ceded losses as they become due from the reinsurer. Recoverables from the following companies were individually between 5% and 10% of AFG's total reinsurance recoverable (net of payables to reinsurers) at December 31, 2008: Ohio Casualty Insurance Company, Swiss Reinsurance America Corporation, XL Reinsurance America, Inc., Everest Reinsurance Company, Munich Reinsurance America, Inc. and Berkley Insurance Company.

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

The following table presents (by type of coverage) the amount of each loss above the specified retention maximum generally covered by treaty reinsurance programs (in millions) as of January 1, 2009:

<u>Coverage</u>	<u>Retention Maximum</u>	<u>Reinsurance Coverage(a)</u>
California Workers' Compensation	\$ 2.7	\$147.3
Other Workers' Compensation	2.0	48.0
Commercial Umbrella	4.2	45.8
Property - General	2.5	97.5
Property - Catastrophe	22.5	137.5

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

In addition to the coverage shown above, AFG reinsures a portion of its crop insurance business through the Federal Crop Insurance Corporation ("FCIC"). The FCIC offers both proportional (or "quota share") and non-proportional coverages. The proportional coverage provides that a fixed percentage of risk is assumed by the FCIC. The non-proportional coverage allows AFG to select desired retention of risk on a state-by-state, county, crop or plan basis. AFG typically reinsures 20% to 30% of gross written premium with the FCIC on a quota share basis. AFG also purchases quota share reinsurance in the private market. This quota share provides for a ceding commission to AFG and a profit sharing provision. During 2008, AFG reinsured 50% of premiums not reinsured by the FCIC in the private market and purchased stop loss protection coverage for the remaining portion of the business. Beginning in 2009, AFG plans to increase this percentage to 90%.

Included in the Balance Sheet caption "recoverables from reinsurers and prepaid reinsurance premiums" were approximately \$617 million on paid losses and LAE and \$2.6 billion on unpaid losses and LAE at December 31, 2008. These amounts are net of allowances of approximately \$28 million for doubtful collection of reinsurance recoverables. The collectibility of a reinsurance balance is based upon the financial condition of a reinsurer as well as individual claim considerations.

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

	<u>2008</u>	<u>2007</u>	<u>2006</u>
Reinsurance ceded	\$1,381	\$1,268	\$1,276
Reinsurance ceded, excluding crop	693	726	827
Reinsurance assumed - including involuntary pools and associations	37	40	189

Reinsurance assumed includes \$152 million in 2006 related to the purchase of the multi-peril crop and crop hail insurance business of Farmers Crop Insurance Alliance, Inc. Beginning in 2007, the majority of this business was written directly by AFG.

To supplement its catastrophe reinsurance programs, AFG has entered into a catastrophe swap with a non-insurance counterparty for protection against a single catastrophic event in the U.S. that leads to industry-wide losses equal to or greater than \$40 billion. Should such loss occur during 2009, AFG would receive a payment of \$30 million, regardless of the amount of losses it incurs from the catastrophe.

#### Loss and Loss Adjustment Expense Reserves

The consolidated financial statements include the estimated liability for unpaid losses and LAE of AFG's insurance subsidiaries. This liability represents estimates of the ultimate net cost of all unpaid losses and LAE and is determined by using

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case-basis evaluations, actuarial projections and management's judgment. These estimates are subject to the effects of changes in claim amounts and frequency and are periodically reviewed and adjusted as additional information becomes known. In accordance with industry practices, such adjustments are reflected in current year operations. Generally, reserves for reinsurance assumed and involuntary pools and associations are reflected in AFG's results at the amounts reported by those entities.

The following table presents the development of AFG's liability for losses and LAE, net of reinsurance, on a GAAP basis for the last ten years. The top line of the table shows the estimated liability (in millions) for unpaid losses and LAE recorded at the balance sheet date for the indicated years. The second line shows the re-estimated liability as of December 31, 2008. The remainder of the table presents intervening development as percentages of the initially estimated liability. The development results from additional information and experience in subsequent years, particularly with regard to A&E charges, settlements and reallocations as detailed below. The middle line shows a cumulative deficiency (redundancy), which represents the aggregate percentage increase (decrease) in the liability initially estimated. The lower portion of the table indicates the cumulative amounts paid as of successive periods as a percentage of the original loss reserve liability. For purposes of this table, reserves of businesses sold are considered paid at the date of sale. For example, the percentage of the December 31, 2002 reserve liability paid in 2003 includes approximately 20 percentage points for reserves of a former insurance subsidiary at its sale date in February 2003. See *Note N - "Insurance - Insurance Reserves"* to the Financial Statements for an analysis of changes in AFG's estimated liability for losses and LAE, net and gross of reinsurance, over the past three years on a GAAP basis.

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	<u>1998</u>	<u>1999</u>	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>
Liability for unpaid losses <u>and loss adjustment expenses</u>										
:										
As originally estimated	\$3,430	\$3,321	\$3,282	\$3,338	\$3,466	\$2,901	\$3,155	\$3,619	\$3,791	\$3,860
As re-estimated at December 31, 2008	\$3,818	\$3,886	\$4,095	\$4,263	\$4,264	\$3,437	\$3,346	\$3,444	\$3,500	\$3,600

Liability re-estimated

:										
One year later	97.2%	97.7%	104.2%	104.5%	104.4%	104.9%	106.3%	98.4%	97.4%	93.6%
Two years later	95.3%	98.8%	103.8%	110.0%	109.7%	114.0%	106.1%	98.8%	92.3%	
Three years later	95.6%	97.4%	108.0%	113.8%	118.0%	114.7%	107.7%	95.2%		
Four years later	93.8%	100.5%	111.2%	121.1%	118.8%	118.0%	106.0%			
Five years later	96.6%	103.5%	118.1%	122.8%	122.1%	118.5%				
Six years later	99.3%	110.7%	120.0%	126.5%	123.0%					
Seven years later	105.6%	112.4%	123.5%	127.7%						
Eight years later	107.2%	115.9%	124.8%							
Nine years later	110.4%	117.0%								
Ten years later	111.3%									

Cumulative deficiency

	<u>11.3</u>	<u>17.0</u>	<u>24.8</u>	<u>27.7</u>	<u>23.0</u>	<u>18.5</u>	<u>6.0</u>	<u>(4.8)</u>	<u>(7.7)</u>	<u>(10.0)</u>
(redundancy) (a)	%	%	%	%	%	%	%	%)	%)	%)

Cumulative paid as of

:										
One year later	27.4%	33.5%	37.1%	32.7%	42.2%	27.3%	25.4%	23.5%	22.3%	21.0%
Two years later	49.6%	50.7%	50.6%	61.3%	60.9%	46.4%	40.8%	37.5%	34.8%	
Three years later	59.8%	57.8%	69.3%	74.4%	72.7%	58.8%	52.4%	46.9%		
Four years later	62.9%	69.9%	79.2%	82.8%	80.3%	68.5%	60.1%			
Five years later	70.9%	77.8%	84.9%	88.4%	86.2%	75.2%				
Six years later	77.5%	81.7%	89.2%	93.4%	90.7%					
Seven years later	80.4%	85.1%	93.6%	97.0%						

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Eight years later	83.2%	88.7%	96.6%
Nine years later	86.2%	91.3%	
Ten years later	88.3%		

(a) Cumulative deficiency (redundancy):

Special A&E charges,

settlements and

reallocations

10.6%	11.0%	11.2%	8.0%	6.8%	8.2%	7.4%	1.6%	1.5%	.3
<u>0.7</u>	<u>6.0</u>	<u>13.6</u>	<u>19.7</u>	<u>16.2</u>	<u>10.3</u>	<u>(1.4)</u>	<u>(6.4)</u>	<u>(9.2)</u>	(

Other

%	%	%	%	%	%	%)	%)	%)	%)
<u>11.3</u>	<u>17.0</u>	<u>24.8</u>	<u>27.7</u>	<u>23.0</u>	<u>18.5</u>	<u>6.0</u>	<u>(4.8)</u>	<u>(7.7)</u>	(

Total

%	%	%	%	%	%	%	%)	%)	%)
---	---	---	---	---	---	---	----	----	----

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

	<u>1998</u>	<u>1999</u>	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>
As originally estimated:										
Net liability shown above	\$3,430	\$3,321	\$3,282	\$3,338	\$3,466	\$2,901	\$3,155	\$3,619	\$3,791	\$3,868
Add reinsurance										
	<u>1,468</u>	<u>1,571</u>	<u>1,324</u>	<u>1,525</u>	<u>1,804</u>	<u>2,059</u>	<u>2,234</u>	<u>2,243</u>	<u>2,309</u>	<u>2,309</u>
recoverables										
	<u>\$4,898</u>	<u>\$4,892</u>	<u>\$4,606</u>	<u>\$4,863</u>	<u>\$5,270</u>	<u>\$4,960</u>	<u>\$5,389</u>	<u>\$5,862</u>	<u>\$6,100</u>	<u>\$6,177</u>
Gross liability										
As re-estimated at										
December 31, 2008:										
Net liability shown above	\$3,818	\$3,886	\$4,095	\$4,263	\$4,264	\$3,437	\$3,346	\$3,444	\$3,500	\$3,622
Add reinsurance										
	<u>2,094</u>	<u>2,285</u>	<u>2,208</u>	<u>2,412</u>	<u>2,539</u>	<u>2,674</u>	<u>2,525</u>	<u>2,369</u>	<u>2,264</u>	<u>2,264</u>
recoverables										

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Gross liability	<u>\$5.912</u>	<u>\$6.171</u>	<u>\$6.303</u>	<u>\$6.675</u>	<u>\$6.803</u>	<u>\$6.111</u>	<u>\$5.871</u>	<u>\$5.813</u>	<u>\$5.764</u>	<u>\$5.8</u>
Gross cumulative										
Deficiency (redundancy)	<u>20.7</u>	<u>26.1</u>	<u>36.8</u>	<u>37.3</u>	<u>29.1</u>	<u>23.2</u>	<u>8.9</u>			
(a)	%	%	%	%	%	%	%	( <u>0.8%</u> )	( <u>5.5%</u> )	( <u>5.4%</u> )
<hr/>										
(a) Gross cumulative deficiency (redundancy):										
Special A&E charges, settlements and reallocations	9.3%	9.3%	9.9%	6.5%	5.4%	5.7%	5.2%	1.3%	1.3%	0.3%
	<u>11.4</u>	<u>16.8</u>	<u>26.9</u>	<u>30.8</u>	<u>23.7</u>	<u>17.5</u>	<u>3.7</u>			
Other	%	%	%	%	%	%	%	( <u>2.1%</u> )	( <u>6.8%</u> )	( <u>5.7%</u> )
	<u>20.7</u>	<u>26.1</u>	<u>36.8</u>	<u>37.3</u>	<u>29.1</u>	<u>23.2</u>	<u>8.9</u>			
Total	%	%	%	%	%	%	%	( <u>0.8%</u> )	( <u>5.5%</u> )	( <u>5.4%</u> )

In evaluating the re-estimated liability and cumulative deficiency (redundancy), it should be noted that each percentage includes the effects of changes in amounts for prior periods. For example, AFG's \$12 million special A&E charge related to losses recorded in 2008, but incurred before 1998, is included in the re-estimated liability and cumulative deficiency (redundancy) percentage for each of the previous years shown. Conditions and trends that have affected development of the liability in the past may not necessarily exist in the future. Accordingly, it may not be appropriate to extrapolate future redundancies or deficiencies based on this table.

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

The differences between the liability for losses and LAE reported in the annual statements filed with the state insurance departments in accordance with statutory accounting principles ("SAP") and that reported in the accompanying consolidated financial statements in accordance with GAAP at December 31, 2008 are as follows (in millions):

Liability reported on a SAP basis, net of \$195 million	
of retroactive reinsurance	\$3,890
Reinsurance recoverables, net of allowance	2,610
Other, including reserves of foreign insurers	<u>264</u>
Liability reported on a GAAP basis	<u>\$6.764</u>

## Asbestos and Environmental Reserves ("A&amp;E")

AFG's property and casualty group, like many others in the industry, has A&E claims arising in most cases from general liability policies written in years before 1987. The establishment of reserves for such A&E claims presents unique and difficult challenges and is subject to uncertainties significantly greater than those presented by other types of claims. For a discussion of these uncertainties, see *Item 7 - Management's Discussion and Analysis - "Uncertainties - Asbestos and Environmental-related Reserves"* and *Note L - "Contingencies" to the Financial Statements.*

During the second quarter of 2008, AFG completed its comprehensive internal review of asbestos and environmental exposures relating to the run-off operations of its property and casualty group. As a result of the review, AFG recorded a pretax charge of \$12.0 million, net of \$5.5 million in reinsurance recoverables. A previous study, which was done with the aid of outside actuarial and engineering firms and specialty outside counsel, was completed in the second quarter of 2007 and resulted in a pretax charge of \$44.2 million, net of \$16.4 million in reinsurance recoverables. Management expects to conduct a similar study of AFG's A&E reserves in 2009 and a comprehensive internal review in 2010. For a discussion of the A&E reserve strengthening, see *Management's Discussion and Analysis - "Results of Operations - Asbestos and Environmental Reserve Charges."*

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

	<u>2008</u>	<u>2007</u>	<u>2006</u>
Reserves at beginning of year	\$422.8	\$432.3	\$461.0
Incurred losses and LAE	12.4	50.9	-
Paid losses and LAE	(36.5)	(60.4)	(32.2)
Reserves not previously classified as A&E	<u>-</u>	<u>-</u>	<u>3.5</u>
Reserves at end of year, net of reinsurance recoverable	398.7	422.8	432.3
Reinsurance recoverable, net of allowance	<u>67.3</u>	<u>63.6</u>	<u>85.4</u>
Gross reserves at end of year	<u>\$466.0</u>	<u>\$486.4</u>	<u>\$517.7</u>

The survival ratio, which is an industry measure of A&E claim reserves, is derived by dividing reserves for A&E exposures by average annual paid losses over the past three years. At December 31, 2008, AFG's three year survival ratio was 9.7 times average paid losses for the asbestos reserves and 9.3 times average paid losses for the total A&E reserves. Excluding amounts associated with the settlements of asbestos-related coverage litigation for A.P. Green Industries (see *"Legal Proceedings"*) and another large claim, AFG's three year survival ratio was 8.2 and 8.1 times paid losses for the asbestos reserves and total A&E reserves, respectively. According to A.M. Best's most recent (November 2007) report on A&E, three year survival ratios were 8.6 for asbestos and 7.9 for total industry A&E reserves at December 31, 2006.

## Marketing

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

## Competition

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

## Annuity and Supplemental Insurance Operations

### General

AFG's annuity and supplemental insurance operations are conducted through Great American Financial Resources, Inc. ("GAFRI"). In September 2007, GAFRI completed the acquisition of the shares of its common stock not previously owned by AFG, increasing AFG's ownership from 81% to 100%. GAFRI's primary insurance subsidiaries include Great American Life Insurance Company ("GALIC"), Annuity Investors Life Insurance Company ("AILIC"), Loyal American Life Insurance Company ("Loyal") and United Teacher Associates Insurance Company ("UTA"). These companies market retirement products, primarily fixed, indexed and variable annuities, and various forms of supplemental insurance. All of these companies sell their products through independent producers. In addition, certain GAFRI subsidiaries also sell products through captive agents. GAFRI and its subsidiaries employed approximately 1,100 persons at December 31, 2008.

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In August 2006, GAFRI acquired Ceres Group, Inc. ("Ceres") for approximately \$204 million in cash. Prior to the acquisition, Ceres' primary insurance subsidiaries sold health and life insurance products through two primary business segments. Its senior segment included Medicare supplement and other senior health, life and annuity products for individuals age 55 and over. Its medical segment included major medical health insurance for individuals, families, associations and small businesses. In connection with the acquisition, Ceres' insurance subsidiaries entered into reinsurance agreements under which all of Ceres' medical business and half of its in-force senior business were ceded to unaffiliated companies. As a result of these reinsurance transactions, Ceres has paid approximately \$101 million in return of capital distributions to GAFRI since the acquisition. The retained Ceres business generated statutory premiums of \$145 million in 2008 and \$129 million in 2007.

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

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

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

<u>Company</u>	<u>Principal Products</u>	2008 <u>Statutory Premiums</u>	<u>Policies In Force</u>	<u>AM Best Rating</u>	<u>S&amp;P Rating</u>
GALIC	Fixed and indexed annuities	\$1,214	387,000	A	A
AILIC	Fixed, indexed and variable annuities	419	118,000	A	A
UTA	Supplemental insurance	203	189,000	A-	Not rated
Loyal	Fixed annuities and supplemental insurance	108	112,000	A	Not rated

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

	<u>Premiums</u>		
	<u>2008</u>	<u>2007</u>	<u>2006</u>
Non-403(b) indexed annuities	\$ 571	\$ 874	\$ 608
Non-403(b) fixed annuities	311	272	375
403(b) fixed and indexed annuities	358	345	306
Bank fixed annuities	345	-	-
Variable annuities	<u>91</u>	<u>81</u>	<u>87</u>
Total annuities	1,676	1,572	1,376
Supplemental insurance	381	364	298
Life insurance	<u>32</u>	<u>59</u>	<u>53</u>
Total	<u>\$2,089</u>	<u>\$1,995</u>	<u>\$1,727</u>

AFG believes that the ratings assigned by independent insurance rating agencies are important because agents, potential policyholders and school districts often use a company's rating as an initial screening device in considering annuity products. AFG believes that (i) a rating in the "A" category by A.M. Best is necessary to successfully market tax-deferred annuities to public education employees and other non-profit groups and (ii) a rating in the "A" category by at least one rating agency is necessary to successfully compete in other annuity markets. AFG's annuity and supplemental insurance entities also compete in markets other than the sale of tax-deferred annuities. Ratings are an important competitive factor; AFG believes that these entities can successfully compete in these markets with their respective ratings. AFG's annuity and supplemental insurance operations could be materially and adversely affected by ratings downgrades.

#### Annuities

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

deductions. SPDAs are generally issued in exchange for a one-time lump-sum premium payment.

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

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

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

#### Supplemental Insurance Products

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

Although GALIC no longer issues new life insurance policies, it continues to service and receive renewal premiums on its in-force block of approximately 160,000 policies and \$25 billion gross (\$6 billion net) of life insurance in force at December 31, 2008.

#### Marketing

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

AFG sells its fixed rate annuities primarily through a network of approximately 200 managing general agents ("MGAs") who, in turn, direct approximately 2,300 actively producing independent agents. The top 10 MGAs accounted for less than one-third of AFG's fixed rate annuity premiums in 2008. The largest MGA represented less than 7% of total fixed rate annuity premiums in 2008. In 2008, AFG began selling fixed rate annuities through banks. National City Bank, which became a subsidiary of PNC Financial Group in December 2008, is its primary distribution channel for this business.

In recent years, AFG has offered its variable annuity as an ancillary product solely through its 403(b) and 401(k) sales channels. Approximately one-half of AFG's variable annuity sales in 2008 were made through a wholly-owned subsidiary, Great American Advisors, Inc. ("GAA"). GAA is a broker/dealer licensed in all 50 states to sell stocks, bonds, options, mutual funds and variable insurance contracts through independent representatives and financial institutions. GAA also acts as the principal underwriter and distributor for AFG's variable annuity products.

AFG is licensed to sell its fixed annuity products in all 50 states; it is licensed to sell its variable products in all states except New York and Vermont. In 2008, no individual state accounted for more than 10% of AFG's annuity premiums other than Ohio (13%) and California (11%). At December 31, 2008, AFG had approximately 398,000 annuity policies in force.

## Competition

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

No single insurer dominates the markets in which AFG's annuity and supplemental insurance businesses compete. See *Item 1A - "Risk Factors."* Competitors include (i) individual insurers and insurance groups, (ii) mutual funds and (iii) other financial institutions. In a broader sense, AFG's annuity and supplemental insurance businesses compete for retirement savings with a variety of financial institutions offering a full range of financial services.

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

## Other Operations

Through subsidiaries, AFG is engaged in a variety of other operations, including commercial real estate operations in Cincinnati (office buildings and The Cincinnati Hotel), New Orleans (Le Pavillon Hotel), New Hampshire (Mountain View Grand Resort), Chesapeake Bay (Skipjack Cove Yachting Resort and Bay Bridge Marina), Charleston (Charleston Harbor Resort and Marina), Palm Beach (Sailfish Marina and Resort) and apartments in Louisville and Pittsburgh. These operations employed approximately 600 full-time employees at December 31, 2008.

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## Investment Portfolio

### General

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

2008

2007

2006

Yield on Fixed Income Investments (a):			
Excluding realized gains and losses	6.3%	5.8%	5.8%
Including realized gains and losses	5.5%	5.7%	5.6%
Yield on Equity Securities (a):			
Excluding realized gains and losses	2.5%	2.8%	3.0%
Including realized gains and losses	(40.5%)	(5.8%)	8.8%
Yield on Investments (a)(b):			
Excluding realized gains and losses	6.2%	5.6%	5.7%
Including realized gains and losses	3.8%	5.2%	5.7%

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

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

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

	<u>2008</u>	<u>2007</u>	<u>2006</u>
Total return on AFG's fixed income investments	(5.2%)	5.8%	5.0%
Barclays Capital U.S. Universal Bond Index	2.4%	6.5%	5.0%
Total return on AFG's equity securities	(27.0%)	(15.8%)	19.1%
Standard & Poor's 500 Index	(36.6%)	5.5%	15.8%

#### Fixed Maturity Investments

AFG's bond portfolio is invested primarily in taxable bonds. The National Association of Insurance Commissioners ("NAIC") assigns quality ratings, which range from Class 1 (highest quality) to Class 6 (lowest quality). The following table shows AFG's available for sale bonds and redeemable preferred stocks, by NAIC designation (and comparable Standard & Poor's Corporation rating) as of December 31, 2008 (dollars in millions).

NAIC		Amortized		
		<u>Fair Value</u>		
<u>Rating</u>	<u>Comparable S&amp;P Rating</u>	<u>Cost</u>	<u>Amount</u>	<u>%</u>
1	AAA, AA, A	\$11,399	\$10,258	73%
2	BBB	<u>3,482</u>	<u>3,023</u>	<u>21</u>

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	Total investment grade	<u>14,881</u>	<u>13,281</u>	<u>94</u>
3	BB	486	367	3
4	B	361	260	2
5	CCC, CC, C	175	127	1
6	D	<u>45</u>	<u>44</u>	<u>*</u>
	Total noninvestment grade	<u>1,067</u>	<u>798</u>	<u>6</u>
	Total	<u>\$15,948</u>	<u>\$14,079</u>	<u>100</u>
				%

(\*) less than 1%

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

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#### Equity Investments

At December 31, 2008, AFG held common and perpetual preferred stocks with a fair value of \$354 million, the largest of which was a \$137 million common stock investment in Insurance Services Office, Inc. ("ISO"), a provider of risk information for insurance companies. ISO is contemplating an initial public offering under the name Verisk Analytics, Inc.

#### Regulation

AFG's insurance company subsidiaries are subject to regulation in the jurisdictions where they do business. In general, the insurance laws of the various states establish regulatory agencies with broad administrative powers governing, among other things, premium rates, solvency standards, licensing of insurers, agents and brokers, trade practices, forms of policies, maintenance of specified reserves and capital for the protection of policyholders, deposits of securities for the benefit of policyholders, investment activities and relationships between insurance subsidiaries and their parents and affiliates. Material transactions between insurance subsidiaries and their parents and affiliates generally must receive prior approval of the applicable insurance regulatory authorities and be disclosed. In addition, while differing from state to state, these regulations typically restrict the maximum amount of dividends that may be paid by an insurer to its shareholders in any twelve-month period without advance regulatory approval. Such limitations are generally based on net earnings or statutory surplus. Under applicable restrictions, the maximum amount of dividends available to AFG in 2009 from its insurance subsidiaries without seeking regulatory clearance is approximately \$355 million.

Legislation has been proposed to establish procedures for insurers to be subject to federal regulation. The implications of this proposal on AFG's insurance operations cannot be determined at this time.

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

ITEM 1A

Risk Factors

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

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

Worldwide economic conditions deteriorated significantly during 2008. The highly volatile debt and equity markets, lack of liquidity, widening credit spreads and the collapse of several financial institutions have resulted in significant realized and unrealized losses in AFG's investment portfolio. Although the U.S. and other foreign governments have taken, and continue to take, a number of unprecedented actions to try to stabilize the financial markets, it is unclear to what extent these actions will be effective.

AFG's investment performance could also be adversely impacted by the types of investments, industry groups and/or individual securities in which it invests. As of December 31, 2008, 85% of AFG's investment portfolio was invested in fixed maturity securities. Certain risks are inherent in connection with fixed maturity securities including loss upon default and price volatility in reaction to changes in interest rates and general market factors. AFG's equity securities, which represent 2% of its investment portfolio, are subject to market price volatility.

Mortgage-backed securities ("MBS") represented about one-third of AFG's fixed maturity securities at December 31, 2008. MBS in which the underlying collateral is subprime mortgages represented 3% of AFG's total fixed maturity portfolio at

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December 31, 2008; MBS in which the underlying collateral is Alt-A mortgages (risk profile between prime and subprime) represented approximately 6%. See *Item 7A, "Quantitative and Qualitative Disclosures About Market Risk - Fixed Maturity Portfolio."*

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

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

In addition, the continuing economic downturn could have a material adverse effect on AFG's insureds and reinsurers. However, the impact that this would have on AFG's business cannot be predicted.

Legislation being debated in Congress could adversely impact the credit ratings of AFG's MBS portfolio, potentially resulting in material write-downs of these securities.

Certain proposed legislation aimed at resolving the mortgage loan crisis includes a provision that would allow bankruptcy judges to unilaterally change the terms of mortgage loans as part of the bankruptcy proceedings. Depending on its final form, the so-called bankruptcy cram-down bill could result in AFG's portfolio of highly-rated MBS being downgraded by rating agencies. To the extent such actions indicate AFG may not recover its entire carrying value, AFG may be required to record a material write-down (to fair value) on these investments even though the expected economic loss (difference between AFG's cost and ultimate recovery) would be relatively small.

AFG's ability to recognize future tax benefits on realized and unrealized investment losses is limited.

At December 31, 2008, AFG had net deferred tax assets of \$415.7 million related to investment securities and \$44.4 million related to capital loss carryforwards. Future realization of these assets, as well as the ability to record tax benefits on future realized and unrealized capital losses, will depend on management's assessment of available tax planning strategies such as realizing the existing appreciation in certain investment assets. If management believes realization of a deferred tax asset is not likely, a valuation allowance would be established by increasing income tax expense, or in the case of additional future unrealized losses, reducing accumulated other comprehensive income.

Continued adverse developments in the financial markets may limit AFG's access to capital.

Financial markets in the U.S. and elsewhere have been experiencing extreme volatility over the past several months. These circumstances have exerted downward pressure on stock prices and limited access to the equity and debt markets for certain issuers, including AFG.

The 364-day credit facility entered into by AFG in 2008 under which it can borrow up to \$120 million expires in July 2009. There is no assurance that this facility will be renewed. In addition, AFG's access to funds through this facility and its primary credit facility is dependent on the ability of its banks to meet their funding commitments. At December 31, 2008, no amounts were borrowed under the \$120 million facility and \$465 million was borrowed under the \$500 million credit facility.

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

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Intense competition could adversely affect AFG's profitability.

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

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

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

adversely affected.

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

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

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

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

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

In December 2008, the Securities and Exchange Commission adopted rules effective January 2011 whereby certain indexed annuities will be considered securities which can only be sold by registered representatives. Approximately 43% of AFG's statutory annuity premiums in 2008 were from sales of indexed annuities. Future premium volume may be adversely impacted by these new rules.

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New IRS regulations governing 403(b) plans became effective January 1, 2009. As a result, school districts and other not-for-profit employers are required to assume additional responsibilities for 403(b) plans offered to their employees. One consequence of these new regulations is that many of these employers are reviewing the companies offering 403(b) products to their employees. AFG's annuity premiums could be negatively impacted if its insurance company subsidiaries are excluded from school districts that have historically been the source of a significant amount of premiums.

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

As discussed under "Property and Casualty Insurance Operations" and "Annuity and Supplemental Insurance Operations - General," financial strength ratings are an important factor in establishing the competitive position of insurance companies and

may be expected to have an effect on an insurance company's sales. A downgrade out of the "A" category in AFG's insurers' claims-paying and financial strength ratings could significantly reduce AFG's business volumes, adversely impact AFG's ability to access the capital markets and increase AFG's borrowing costs.

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

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

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

AFG's property and casualty insurance subsidiaries record reserve liabilities for the estimated payment of losses and loss adjustment expenses for both reported and unreported claims. Due to the inherent uncertainty of estimating reserves, it has been necessary in the past, and will continue to be necessary in the future, to revise estimated liabilities as reflected in AFG's reserves for claims and related expenses. While AFG recorded favorable development of \$242 million in 2008, \$99 million in 2007 and \$57 million in 2006, it had unfavorable development of \$199 million (due primarily to A&E charges) in 2005. The historic development of reserves for losses and loss adjustment expense may not necessarily reflect future trends in the development of these amounts. Accordingly, it is not appropriate to extrapolate redundancies or deficiencies based on historical information. To the extent that reserves are inadequate and are strengthened, the amount of such increase is treated as a charge to earnings in the period in which the deficiency is recognized.

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

AFG recorded catastrophe losses of \$59 million in 2008 (principally wind-related storm damage from hurricanes Gustav and Ike and tornadoes), \$5 million in 2007 and \$22 million in 2006 (primarily from tornadoes). Catastrophes (some of which are seasonal) can be caused by natural events such as hurricanes, windstorms, tornadoes, hailstorms, severe winter weather, earthquakes, explosions and fire, and by man-made events, such as terrorist attacks and riots. The extent of losses from a catastrophe is a function of the amount of insured exposure in the area affected by the event and the severity of the event. In addition, certain catastrophes could result in both property and non-property claims from the same event. A severe catastrophe or a series of catastrophes could result in losses exceeding AFG's reinsurance protection and may have a material adverse impact on its results of operations or financial condition.

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

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

Further declines in used car prices could negatively impact AFG's financial results.

AFG's run-off residual value business is heavily impacted by the level of used car prices obtained at auction. Further declines in the market value of used automobiles could result in significant losses.

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

AFG relies on the use of reinsurance to limit the amount of risk it retains. The following amounts of gross property and casualty premiums have been ceded to other insurers: 2008 - \$1.4 billion (32%); 2007 - \$1.3 billion (32%); and 2006 - \$1.3 billion (32%). The availability and cost of reinsurance are subject to prevailing market conditions, which are beyond AFG's control and which may affect AFG's level of business and profitability. AFG also reinsures the death benefits above certain retained amounts on its run-off life insurance business. AFG is also subject to credit risk

with respect to its reinsurers, as the ceding of risk to reinsurers does not relieve AFG of its liability to insureds.

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

The earnings on certain products sold by AFG's annuity and supplemental insurance business depend significantly upon the extent to which actual experience is consistent with the assumptions used in setting reserves and establishing and amortizing deferred policy acquisition costs ("DPAC"). These assumptions relate to investment yields (and spreads over fixed annuity crediting rates), mortality, surrenders, annuitizations and, on some policies, morbidity. Developing such assumptions is complex and involves information obtained from company-specific and industry-wide data, as well as general economic information. These assumptions, and therefore AFG's results of operations, could be negatively impacted by changes in any of the factors listed above. For example, AFG recorded pretax charges of \$10.0 million in 2008 related to the impact of poor stock market performance on its variable annuity business.

The continued threat of terrorism and ongoing military and other actions may adversely affect AFG's financial results.

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

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

AFG is a holding company and a legal entity separate and distinct from its insurance company subsidiaries. As a holding company without significant operations of its own, AFG's principal sources of funds are dividends and other distributions from its insurance company subsidiaries. As discussed under "Regulation," state insurance laws limit the ability of insurance companies to pay dividends or other

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distributions and require insurance companies to maintain specified levels of statutory capital and surplus. AFG's rights to participate in any distribution of assets of its insurance company subsidiaries are subject to prior claims of policyholders and creditors (except to the extent that its rights, if any, as a creditor are recognized). Consequently, AFG's ability to pay debts, expenses and cash dividends to its shareholders may be limited.

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

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

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

AFG and its subsidiaries are named as defendants in a number of lawsuits. See *Item 1 - "Property and Casualty Insurance Operations - Asbestos and Environmental Reserves ("A&E"),* *Item 3 - "Legal Proceedings,"* and *Item 7 - "Management's Discussion and Analysis - Uncertainties."* Litigation, by its very nature, is unpredictable and the outcome of these cases is uncertain. AFG is unable to predict the precise nature of the relief that may be sought or granted in any lawsuits or the effect that pending or future cases may have on AFG's business, operations, profitability or financial condition.

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

Carl H. Lindner is Chairman of the Board of Directors of AFG, and his sons, Carl H. Lindner III and S. Craig Lindner, are each Co-Chief Executive Officers and Directors of AFG. Carl H. Lindner, Carl H. Lindner III and S. Craig Lindner beneficially own 6.6%, 10.2% and 9.3% of AFG's outstanding Common Stock as of February 1, 2009. As a result, certain members of the Lindner family have the ability to exercise significant influence over AFG's management, including over matters requiring shareholder approval.

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

The price of AFG's Common Stock as listed on the NYSE and Nasdaq Global Select Market constantly changes. During 2008, AFG's Common Stock traded at prices ranging between \$13.65 and \$32.00. AFG's Common Stock price can fluctuate as a result of a variety of factors, many of which are beyond its control. These factors include but are not limited to:

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

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## ITEM 2

### Properties

Subsidiaries of AFG own several buildings in downtown Cincinnati. AFG and its affiliates occupy about half of the aggregate 675,000 square feet of commercial and office space in these buildings.

AFG's insurance subsidiaries lease the majority of their office and storage facilities in numerous cities throughout the United States, including Great American's and GAFRI's home offices in Cincinnati. In December 2007, AFG signed a 15-year lease for space in a new office tower currently under construction in downtown Cincinnati. The new building is scheduled for completion in 2011 and will enable AFG to consolidate operations from several leased locations. A property and casualty insurance subsidiary owns approximately 177,000 square feet of office space on 17.5 acres of land in Richfield, Ohio, approximately two-thirds of which it occupies; the remaining space is leased to unaffiliated tenants. A GAFRI subsidiary owns a 45,000 square foot office building in Mission, Kansas which is for sale. See *Item 1 - "Other Operations"* for a discussion of AFG's other commercial real estate operations.

ITEM 3

Legal Proceedings

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

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

On January 4, 2008, the Commonwealth of Massachusetts filed suit in the Superior Court of Suffolk County against AFG subsidiaries Great American Insurance Group and Professional Risk Brokers, Inc. The suit alleges improper conduct in issuance of one quotation in 2004 for insurance coverage for a Massachusetts company. The suit seeks monetary amounts for restitution, disgorgement, civil penalties and the Commonwealth's costs of investigation (including attorneys' fees) in amounts unspecified in the Complaint. Considering the amounts of premium at issue, AFG believes that the amounts would not individually or in total be material to the Company's financial condition. The suit also seeks injunctive relief. The AFG subsidiaries had previously resolved and were released from any potential legal issue directly with the Massachusetts company at issue in the Commonwealth's suit. Although no estimate or prediction can be made as to the outcome of the litigation, the AFG subsidiaries deny the allegations of the complaint and intend to vigorously defend against them.

AFG's insurance company subsidiaries and its 100%-owned subsidiary, American Premier Underwriters (including its subsidiaries, "American Premier"), are parties to litigation and receive claims alleging injuries and damages from asbestos, environmental and other substances and workplace hazards and have established loss accruals for such potential liabilities. The ultimate loss for these claims may vary materially from amounts currently recorded as the conditions surrounding resolution of these claims continue to change.

American Premier is a party or named as a potentially responsible party in a number of proceedings and claims by regulatory agencies and private parties under various environmental protection laws, including the Comprehensive Environmental Response, Compensation and Liability Act ("CERCLA"), seeking to impose responsibility on American Premier for hazardous waste or discharge remediation costs at certain railroad sites formerly owned by its predecessor, Penn Central Transportation Company ("PCTC"), and at certain other sites where hazardous waste or discharge allegedly generated by PCTC's railroad operations and American Premier's former manufacturing operations is present. It is difficult to estimate American Premier's liability for remediation costs at these sites for a number of reasons,

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including the number and financial resources of other potentially responsible parties involved at a given site, the varying availability of evidence by which to allocate responsibility among such parties, the wide range of costs for possible remediation alternatives, changing technology and the period of time over which these matters develop. Nevertheless, American Premier believes that its accruals for potential environmental liabilities are adequate to cover the probable amount of such liabilities, based on American Premier's estimates of remediation costs and related expenses and its estimates of the portions of such costs that will be borne

by other parties. Such estimates are based on information currently available to American Premier and are subject to future change as additional information becomes available.

As previously reported, Great American Insurance Company and certain other insurers were parties to coverage litigation (arising from claims alleging asbestos exposure resulted in bodily injury) under insurance policies issued

during the 1970's and 1980's to Bigelow-Liptak Corporation and related companies, subsequently known as A.P. Green Industries, Inc. ("A.P. Green"). A.P. Green sought to recover defense and indemnity expenses related to those claims from a number of insurers, including Great American.

In February 2002, A.P. Green filed petitions for bankruptcy under Chapter 11 of the Bankruptcy Code in the United States Bankruptcy Court for the Western District of Pennsylvania (In Re Global Industrial Technologies, Inc., et al, filed February 14, 2002).

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

During 2007, the Bankruptcy Court confirmed the A. P. Green Plan of Reorganization which includes the injunction required by Great American's settlement agreement. Certain parties appealed the confirmation on issues that management believes are ancillary to the Great American settlement.

## PART II

### ITEM 5

#### Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

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

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

		<u>2008</u>		<u>2007</u>	
	<u>High</u>	<u>Low</u>	<u>High</u>	<u>Low</u>	
First Quarter	\$29.30	\$24.19	\$36.84	\$32.87	
Second Quarter	30.45	25.23	36.30	33.33	
Third Quarter	32.00	24.58	34.92	23.94	
Fourth Quarter	29.75	13.65	30.82	26.50	

There were approximately 8,200 shareholders of record of AFG Common Stock at February 1, 2009. In 2008 and 2007, AFG declared and paid quarterly dividends of \$.125 and \$.10 per share, respectively. In January 2009, AFG increased its quarterly dividend to \$.13 per share. The ability of AFG to pay dividends will be dependent upon, among other things, the availability of dividends and payments under intercompany tax allocation agreements from its

insurance company subsidiaries.

## ITEM 6

### Selected Financial Data

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

	<u>2008</u>	<u>2007</u>	<u>2006</u>	<u>2005</u>	<u>2004</u>
<u>Earnings Statement Data</u>					
:					
Total Revenues	\$4,293	\$4,379	\$4,225	\$3,984	\$3,868
Operating Earnings Before Income Taxes	316	639	694	327	585
Earnings from Continuing Operations	196	381	428	196	366
Discontinued Operations	-	2	25	11	-
Cumulative Effect of Accounting Changes (a)	-	-	-	-	(6)
Net Earnings	196	383	453	207	360
Basic Earnings (Loss) Per Common Share:					
Earnings from Continuing Operations	\$1.71	\$3.24	\$3.63	\$1.69	\$3.31
Discontinued Operations	-	.01	.21	.09	-
Cumulative Effect of Accounting Change	-	-	-	-	(.05)
Net Earnings Available to Common Shares	1.71	3.25	3.84	1.78	3.26
Diluted Earnings (Loss) Per Common Share:					
Earnings from Continuing Operations	\$1.67	\$3.09	\$3.54	\$1.66	\$3.26
Discontinued Operations	-	.01	.21	.09	-
Cumulative Effect of Accounting Change	-	-	-	-	(.05)
Net Earnings Available to Common Shares	1.67	3.10	3.75	1.75	3.21
Cash Dividends Paid Per Share of Common Stock	\$.50	\$.40	\$.37	\$.33	\$.33
Ratio of Earnings to Fixed Charges Including					
Annuity Benefits (b)	1.63	2.40	2.62	1.77	2.42

### Balance Sheet Data

:					
Total Assets	\$26,428	\$25,808	\$25,101	\$22,816	\$22,560
Long-term Debt	1,030	937	921	1,000	1,106
Minority Interest	112	100	284	261	220
Shareholders' Equity	2,490	3,046	2,929	2,458	2,431

- (a) Reflects the implementation of required accounting changes.
- (b) Fixed charges are computed on a "total enterprise" basis. For purposes of calculating the ratios, "earnings" have been computed by adding to pretax earnings the fixed charges and the minority interest in earnings of subsidiaries having fixed charges and the undistributed equity in losses of investees. Fixed charges include interest (including interest credited to annuity policyholders' accounts as indicated), amortization of debt premium/discount and expense, preferred dividend and distribution requirements of subsidiaries and a portion of rental expense deemed to be representative of the interest factor.

The ratio of earnings to fixed charges *excluding* interest credited to annuity policyholders' accounts was 4.75, 8.49, 9.15, 4.58 and 7.02 for 2008, 2007, 2006, 2005 and 2004, respectively. Although the ratio of earnings to fixed charges *excluding* interest on annuities is not required or encouraged to be disclosed under Securities and Exchange Commission rules, some investors and lenders may not consider interest credited to annuity policyholders' accounts a borrowing cost for an insurance company, and accordingly, believe this ratio is meaningful.

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## ITEM 7

## Management's Discussion and Analysis

of Financial Condition and Results of Operations

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

## GENERAL

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

## OVERVIEW

### Financial Condition

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

At December 31, 2008, AFG (parent) held approximately \$186 million in cash and securities, of which it expects to use \$136 million to retire its Senior Debentures due April 2009. At December 31, 2008, AFG had \$120 million available under a bank line of credit expiring in July 2009 and \$35 million available under a bank line of credit expiring in 2011.

### Results of Operations

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

The property and casualty business is cyclical in nature with periods of high competition resulting in low premium rates, sometimes referred to as a "soft market" or "downcycle" followed by periods of reduced competition and higher premium rates, referred to as a "hard market" or "upcycle." The 1990's were a soft market period; prices started to harden in 2000 and accelerated significantly following the terrorist attacks in 2001. Rate increases for AFG's specialty businesses moderated during the latter part of 2003 and that trend continued until 2005, when renewal rates were flat. While AFG's workers' compensation operations experienced significant rate decreases from 2005 through 2008, reflecting the improved claims environment from reform legislation, overall average renewal pricing was down about 2% in 2006 and 4% in 2007 and 2008.

AFG reported net earnings of \$195.8 million (\$1.67 per share diluted) in 2008 compared to \$383.2 million (\$3.10 per share diluted) in 2007. Results for 2008 reflect higher net realized losses on investments, including other than temporary impairments. In addition, improved earnings in AFG's annuity and supplemental insurance operations and

increased investment income were more than offset by lower property and casualty underwriting profits.

## CRITICAL ACCOUNTING POLICIES

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

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

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

## LIQUIDITY AND CAPITAL RESOURCES

### Ratios

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

	<u>December 31,</u>	
	<u>2008</u>	<u>2007</u>
Consolidated debt	\$1,030	\$ 937
Total capital (*)	4,351	4,108
Ratio of debt to total capital:		
Including debt secured by real estate	23.7%	22.8%
Excluding debt secured by real estate	22.5%	21.5%

(\*) Includes consolidated debt, minority interest and

shareholders' equity (excluding unrealized gains (losses) related to fixed maturity investments).

AFG's ratio of earnings to fixed charges, including annuity benefits as a fixed charge, was 1.63 for the year ended December 31, 2008. Excluding annuity benefits, this ratio was 4.75 for 2008. Although the ratio excluding interest on annuities is not required or encouraged to be disclosed under Securities and Exchange Commission rules, it is presented because interest credited to annuity policyholder accounts is not always considered a borrowing cost for an insurance company.

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The NAIC's model law for risk based capital ("RBC") applies to both life and property and casualty companies. RBC formulas determine the amount of capital that an insurance company needs so that it has an acceptable expectation of not becoming financially impaired. At December 31, 2008, the capital ratios of all AFG insurance companies substantially exceeded the RBC requirements.

### Parent and Subsidiary Liquidity

#### Parent Holding Company Liquidity

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

AFG can borrow up to \$500 million under its revolving credit facility, which expires in 2011. AFG had \$465 million in borrowings outstanding under this agreement at December 31, 2008, bearing interest at a rate of 4.4%. In October 2008, AFG used funds borrowed under its credit facility to repurchase \$37.3 million of its 7-1/8% Senior Debentures due April 2009 for \$37.2 million. At February 1, 2009, AFG (parent) had enough cash and marketable securities to retire the remaining \$136 million in Senior Debentures due April 2009.

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

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

In February 2009, AFG and Great American Insurance Company ("GAI") established an intercompany credit facility under which AFG can borrow up to \$50 million.

During 2008, AFG repurchased approximately 1.8 million shares of its Common Stock for \$47.4 million. During 2007, AFG repurchased 6.9 million shares of its Common Stock for approximately \$199 million, funded the \$239 million in costs associated with GAFRI's purchase of its Common Stock not previously owned by AFG, and redeemed the \$59.5 million of 7-1/8% Debentures that matured in December 2007.

To better facilitate flows of capital between AFG (parent company) and its annuity and supplemental insurance operations, GAI paid a dividend to AFG in December 2007 in the form of its majority ownership in GAFRI, giving AFG 100% direct ownership of GAFRI.

During 2006, AFG repurchased \$43.5 million of its 7-1/8% debentures due 2009 for \$45.6 million in cash.

All debentures issued by AFG (and AAG Holding Company, a GAFRI subsidiary) are rated investment grade by three nationally recognized rating agencies. Subsequent to filing this Form 10-K, AFG intends to file an automatically effective shelf registration statement under which AFG can offer additional equity or debt securities. The shelf registration provides AFG with flexibility to access the capital markets from time to time as market and other conditions permit.

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

### Subsidiary Liquidity

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

In June 2008, GAFRI used cash on hand to redeem its \$28.5 million in 6-7/8% notes at maturity. In the first quarter of 2007, AAG Holding used funds borrowed under a

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bank credit line to redeem its \$22 million in outstanding 8-7/8% Subordinated Debentures for \$22.9 million in cash. During 2006, AAG Holding repurchased \$68.5 million of its 6-7/8% Senior Notes due 2008 for \$70.8 million in cash.

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

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

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

For statutory accounting purposes, equity securities of non-affiliates are generally carried at fair value. At December 31, 2008, AFG's insurance companies owned publicly traded equity securities with a fair value of \$328 million. In addition, GAI's investment in NATL common stock had a fair value of \$182 million and a statutory carrying value of \$144 million at December 31, 2008. Decreases in market prices could adversely affect the insurance group's capital, potentially impacting the amount of dividends available or necessitating a capital contribution. Conversely, increases in market prices could have a favorable impact on the group's dividend-paying capability.

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

premium rates or reinsurer insolvencies.

### Contractual Obligations

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

	<u>Total</u>	<u>Within One Year</u>	<u>2-3 Years</u>	<u>4-5 Years</u>	<u>More than 5 Years</u>
Annuity, life, accident and health liabilities (a)	\$12,193	\$1,619	\$2,657	\$2,432	\$5,485
Property and casualty unpaid losses and loss adjustment expenses (b)	6,764	2,000	2,200	1,300	1,264
Long-term debt, including interest	1,719	192	560	74	893
Operating leases (c)	<u>324</u>	<u>37</u>	<u>69</u>	<u>49</u>	<u>169</u>
Total (d)	<u>\$21,000</u>	<u>\$3,848</u>	<u>\$5,486</u>	<u>\$3,855</u>	<u>\$7,811</u>

- (a) Reserve projections include anticipated cash benefit payments only. Projections do not include any impact for future earnings or additional premiums.
- (b) Dollar amounts and time periods are estimates based on historical net payment patterns applied to the gross reserves and do not represent actual contractual obligations. Based on the same assumptions, AFG projects reinsurance recoveries related to these reserves totaling \$2.6 billion as follows: Within 1 year - \$800 million; 2-3 years - \$800 million; 4-5 years - \$500 million; and thereafter - \$510 million. Actual payments and their timing could differ significantly from these estimates.
- (c) Includes 15-year lease for new office space with rentals averaging approximately \$11.6 million per year beginning in 2011.
- (d) AFG's \$45 million liability for unrecognized tax benefits as of December 31, 2008, is not included because the period of payment cannot be reliably estimated.

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AFG has no material contractual purchase obligations or other long-term liabilities at December 31, 2008.

### Off-Balance Sheet Arrangements

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

As discussed under "Collateralized Loan Obligations" in Note O to the Financial Statements, AFG owns interests in certain variable interest entities which are not required to be consolidated. There are no contractual requirements or intentions to make additional investments in these entities (which would be "reconsideration events" requiring analysis to determine if AFG would be the primary beneficiary of the entity). See "Proposed Accounting Standards."

### Investments

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

AFG's investment portfolio at December 31, 2008, contained \$14.1 billion in "Fixed maturities" classified as available for sale and \$354 million in "Equity securities", all carried at fair value. In addition, \$281 million in fixed maturities were classified as trading with changes in unrealized holding gains or losses included in investment income.

As detailed under "*Net Unrealized Loss on Marketable Securities*" in Note E to the Financial Statements, unrealized gains and losses on AFG's fixed maturity and equity securities are included in Shareholders' Equity after adjustments for related changes in deferred policy acquisition costs and certain liabilities related to annuities, minority interest and deferred income taxes. DPAC applicable to annuity products is adjusted for the impact of unrealized gains or losses on investments as if these gains or losses had been realized, with corresponding increases or decreases (net of tax) included in equity under "Accumulated other comprehensive income (loss)." At December 31, 2008, DPAC associated with annuity products was increased by approximately \$790 million due to \$1.2 billion in unrealized losses on securities resulting in an increase in equity of approximately \$514 million, net of tax. The amount to which DPAC can be increased is limited to the actual annuity acquisition costs initially deferred plus interest. As of December 31, 2008, AFG estimates that it could incur approximately \$800 million in additional pretax unrealized losses on securities held by its annuity subsidiaries before it reaches its maximum adjustment to DPAC of an additional \$500 million.

Fixed income investment funds are generally invested in securities with intermediate-term maturities with an objective of optimizing total return while allowing flexibility to react to changes in market conditions. At December 31, 2008, the average life of AFG's fixed maturities was about six years.

Management is responsible for the valuation of AFG's portfolio and uses data from pricing services as well as non-binding broker quotes in determining fair value. Prices obtained from these sources are reviewed by internal investment professionals who are familiar with the securities being priced and the markets in which they trade. Equity securities are generally priced using closing prices obtained from pricing services. For mortgage-backed securities ("MBS"), prices are generally obtained from two or three of these sources. AFG's investment professionals select the price they believe most appropriate. For the other two-thirds of AFG's fixed maturities, 90% are priced using a pricing service and the balance is priced internally or by using a non-binding broker quote. Prices obtained from a broker or pricing service are adjusted only in cases where they are deemed not to be representative of an appropriate exit price (fewer than 1% of the securities).

Increasing turmoil in the global financial markets has caused credit spreads (the difference in rates between U.S. government bonds and other fixed maturities) to widen significantly during 2008. These wider spreads, as well as a lack of liquidity and the collapse of several financial institutions, were the primary cause of AFG's pretax net unrealized loss on fixed maturities rising from \$47 million at December 31, 2007, to \$1.9 billion at December 31, 2008.

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Approximately 94% of the fixed maturities held by AFG at December 31, 2008, were rated "investment grade" (credit rating of AAA to BBB) by nationally recognized rating agencies. Investment grade securities generally bear lower yields and

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

MBS represented approximately one-third of its fixed maturities at December 31, 2008. 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.

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Summarized information for AFG's MBS (including those classified as trading) at December 31, 2008, 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 Alt-A securities have an average life of approximately 5 years, the majority of which are backed by fixed-rate mortgages. The subprime securities have an average life of approximately 4 years; substantially all are collateralized by fixed-rate mortgages.

<u>Collateral type</u>	<u>Amortized Cost</u>	<u>Fair Value</u>	<u>Fair Value as % of Cost</u>	<u>Unrealized Gain (Loss)</u>	<u>% Rated Investment Grade</u>
Residential:					
Agency-backed	\$ 828	\$ 839	101%	\$ 11	100%
Non-agency prime	2,526	2,061	82	(465)	98
Alt-A	1,092	817	75	(275)	82
Subprime	477	360	75	(117)	89
Commercial	1,119	906	81	(213)	100
Other	<u>35</u>	<u>28</u>	80	<u>(7)</u>	83
	<u>\$6.077</u>	<u>\$5.011</u>	82%	<u>(\$1.066)</u>	95%

At December 31, 2008, AFG owned approximately \$764 million in securities with credit enhancement provided by bond insurers, including \$577 million of insured municipal bonds, \$90 million in insured subprime securities (included in the \$360 million in total subprime exposure discussed above) and \$85 million in insured corporate bonds. Approximately 89% of the insured municipal bonds carry an explicit underlying rating (i.e. without credit enhancement) with an average of A+, and 52% of the corporate bonds carry an explicit underlying rating with an average of A+. None of the insured subprime securities carry an explicit underlying rating. Management does not believe the risk of loss on the securities without underlying credit ratings is material to AFG's financial condition.

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Summarized information for the unrealized gains and losses recorded in AFG's Balance Sheet at December 31, 2008, is shown in the following table (dollars in millions). Approximately \$310 million of available for sale "Fixed maturities" and \$74 million of "Equity securities" had no unrealized gains or losses at December 31, 2008.

	<u>Securities With Unrealized Gains</u>	<u>Securities With Unrealized Losses</u>
<u>Available for sale Fixed Maturities</u>		
Fair value of securities	\$3,844	\$ 9,925
Amortized cost of securities	\$3,690	\$11,948
Gross unrealized gain (loss)	\$ 154	(\$ 2,023)
Fair value as % of amortized cost	104%	83%
Number of security positions	1,215	1,801
Number individually exceeding \$2 million gain or loss	7	326
Concentration of gains (losses) by type or industry (exceeding 5% of unrealized):		
Mortgage-backed securities	\$ 36.0	(\$1,101.8)
Banks, savings and credit institutions	11.7	(236.8)

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Insurance companies	1.6	(132.2)
Gas and electric services	15.4	(60.2)
Direct obligations of the U.S. Government	25.1	-
States and municipalities	17.4	(19.6)
Percentage rated investment grade	99%	94%

Equity Securities

Fair value of securities	\$ 161	\$ 119
Cost of securities	\$ 47	\$ 176
Gross unrealized gain (loss)	\$ 114	(\$ 57)
Fair value as % of cost	344%	67%
Number of security positions	9	56
Number individually exceeding \$2 million gain or loss	1	10

The table below sets forth the scheduled maturities of AFG's available for sale fixed maturity securities at December 31, 2008, based on their fair values. Asset-backed securities and other securities with sinking funds are reported at average maturity. Actual maturities may differ from contractual maturities because certain securities may be called or prepaid by the issuers.

<u>Maturity</u>	Securities with Unrealized <u>Gains</u>	Securities with Unrealized <u>Losses</u>
One year or less	6%	2%
After one year through five years	41	23
After five years through ten years	27	29
After ten years	<u>5</u>	<u>5</u>
	79	59
Mortgage-backed securities (average life of 5-1/2 years)	<u>21</u>	<u>41</u>
	<u>100</u>	<u>100</u>
	%	%

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

<u>Aggregate Fair Value</u>	<u>Aggregate Unrealized Gain (Loss)</u>	<u>Fair Value as % of Cost Basis</u>
-------------------------------------	---	--

Fixed Maturities at December 31, 2008

Securities with unrealized gains:			
Exceeding \$500,000 (70 issues)	\$ 753	\$ 71	111%
Less than \$500,000 (1,145 issues)	<u>3,091</u>	<u>83</u>	103
	<u>\$3,844</u>	<u>\$ 154</u>	104%
Securities with unrealized losses:			
Exceeding \$500,000 (816 issues)	\$6,962	(\$1,889)	79%
Less than \$500,000 (985 issues)	<u>2,963</u>	<u>(134)</u>	96
	<u>\$9,925</u>	<u>(\$2,023)</u>	83%

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
<u>Securities with Unrealized Losses at December 31, 2008</u>			
Investment grade fixed maturities with losses for:			
Less than one year (1,203 issues)	\$7,113	(\$1,111)	86%
One year or longer (370 issues)	<u>2,184</u>	<u>(642)</u>	77
	<u>\$9,297</u>	<u>(\$1,753)</u>	84%
Non-investment grade fixed maturities with losses for:			
Less than one year (135 issues)	\$ 397	(\$ 147)	73%
One year or longer (93 issues)	<u>231</u>	<u>(123)</u>	65
	<u>\$ 628</u>	<u>(\$ 270)</u>	70%

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Common equity securities with losses for:

Less than one year (14 issues)	\$ 23	(\$ 14)	62%
One year or longer (- issues)	<u>-</u>	<u>-</u>	-
	<u>\$ 23</u>	<u>(\$ 14)</u>	62%

Perpetual preferred equity securities with losses for:

Less than one year (23 issues)	\$ 61	(\$ 19)	76%
One year or longer (19 issues)	<u>35</u>	<u>(24)</u>	59
	<u>\$ 96</u>	<u>(\$ 43)</u>	69%

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

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

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

Uncertainties

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As more fully explained in the following paragraphs, management believes that the areas posing the greatest risk of material loss are the adequacy of its insurance reserves and contingencies arising out of its former railroad and manufacturing operations.

### Property and Casualty Insurance Reserves

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

The estimates of liabilities for unpaid claims and for expenses of investigation and adjustment of unpaid claims are based upon: (a) the accumulation of case estimates for losses reported prior to the close of the accounting periods on direct business written ("case reserves"); (b) estimates received from ceding reinsurers and insurance pools and associations; (c) estimates of claims incurred but not reported or "IBNR" (including possible development on known claims); (d) estimates (based on experience) of expense for investigating and adjusting claims; and (e) the current state of law and coverage litigation.

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

In determining management's best estimate of the ultimate liability, management (including Company actuaries) considers items such as the effect of inflation on medical, hospitalization, material, repair and replacement costs, the nature and maturity of lines of insurance, general economic trends and the legal environment. In addition, historical trends adjusted for changes in underwriting standards, policy provisions, product mix and other factors are analyzed using actuarial reserve development techniques. Weighing all of the factors, the management team determines a single or "point" estimate that it records as its best estimate of the ultimate liabilities. Ranges of loss reserves are not developed by Company actuaries. This reserve analysis and review is completed each quarter and for every line of business.

Each quarterly review includes in-depth analysis of over 500 subdivisions of the business, employing multiple actuarial techniques. For each particular subdivision, actuaries use informed, professional judgment to adjust these techniques as necessary to respond to specific conditions in the data or within the business.

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

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

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Management believes that each method has particular strengths and weaknesses and that no single estimation method is most accurate in all situations. When applied to a particular group of claims, the relative strengths and weaknesses of each method can change over time based on the facts and circumstances. Ultimately, the estimation methods chosen are those which management believes produce the most reliable indication for the particular liabilities under review.

The period of time from the occurrence of a loss through the settlement of the liability is referred to as the "tail". Generally, the same actuarial methods are considered for both short-tail and long-tail lines of business because most

of them work properly for both. The methods are designed to incorporate the effects of the differing length of time to settle particular claims. For short-tail lines, management tends to give more weight to the Case Incurred and Paid Development methods, although the various methods tend to produce similar results. For long-tail lines, more judgment is involved, and more weight may be given to the

Bornhuetter-Ferguson method and the Projected Claim Count times Projected Claim Severity method. Liability claims for long-tail lines are more susceptible to litigation and can be significantly affected by changing contract interpretation and the legal environment. Therefore, the estimation of loss reserves for these classes is more complex and subject to a higher degree of variability.

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

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

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

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

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

Gross Loss Reserves at December 31, 2008

	<u>Case</u>	<u>IBNR</u>	<u>LAE</u>	<u>Total Reserve</u>
Statutory Line of Business				
Other liability - occurrence	\$ 468	\$1,517	\$ 340	\$2,325
Workers' Compensation	692	331	124	1,147
Other liability - claims made	224	419	121	764
Special property (fire, allied lines, inland marine, earthquake)	682	52	30	764
Commercial Auto/Truck Liability/Medical	139	188	68	395

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Commercial multi-peril	141	96	83	320
	<u>151</u>	<u>472</u>	<u>149</u>	<u>772</u>
Other lines				
Total Statutory Reserves	2,497	3,075	915	6,487
Adjustments for GAAP:				
Deferred gains on retroactive reinsurance	-	84	-	84
Reserves of foreign operations	101	121	3	225
Loss reserve discounting	(24)	-	-	(24)
	<u>(8)</u>	<u>-</u>	<u>-</u>	<u>(8)</u>
Other				
	<u>69</u>	<u>205</u>	<u>3</u>	<u>277</u>
Total Adjustments for GAAP				
	<u>\$2,566</u>	<u>\$3,280</u>	<u>\$ 918</u>	<u>\$6,764</u>

Total GAAP Reserves

While current factors and reasonably likely changes in variable factors are considered in estimating the liability for unpaid losses, there is no method or system that can eliminate the risk of actual ultimate results differing from such estimates. As shown in footnote (a) to the reserve development table (loss triangle) on page 8, the original estimates of AFG's liability for losses and loss adjustment expenses, net of reinsurance, over the past 10 years have developed through December 31, 2008, to be deficient (for six years) by as much as 19.7% and redundant (for four years) by as much as 9.2% (excluding the effect of special charges for asbestos, environmental and other mass tort exposures). This development illustrates the historical impact caused by variability in factors considered in estimating its insurance reserves.

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

An important assumption underlying reserve estimates is that the cost trends implicitly built into development patterns will continue into the future. However, future results could vary due to an unexpected change in the underlying cost trends. This unexpected change could arise from a variety of sources including a general increase in economic inflation, inflation from social programs, new medical technologies, or other factors such as those listed below in connection with our largest lines of business. It is not possible to isolate and measure the potential impact of just one of these variables and future cost trends could be partially impacted by several such variables. However, it is reasonable to address the sensitivity of the reserves to potential impact from changes in these variables by measuring the effect of a possible overall 1% change in future cost trends that may be caused by one or more variables. Utilizing the effect of a 1% change in overall cost trends enables changes greater than 1% to be estimated by extrapolation. Each additional 1% change in the cost trend would increase the effect on net earnings by an amount slightly (about 5%) greater than the effect of the previous 1%. For example, if a 1% change in cost trends in a line of business would change net earnings by \$20 million, a 2% change would change net earnings by approximately \$41 million.

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

<u>Line of business</u>	<u>Effect of 1% Change in Cost Trends</u>
Other Liability - Occurrence	\$27
Workers' Compensation	20
Other Liability - Claims made	11
Commercial Auto/Truck Liability/Medical	4
Commercial Multi-peril	5

The judgments and uncertainties surrounding management's reserve estimation process and the potential for reasonably possible variability in management's most recent reserve estimates may also be viewed by looking at how recent historical estimates of reserves have developed. The following table shows (in millions) what the impact on AFG's net earnings would be on the more significant lines of business if the December 31, 2008, reserves (net of reinsurance) developed at the same rate as the average development of the most recent five years.

	<u>5-yr. Average Development(*)</u>	<u>Net Reserves(**) December 31, 2008</u>	<u>Effect on Net Earnings(**)</u>
Other Liability - Occurrence	(1.8%)	\$891	\$16
Workers' Compensation	.1%	725	-
Other Liability - Claims made	2.7%	478	(13)
Commercial Auto/Truck Liability/ Medical	(3.0%)	239	7
Commercial Multi-peril	(.8%)	216	2

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

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

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

#### Other Liability - Occurrence

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

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

AFG recorded favorable development of \$72 million in 2008, \$91 million in 2007 and \$23 million in 2006 related to its other liability-occurrence coverage where both the frequency and severity of claims were lower than previously projected.

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

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### Workers' Compensation

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

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

AFG's workers' compensation business is written primarily in California. Significant reforms passed by the California state legislature in 2003 and in 2004 reduced employer premiums and set treatment standards for injured workers. AFG recorded favorable prior year loss development of \$32 million in 2008, \$22 million in 2007 and \$23 million in 2006 due primarily to the impact of the legislation on medical claim costs being more favorable than previously anticipated. As claims incurred in 2003 through 2005 are now reaching a higher percentage of settlement and maturity, management is able to estimate the ultimate costs of these claims with more precision.

While the standard actuarial techniques do reflect expected favorable impacts from the reforms, the magnitude of future cost savings depends on the implementation and interpretation of the reforms throughout the workers' compensation system over the next several years. Although management applies the actuarial methods mentioned above, more judgment is involved in arriving at the final reserve to be held. For recent accident years, more weight is given to the methods based on claim count and severity. To determine the appropriate reserve level, management reviewed the frequency, severity and loss and LAE ratios implied by the projections from the standard methods in light of the uncertainties of future cost savings and recent rate actions since the reforms. Due to the long-tail nature of this business, AFG has recognized the favorable effects of the reform legislation on more recent claims only after a higher percentage of claims have been paid and the ultimate impact of reforms could be estimated with more precision.

### Other Liability - Claims Made

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

- Litigious climate
- The economy
- Variability of stock prices
- Magnitude of jury awards

The general state of the economy and the variability of the stock price of the insured can affect the frequency and severity of shareholder class action suits that trigger coverage under directors' and officers' liability policies.

AFG recorded favorable prior year loss development of \$29 million in 2008 on its directors' and officers' liability business as claim severity was significantly less than expected. AFG recorded adverse prior year loss development of \$2 million in 2008, \$1 million in 2007 and \$13 million in 2006 on its lawyers' professional liability business (now in run-off) as claim severity continued to be higher than previous underlying assumptions.

While management applies the actuarial methods mentioned above, more judgment is involved in arriving at the final reserve to be held. The selection of methods vary by subdivision of the data within this line. Some businesses within this line use the Paid Development method while others use the Case Incurred Development method and the

Bornhuetter-Ferguson method.

#### Commercial Auto/Truck Liability/Medical

This line of business is a mix of coverage protecting the insured against legal liability for property damage or personal injury to others arising from the operation of commercial motor vehicles. The property damage liability exposure is usually short-tail with relatively quick reporting and settlement of claims. The

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bodily injury and medical payments exposures are longer-tailed; although the claim reporting is relatively quick, the final settlement can take longer to achieve.

Some of the important variables affecting estimation of loss reserves for Commercial Auto/Truck Liability/Medical are similar to Other Liability - Occurrence and include:

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

AFG recorded favorable prior year loss development of \$8 million in 2008, \$7 million in 2007 and \$25 million in 2006 for this line of business as claim severity was significantly lower than in prior assumptions.

#### Commercial Multi-Peril

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

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

AFG recorded favorable prior year loss development of \$7 million in 2008 and adverse prior year loss development of \$21 million in 2007 and \$7 million in 2006 on its run-off homebuilders business (mostly from exposures in California and Nevada).

#### Recoverables from Reinsurers and Availability of Reinsurance

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

The availability and cost of reinsurance are subject to prevailing market conditions, which are beyond AFG's control and which may affect AFG's level of business and profitability. Although the cost of certain reinsurance programs may increase, management believes that AFG will be able to maintain adequate reinsurance coverage at acceptable

rates without a material adverse effect on AFG's results of operations. AFG's gross and net combined ratios are shown in the table below.

See *Item 1 - "Business" - "Property and Casualty Operations - Reinsurance"* for more information on AFG's reinsurance programs. For additional information on the effect of reinsurance on AFG's historical results of operations see *Note N -*

"Insurance

*- Reinsurance" and the gross loss development table under Item 1 - "Business" - "Property and Casualty Operations - Loss and Loss Adjustment Expense Reserves."*

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

	<u>2008</u>	<u>2007</u>	<u>2006</u>
Before reinsurance (gross)	89.1%	81.0%	88.0%
Effect of reinsurance	<u>(1.5)</u>	<u>2.3</u>	<u>(.4)</u>
	)	)	
Actual (net of reinsurance)	<u>87.6</u>	<u>83.3</u>	<u>87.6</u>
	%	%	%

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

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

	<u>December 31,</u>	
	<u>2008</u>	<u>2007</u>
Asbestos	\$315.2	\$335.5
Environmental	<u>83.5</u>	<u>87.3</u>
A&E reserves, net of reinsurance recoverable	398.7	422.8
Reinsurance recoverable, net of allowance	<u>67.3</u>	<u>63.6</u>
Gross A&E reserves	<u>\$466.0</u>	<u>\$486.4</u>

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

Asbestos claims against manufacturers, distributors or installers of asbestos products were presented under the products liability section of their policies which typically had aggregate limits that capped an insurer's liability. In recent years, a number of asbestos claims are being presented as "non-products" claims, such as those by installers of asbestos products and by property owners or operators who allegedly had asbestos on their property, under the premises or operations section of their policies. Unlike products exposures, these non-products exposures typically had no aggregate limits, creating potentially greater exposure for insurers. Further, in an effort to seek additional insurance coverage, some insureds with installation activities who have substantially eroded their products coverage

are presenting new asbestos claims as non-products operations claims or attempting to reclassify previously settled products claims as non-products claims to restore a portion of previously exhausted products aggregate limits. AFG, along with other insurers, is and will be subject to such non-products claims. It is difficult to predict whether insureds will be successful in asserting claims under non-products coverage or whether AFG and other insurers will be successful in asserting additional defenses. Therefore, the future impact of such efforts is uncertain.

Approximately 60% of AFG's net asbestos reserves relate to policies written directly by AFG subsidiaries. Claims from these policies generally are product oriented claims with only a limited amount of non-product exposures, and are dominated by small to mid-sized commercial entities that are mostly regional policyholders with few national target defendants. The remainder is assumed reinsurance business that includes exposures for the periods 1954 to 1983. The asbestos and environmental assumed claims are ceded by various insurance companies under reinsurance treaties. A majority of the individual assumed claims have exposures of less than \$100,000 to AFG. Asbestos losses assumed include some of the industry known manufacturers, distributors and installers. Pollution losses include industry known insured names and sites.

Establishing reserves for A&E claims relating to policies and participations in reinsurance treaties and former operations is subject to uncertainties that are significantly greater than those presented by other types of claims. For this group of claims, traditional actuarial techniques that rely on historical loss development trends cannot be used and a meaningful range of loss cannot be estimated. Case reserves and expense reserves are established by the claims department as specific policies are identified. In addition to the case reserves established for known claims, management establishes additional reserves for claims not yet known or reported and for possible development on known claims. These additional reserves are management's best estimate based on periodic detailed "ground up" studies adjusted for payments and identifiable changes, supplemented by management's review of industry information about such claims, with due consideration to individual claim situations. Management believes that estimating the ultimate liability for asbestos claims presents a unique and difficult challenge to the insurance industry due to, among other things, inconsistent court decisions, an increase in bankruptcy filings as a result of asbestos-related liabilities, novel theories of coverage, and judicial interpretations that often expand theories of recovery and broaden the scope of coverage. The casualty insurance industry is engaged in extensive litigation over these coverage and liability issues as the volume and severity of claims against asbestos defendants continue to increase.

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Emerging trends, such as those named below, could impact AFG's reserves and payments:

- There is a growing interest at the state level to attempt to legislatively address asbestos liabilities and the manner in which asbestos claims are resolved. These developments are fluid and could result in piecemeal state-by-state solutions.
- The manner by which bankruptcy courts are addressing asbestos liabilities is in flux.
- AFG's insureds may make claims alleging significant non-products exposures.

While management believes that AFG's reserves for A&E claims are a reasonable estimate of ultimate liability for such claims, actual results may vary materially from the amounts currently recorded due to the difficulty in predicting the number of future claims, the impact of recent bankruptcy filings, and unresolved issues such as whether coverage exists, whether policies are subject to aggregate limits on coverage, how claims are to be allocated among triggered policies and implicated years, and whether claimants who exhibit no signs of illness will be successful in pursuing their claims. A 1% variation in loss cost trends, caused by any of the factors previously described, would change net income by approximately \$20 million.

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

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As a result of the internal review, AFG recorded a \$12 million charge (net of reinsurance recoverables) to increase the property and casualty group's A&E reserves in the second quarter of 2008. The outside study in 2007 resulted in AFG recording a pretax charge of \$44.2 million (net of reinsurance recoverables) to increase its insurance A&E reserves. Management expects to conduct an outside study of its A&E reserves in 2009 and another internal comprehensive review in 2010. For a discussion of the 2008 and 2007 A&E reserve strengthening, see *Management's Discussion and Analysis - "Results of Operations - Asbestos and Environmental Reserve Charges."*

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

	<u>2008</u>	<u>2007</u>	<u>2006</u>
Number of policyholders with no payments:			
Asbestos	108	83	103