

AMERICAN FINANCIAL GROUP INC
Form 10-Q
November 08, 2006

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

For the Quarterly Period Ended
September 30, 2006

Commission File

No. 1-13653

AMERICAN FINANCIAL GROUP, INC.

Incorporated under
the Laws of Ohio

IRS Employer I.D.
No. 31-1544320

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

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

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

Large Accelerated Filer Accelerated Filer Non-Accelerated Filer

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

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As of November 1, 2006, there were 79,153,318 shares of the Registrant's Common Stock outstanding, excluding 9,953,392 shares owned by a subsidiary.

AMERICAN FINANCIAL GROUP, INC.

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AMERICAN FINANCIAL GROUP, INC. 10-Q

PART I

ITEM I - FINANCIAL STATEMENTS

AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEET (unaudited)

(Dollars In Thousands)

| | September 30, <u>2006</u> | December 31, <u>2005</u> |
|--|------------------------------|-----------------------------|
| Assets: | | |
| Cash and cash equivalents | \$ 1,139,818 | \$ 471,849 |
| Investments: | | |
| Fixed maturities: | | |
| Available for sale - at fair value (amortized cost - \$14,450,880 and \$14,272,314) | 14,401,580 | 14,326,614 |
| Trading - at fair value | 279,779 | 271,851 |
| Other stocks - at fair value (cost - \$635,510 and \$501,459) | 716,010 | 556,659 |
| Policy loans | 264,930 | 258,744 |
| | <u>502,741</u> | <u>338,254</u> |
| Real estate and other investments | | |
| Total cash and investments | 17,304,858 | 16,223,971 |

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| | | |
|---|---------------------|---------------------|
| Recoverables from reinsurers and prepaid reinsurance premiums | 3,881,564 | 3,263,128 |
| Agents' balances and premiums receivable | 797,714 | 574,882 |
| Deferred policy acquisition costs | 1,233,613 | 1,139,515 |
| Other receivables | 434,094 | 388,078 |
| Variable annuity assets (separate accounts) | 663,533 | 643,506 |
| Prepaid expenses, deferred charges and other assets | 575,945 | 416,030 |
| | <u>178,807</u> | <u>166,882</u> |
| Goodwill | | |
| | <u>\$25,070,128</u> | <u>\$22,815,992</u> |
| Liabilities and Capital: | | |
| Unpaid losses and loss adjustment expenses | \$ 6,117,648 | \$ 5,790,709 |
| Unearned premiums | 1,850,042 | 1,643,954 |
| Annuity benefits accumulated | 9,180,740 | 8,417,298 |
| Life, accident and health reserves | 1,396,303 | 1,088,016 |
| Payable to reinsurers | 480,004 | 298,664 |
| Long-term debt | 923,720 | 999,703 |
| Variable annuity liabilities (separate accounts) | 663,533 | 643,506 |
| Accounts payable, accrued expenses and other liabilities | <u>1,417,358</u> | <u>1,215,490</u> |
| Total liabilities | 22,029,348 | 20,097,340 |
| Minority interest | 280,557 | 261,110 |
| Shareholders' Equity: | | |
| Common Stock, no par value | | |
| - 200,000,000 shares authorized | | |
| - 79,115,424 and 78,067,514 shares outstanding | 79,115 | 78,068 |
| Capital surplus | 1,245,175 | 1,194,600 |
| Retained earnings | 1,415,833 | 1,134,074 |
| Unrealized gain on marketable securities, net | <u>20,100</u> | <u>50,800</u> |
| Total shareholders' equity | <u>2,760,223</u> | <u>2,457,542</u> |
| | <u>\$25,070,128</u> | <u>\$22,815,992</u> |

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AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF OPERATIONS (unaudited)

(In Thousands, Except Per Share Data)

| | <u>Three months ended</u> <u>September 30,</u> | | <u>Nine months ended</u> <u>September 30,</u> | |
|---|---|------------------|--|------------------|
| | <u>2006</u> | <u>2005</u> | <u>2006</u> | <u>2005</u> |
| Income: | | | | |
| Property and casualty insurance premiums | \$ 730,859 | \$ 651,361 | \$1,924,965 | \$1,775,795 |
| Life, accident and health premiums | 91,742 | 91,811 | 249,291 | 276,256 |
| Investment income | 233,148 | 214,076 | 698,512 | 640,734 |
| Realized gains (losses) on securities | (2,454) | 10,748 | 19,876 | 27,303 |
| Other income | <u>83,216</u> | <u>107,837</u> | <u>234,956</u> | <u>265,904</u> |
| | 1,136,511 | 1,075,833 | 3,127,600 | 2,985,992 |
| Costs and Expenses: | | | | |
| Property and casualty insurance: | | | | |
| Losses and loss adjustment expenses | 424,801 | 604,433 | 1,135,269 | 1,311,613 |
| Commissions and other underwriting expenses | 225,276 | 181,283 | 567,232 | 497,589 |
| Annuity benefits | 88,331 | 81,122 | 255,142 | 244,950 |
| Life, accident and health benefits | 69,136 | 72,962 | 203,330 | 212,593 |
| Annuity and supplemental insurance acquisition expenses | 38,281 | 31,592 | 102,041 | 99,835 |
| Interest charges on borrowed money | 18,324 | 20,004 | 53,931 | 59,637 |
| Other operating and general expenses | <u>115,035</u> | <u>112,749</u> | <u>336,903</u> | <u>335,345</u> |
| | <u>979,184</u> | <u>1,104,145</u> | <u>2,653,848</u> | <u>2,761,562</u> |
| Operating earnings (loss) before income taxes | | | | |
| | 157,327 | (28,312) | 473,752 | 224,430 |
| Provision (credit) for income taxes | <u>56,482</u> | <u>(6,506)</u> | <u>157,771</u> | <u>82,830</u> |
| |) | | | |
| Net operating earnings (loss) | 100,845 | (21,806) | 315,981 | 141,600 |

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| | | | | |
|---|------------------|--------------------|-------------------|-------------------|
| Minority interest expense | (6,668) | (6,772) | (21,712) | (21,453) |
| Equity in net losses of investee, net of tax | <u>(627)</u> | <u>(66)</u> | <u>(1,605)</u> | <u>(4,904)</u> |
| |) |) |) |) |
| Earnings (loss) from continuing operations | 93,550 | (28,644) | 292,664 | 115,243 |
| Discontinued operations, net of tax | <u>-</u> | <u>2,214</u> | <u>25,246</u> | <u>2,827</u> |
| | | | | |
| Net Earnings (Loss) | <u>\$ 93,550</u> | <u>(\$ 26,430)</u> | <u>\$ 317,910</u> | <u>\$ 118,070</u> |
| | | | | |
| Basic earnings (loss) per Common Share: | | | | |
| Continuing operations | \$1.19 | (\$0.37) | \$3.73 | \$1.49 |
| Discontinued operations | <u>-</u> | <u>.03</u> | <u>.32</u> | <u>.04</u> |
| | | | | |
| Net earnings (loss) available to Common Shares | <u>\$1.19</u> | <u>(\$0.34)</u> | <u>\$4.05</u> | <u>\$1.53</u> |
| | | | | |
| Diluted earnings (loss) per Common Share: | | | | |
| Continuing operations | \$1.16 | (\$0.37) | \$3.64 | \$1.47 |
| Discontinued operations | <u>-</u> | <u>.03</u> | <u>.32</u> | <u>.04</u> |
| | | | | |
| Net earnings (loss) available to Common Shares | <u>\$1.16</u> | <u>(\$0.34)</u> | <u>\$3.96</u> | <u>\$1.51</u> |
| | | | | |
| Average number of Common Shares: | | | | |
| Basic | 78,760 | 77,335 | 78,519 | 77,060 |
| Diluted | 80,400 | 78,702 | 80,043 | 78,267 |
| Cash dividends per Common Share | \$.1375 | \$.125 | \$.4125 | \$.375 |

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AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY (unaudited)

(Dollars in Thousands)

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| | <u>Common</u> <u>Shares</u> | Common Stock and Capital <u>Surplus</u> | <u>Retained</u> <u>Earnings</u> | <u>Unrealized</u> <u>Gain on</u> <u>Securities</u> | <u>Total</u> |
|--------------------------------------|--------------------------------|---|------------------------------------|--|--------------------|
| Balance at January 1, 2006 | 78,067,514 | \$1,272,668 | \$1,134,074 | \$ 50,800 | \$2,457,542 |
| Net earnings | - | - | 317,910 | - | 317,910 |
| Change in unrealized | - | - | - | (30,700) | <u>(30,700)</u> |
| | | | |) | |
| Comprehensive income | | | | | 287,210 |
| Dividends on Common Stock | - | - | (32,338) | - | (32,338) |
| Shares issued: | | | | | |
| Exercise of stock options | 1,027,618 | 35,823 | - | - | 35,823 |
| Dividend reinvestment plan | 96,829 | 3,787 | - | - | 3,787 |
| Employee stock purchase plan | 18,137 | 757 | - | - | 757 |
| Deferred compensation distributions | 42,108 | 1,646 | - | - | 1,646 |
| Directors fees paid in stock | 8,520 | 365 | - | - | 365 |
| Shares tendered in option exercises | (145,302) | (2,386) | (3,813) | - | (6,199) |
| Stock-based compensation expense | - | 5,135 | - | - | 5,135 |
| Capital transactions of subsidiaries | - | 1,919 | - | - | 1,919 |
| Other | <u>-</u> | <u>4,576</u> | <u>-</u> | <u>-</u> | <u>4,576</u> |
| Balance at September 30, 2006 | <u>79,115,424</u> | <u>\$1,324,290</u> | <u>\$1,415,833</u> | <u>\$ 20,100</u> | <u>\$2,760,223</u> |
| Balance at January 1, 2005 | 76,634,204 | \$1,222,507 | \$ 976,340 | \$231,700 | \$2,430,547 |
| Net earnings | - | - | 118,070 | - | 118,070 |
| Change in unrealized | - | - | - | (138,000) | <u>(138,000)</u> |
| | | | |) | |
| Comprehensive loss | | | | | (19,930) |
| Dividends on Common Stock | - | - | (28,859) | - | (28,859) |
| Shares issued: | | | | | |
| Exercise of stock options | 947,138 | 25,518 | - | - | 25,518 |
| Dividend reinvestment plan | 144,303 | 4,214 | - | - | 4,214 |
| Employee stock purchase plan | 19,873 | 633 | - | - | 633 |
| Retirement plan contributions | 113,414 | 3,622 | - | - | 3,622 |
| Deferred compensation distributions | 7,374 | 222 | - | - | 222 |
| Directors fees paid in stock | 9,320 | 300 | - | - | 300 |

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| | | | | | |
|--------------------------------------|-----------|--------------|----------|----------|--------------|
| Shares tendered in option exercises | (401,784) | (6,415) | (6,015) | - | (12,430) |
| Capital transactions of subsidiaries | - | (7,850) | - | - | (7,850) |
| Other | <u>-</u> | <u>6,995</u> | <u>-</u> | <u>-</u> | <u>6,995</u> |

| | | | | | |
|-------------------------------|-------------------|--------------------|--------------------|------------------|--------------------|
| Balance at September 30, 2005 | <u>77,473,842</u> | <u>\$1,249,746</u> | <u>\$1,059,536</u> | <u>\$ 93,700</u> | <u>\$2,402,982</u> |
|-------------------------------|-------------------|--------------------|--------------------|------------------|--------------------|

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AMERICAN FINANCIAL GROUP, INC. 10-Q

AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF CASH FLOWS (UNAUDITED)

(In Thousands)

| | Nine months ended <u>September 30,</u> | |
|--|---|----------------|
| | <u>2006</u> | <u>2005</u> |
| Operating Activities: | | |
| Net earnings | \$ 317,910 | \$ 118,070 |
| Adjustments: | | |
| Equity in net losses of investee | 1,605 | 4,904 |
| Minority interest | 27,481 | 22,075 |
| Depreciation and amortization | 120,670 | 148,442 |
| Annuity benefits | 255,142 | 246,529 |
| Realized gains on investing activities | (82,783) | (68,320) |
| Net purchases/sales of trading securities | (10,767) | 12,047 |
| Deferred annuity and life policy acquisition costs | (114,612) | (94,021) |
| Increase in reinsurance and other receivables | (503,585) | (38,456) |
| Decrease (increase) in other assets | 48,832 | (5,053) |
| Increase in insurance claims and reserves | 546,213 | 753,862 |
| Increase (decrease) in payable to reinsurers | 181,037 | (251,267) |
| Decrease in other liabilities | (6,848) | (12,626) |
| Other, net | <u>17,358</u> | <u>18,395</u> |
| Net cash provided by operating activities | <u>797,653</u> | <u>854,581</u> |

Investing Activities

| | | |
|---|-----------------|--------------------|
| : | | |
| Purchases of and additional investments in: | | |
| Fixed maturity investments | (1,871,990) | (3,258,133) |
| Equity securities | (264,665) | (181,606) |
| Subsidiaries | (206,996) | (17,500) |
| Real estate, property and equipment | (36,895) | (69,327) |
| Maturities and redemptions of fixed maturity investments | 708,482 | 864,715 |
| Sales of: | | |
| Fixed maturity investments | 1,176,870 | 1,331,269 |
| Equity securities | 185,907 | 202,968 |
| Subsidiary | 37,500 | - |
| Real estate, property and equipment | 36,219 | 44,727 |
| Cash and cash equivalents of businesses acquired or sold, net | 201,936 | 52,556 |
| Increase in other investments | <u>(38,766)</u> | <u>(9,615)</u> |
| |) |) |
| Net cash used in investing activities | <u>(72,398)</u> | <u>(1,039,946)</u> |

Financing Activities

| | | |
|---|-----------------|-----------------|
| : | | |
| Fixed annuity receipts | 914,292 | 632,465 |
| Annuity surrenders, benefits and withdrawals | (898,561) | (688,416) |
| Net transfers from variable annuity assets | 17,801 | 10,127 |
| Additional long-term borrowings | 117,513 | 14,716 |
| Reductions of long-term debt | (206,993) | (28,342) |
| Issuances of Common Stock | 27,899 | 11,558 |
| Subsidiary's issuance of stock in public offering | - | 40,391 |
| Cash dividends paid on Common Stock | (28,551) | (24,645) |
| Other, net | <u>(686)</u> | <u>(2,923)</u> |
| |) |) |
| Net cash used in financing activities | <u>(57,286)</u> | <u>(35,069)</u> |

| | | |
|--|--------------------|-------------------|
| |) |) |
| Net Increase (Decrease) in Cash and Cash Equivalents | 667,969 | (220,434) |
| Cash and cash equivalents at beginning of period | <u>471,849</u> | <u>861,742</u> |
| Cash and cash equivalents at end of period | <u>\$1,139,818</u> | <u>\$ 641,308</u> |

AMERICAN FINANCIAL GROUP, INC. 10-Q

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

INDEX TO NOTES

- | | |
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| A. <u>Accounting Policies</u> | E. <u>Long-Term Debt</u> |
| B. <u>Acquisitions and Sales of Operations</u> | F. <u>Shareholders' Equity</u> |
| C. <u>Segments of Operations</u> | G. <u>Discontinued Operations</u> |
| D. <u>Deferred Policy Acquisition Costs</u> | H. <u>Commitments and Contingencies</u> |
-

A. Accounting Policies

Basis of Presentation

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

Certain reclassifications have been made to prior years to conform to the current year's presentation. All significant intercompany balances and transactions have been eliminated. All acquisitions have been treated as purchases. The results of operations of companies since their formation or acquisition are included in the consolidated financial statements.

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

Investments

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

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

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

Certain AFG subsidiaries loan fixed maturity and equity securities to other institutions for short periods of time. The borrower is required to provide collateral on which AFG earns investment income, net of a fee to the lending agent. AFG records the collateral held (included in other assets) and the liability to return the collateral (included in other liabilities) in its Balance Sheet. The securities loaned remain a recorded asset on AFG's Balance Sheet. At September 30, 2006, the amount of collateral held was approximately \$159 million and the fair value of the securities lent was approximately \$156 million. There were no securities loaned at December 31, 2005.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

Derivatives

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

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

Goodwill

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

Insurance

As discussed under "Reinsurance" below, unpaid losses and loss adjustment expenses and unearned premiums have not been reduced for reinsurance recoverable.

Reinsurance

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

Subsidiaries of AFG's 81%-owned subsidiary, Great American Financial Resources, Inc. ("GAFRI"), cede life insurance policies to a third party on a funds withheld basis whereby GAFRI retains the assets (securities) associated with the reinsurance contracts. Interest is credited to the reinsurer based on the actual investment performance of the retained assets. These reinsurance contracts are considered to contain embedded derivatives (that must be adjusted to fair value) because the yield on the payables is based on specific blocks of the ceding companies' assets, rather than the overall creditworthiness of the ceding company. GAFRI determined that changes in the fair value of the underlying portfolios of fixed maturity securities is an appropriate measure of the value of the embedded derivative. GAFRI classifies the securities related to these transactions as "trading." The adjustment to fair value on the embedded derivatives offsets the investment income recorded on the adjustment to fair value of the related trading portfolios.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

Deferred Policy Acquisition Costs ("DPAC")

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

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

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

policies for annuities and universal life products and in relation to the premium paying period for traditional life and health insurance products.

Annuity and Supplemental Insurance Acquisition Expenses

Annuity and supplemental insurance acquisition expenses on the Statement of Operations consists of amortization of DPAC related to the annuity, supplemental insurance and run-off life businesses. This line item also includes certain marketing and commission costs of those businesses that are expensed as paid.

Unpaid Losses and Loss Adjustment Expenses

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

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

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

Annuity Benefits Accumulated

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

Life, Accident and Health Reserves

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

Variable Annuity Assets and Liabilities

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

Premium Recognition

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

Payable to Subsidiary Trusts

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

Minority Interest

For Balance Sheet purposes, minority interest represents the interests of noncontrolling shareholders in consolidated entities. In the Statement of Operations, minority interest expense represents such shareholders' interest in the earnings of those entities.

Income Taxes

AFG files consolidated federal income tax returns that include all U.S. subsidiaries that are at least 80%-owned, except for certain life insurance subsidiaries that have been owned for less than five years.

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

Stock-Based Compensation

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Effective January 1, 2006, AFG implemented Statement of Financial Accounting Standards ("SFAS") No. 123(R), "Share-Based Payment" using the modified prospective method under which prior year amounts are not restated. Under SFAS No. 123(R), companies must recognize compensation expense for all new share-based awards (including employee stock options), and the nonvested portions of prior awards, based on their calculated "fair value" at the date of grant. Beginning in 2006, all share-based grants are recognized as compensation expense over the vesting period. AFG uses the Black-Scholes pricing model to measure the fair value of employee stock options.

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

Benefit Plans

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

AFG and many of its subsidiaries provide health care and life insurance benefits to eligible retirees. AFG also provides postemployment benefits to former or inactive employees (primarily those on disability) who were not deemed retired under other company plans. The projected future cost of providing these benefits is expensed over the period employees earn such benefits.

Earnings Per Share

Basic earnings per share is calculated using the weighted average number of shares of common stock outstanding during the period. The calculation of diluted earnings per share includes (i) deductions of \$386,000 in the third quarter of 2006 and \$873,000 in the nine months of 2006 from net earnings related to dilution of majority-owned subsidiaries and (ii) the following additions to average shares outstanding representing the dilutive effect of stock-based compensation plans: third quarter of 2006 and 2005 - 1,640,000 and 1,367,000 shares; nine months of 2006 and 2005 - 1,524,000 shares and 1,207,000 shares, respectively.

Statement of Cash Flows

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

B.

Acquisitions and Sales of Operations

Ceres Group, Inc.

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On August 7, 2006, GAFRI acquired Ceres Group, Inc. ("Ceres") for \$204.4 million in cash. In connection with the acquisition, Ceres reinsured 100% of its major medical business and 50% of its in-force senior business, which focuses primarily on sales of Medicare supplement and other supplemental insurance products to the senior market. As a result of the reinsurance, Ceres

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AMERICAN FINANCIAL GROUP, INC. 10-Q

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

has exited the major medical business. Following the acquisition, Ceres paid a \$60 million return of capital distribution to GAFRI. GAFRI expects the retained Ceres business to generate at least \$120 million in life, accident and health premiums in 2007. The preliminary allocation of purchase price for the Ceres acquisition resulted in an increase in goodwill of \$11.9 million. Pro forma results of operations for the three and nine months ended September 30, 2006, assuming the acquisition of Ceres had taken place at the beginning of 2006 would not differ significantly from actual reported results.

Chatham Bars Inn

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

Old Standard Life Fixed Annuity Business

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

Great American Life Assurance Company of Puerto Rico

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

Farmers Crop Insurance Alliance, Inc.

On September 30, 2005, AFG acquired the multi-peril crop insurance and the crop hail insurance business written through Farmers Crop Insurance Alliance, Inc. for \$17.5 million in cash. AFG will pay additional amounts of up to 10% of annual premiums over the next three years based on certain customer retention criteria. Approximately \$16.5 million of the initial Farmers Crop purchase price was recorded as intangible renewal rights and is being amortized over an estimated retention period of four years on a straight-line basis. Any future payments (not expected to exceed \$15 million) based on customer retention will also be recorded as intangible renewal rights. While there is uncertainty as to the amount of premiums that ultimately will be retained due to the departure of several Farmers' employees in the months preceding the acquisition, AFG expects this acquired business will generate gross written premiums of about

\$170 million in 2006.

C.

Segments of Operations AFG manages its business as three segments: (i) property and casualty insurance, (ii) annuity and supplemental insurance and (iii) other, which includes holding company costs.

AFG reports its property and casualty insurance business in the following Specialty sub-segments: (i) Property and transportation, which includes inland and ocean marine, agricultural-related business and commercial automobile, (ii) Specialty casualty, which includes executive and professional liability, umbrella and excess liability and excess and surplus, (iii) Specialty financial, which includes fidelity and surety bonds and collateral protection, and (iv) California workers' compensation. AFG's annuity and supplemental insurance business markets primarily retirement annuities and various forms of supplemental insurance. AFG's reportable segments and their components were determined based primarily upon similar economic characteristics, products and services.

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AMERICAN FINANCIAL GROUP, INC. 10-Q

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

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

| | Three months ended | | Nine months ended | |
|----------------------------------|----------------------|-------------|----------------------|--------------|
| | <u>September 30,</u> | | <u>September 30,</u> | |
| | <u>2006</u> | <u>2005</u> | <u>2006</u> | <u>2005</u> |
| Revenues (a) | | | | |
| Property and casualty insurance: | | | | |
| Premiums earned: | | | | |
| Specialty | | | | |
| Property and transportation | \$ 322,419 | \$ 270,662 | \$ 747,528 | \$ 640,319 |
| Specialty casualty | 207,557 | 183,794 | 593,075 | 550,858 |
| Specialty financial | 110,545 | 91,586 | 304,236 | 270,008 |
| California workers' compensation | 69,640 | 88,128 | 222,767 | 262,029 |
| Other | 20,338 | 16,496 | 55,895 | 49,507 |
| Other lines | <u>360</u> | <u>695</u> | <u>1,464</u> | <u>3,074</u> |

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| | | | | |
|--|--------------------|--------------------|--------------------|--------------------|
| | 730,859 | 651,361 | 1,924,965 | 1,775,795 |
| Investment income | 79,835 | 71,336 | 240,471 | 209,821 |
| Realized gains | 1,431 | 7,561 | 28,754 | 16,857 |
| Other | <u>45,878</u> | <u>76,636</u> | <u>143,776</u> | <u>179,666</u> |
| | 858,003 | 806,894 | 2,337,966 | 2,182,139 |
| Annuities and supplemental insurance: | | | | |
| Investment income | 151,667 | 141,951 | 452,468 | 428,685 |
| Life, accident and health premiums | 91,742 | 91,811 | 249,291 | 276,256 |
| Realized gains (losses) | (2,812) | 3,008 | (7,887) | 16,635 |
| Other | <u>33,019</u> | <u>22,020</u> | <u>79,278</u> | <u>63,816</u> |
| | 273,616 | 258,790 | 773,150 | 785,392 |
| Other | <u>4,892</u> | <u>10,149</u> | <u>16,484</u> | <u>18,461</u> |
| | <u>\$1,136,511</u> | <u>\$1,075,833</u> | <u>\$3,127,600</u> | <u>\$2,985,992</u> |
| Operating Earnings (Loss) Before Income Taxes Property and casualty insurance: Underwriting: Specialty | | | | |
| Property and transportation | \$ 40,386 | \$ 5,242 | \$ 113,551 | \$ 72,701 |
| Specialty casualty | 44,040 | 19,475 | 87,014 | 33,709 |
| Specialty financial | (24,091) | (9,253) | (22,676) | (21,159) |
| California workers' compensation | 25,275 | 29,406 | 54,115 | 63,970 |
| Other | (3,378) | (1,738) | (3,049) | (2,295) |
| Other lines (b) | <u>(1,450)</u> | <u>(177,487)</u> | <u>(6,491)</u> | <u>(180,333)</u> |
| |) |) |) |) |
| | 80,782 | (134,355) | 222,464 | (33,407) |
| Investment income, realized gains and other | <u>70,942</u> | <u>98,397</u> | <u>244,100</u> | <u>230,560</u> |

| | | | | |
|--|-------------------|--------------------|-------------------|-------------------|
| | 151,724 | (35,958) | 466,564 | 197,153 |
| Annuities and supplemental insurance (c) | 30,804 | 22,721 | 78,887 | 89,311 |
| Other (d) | <u>(25,201)</u> | <u>(15,075)</u> | <u>(71,699)</u> | <u>(62,034)</u> |
| |) |) |) |) |
| | <u>\$ 157,327</u> | <u>(\$ 28,312)</u> | <u>\$ 473,752</u> | <u>\$ 224,430</u> |

- (a) Revenues include sales of products and services as well as other income earned by the respective segments.
- (b) Includes a third quarter 2005 charge of \$179.3 million to increase asbestos, environmental and other mass tort reserves.
- (c) Includes a third quarter 2005 charge of \$9.5 million related to environmental liabilities at GAFRI's former manufacturing operations.
- (d) Includes holding company expenses.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

• **Deferred Policy Acquisition Costs**

As discussed in Note A - "Accounting Policies," deferred policy acquisition costs related to annuities are adjusted for changes in unrealized gains (losses) on securities. The decrease in net unrealized gains during the first nine months of 2006 resulted in a \$18.7 million increase in deferred acquisition costs.

Included in deferred policy acquisition costs in AFG's Balance Sheet are \$94.4 million and \$54.1 million at September 30, 2006, and December 31, 2005, respectively, representing the present value of future profits ("PVFP") related to acquisitions by AFG's annuity and supplemental insurance business. The PVFP amounts are net of \$67.5 million and \$82.5 million of accumulated amortization. The change in PVFP and related accumulated amortization reflects the August 2006 acquisition of Ceres, partially offset by the January 2006 sale of GAPR. Amortization of the PVFP was \$2.8 million in the third quarter and \$6.1 million in the first nine months of 2006 and \$1.6 million in the third quarter and \$7.5 million in the first nine months of 2005, respectively.

Long-Term Debt The carrying value of long-term debt consisted of the following (in thousands):

September 30, December 31,

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| | <u>2006</u> | <u>2005</u> |
|---|------------------|------------------|
| Holding Company: | | |
| AFG 7-1/8% Senior Debentures due April 2009 | \$182,814 | \$226,052 |
| AFG Senior Convertible Notes due June 2033 | 189,825 | 189,857 |
| AFG 7-1/8% Senior Debentures due February 2034 | 115,000 | 115,000 |
| AFG 7-1/8% Senior Debentures due December 2007 | 59,493 | 59,493 |
| Other | <u>3,783</u> | <u>3,768</u> |
| | <u>550,915</u> | <u>594,170</u> |
| Subsidiaries | | |
| : | | |
| GAFRI 7-1/2% Senior Debentures due November 2033 | 112,500 | 112,500 |
| GAFRI 7-1/4% Senior Debentures due January 2034 | 86,250 | 86,250 |
| GAFRI 6-7/8% Senior Notes due June 2008 | 33,590 | 100,000 |
| Notes payable secured by real estate | 67,925 | 33,112 |
| American Premier Underwriters 10-7/8% Subordinated Notes due May 2011 | 8,079 | 8,125 |
| Other | <u>7,501</u> | <u>8,586</u> |
| | <u>315,845</u> | <u>348,573</u> |
| Payable to Subsidiary Trusts: | | |
| GAFRI 8-7/8% Subordinated Debentures due January 2027 | 21,960 | 21,960 |
| GAFRI 7.35% Subordinated Debentures due May 2033 | 20,000 | 20,000 |
| National Interstate Variable Rate Subordinated Debentures due May 2033 | <u>15,000</u> | <u>15,000</u> |
| | <u>56,960</u> | <u>56,960</u> |
| | <u>\$923,720</u> | <u>\$999,703</u> |

At September 30, 2006, scheduled principal payments on debt for the balance of 2006 and the subsequent five years were as follows: 2006 - \$.1 million; 2007 - \$60.8 million; 2008 - \$34.4 million; 2009 - \$184.5 million; 2010 - \$3.0 million; and 2011 - \$9.1 million.

During the first nine months of 2006, AFG repurchased \$43.5 million of its 7-1/8% Debentures due 2009 for \$45.6 million in cash and GAFRI repurchased \$66.4 million of its 6-7/8% Notes for \$68.7 million in cash. In July 2006, an AFG subsidiary borrowed \$42 million under a 6.3% 10-year mortgage loan secured by one of its hotel properties.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

In March 2006, AFG and GAFRI replaced their existing credit agreements with a new five-year revolving credit facility under which they can borrow a combined \$500 million. AFG and GAFRI have agreed not to borrow more than \$325 million and \$200 million, respectively, under the credit facility and AFG has agreed to guarantee amounts borrowed by GAFRI. Amounts borrowed bear interest at rates ranging from 0.5% to 1.25% over LIBOR based on AFG's credit rating. No amounts were borrowed under these agreements at September 30, 2006 or December 31, 2005.

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

AFG's Senior Convertible Notes were issued at a price of 37.153% of the principal amount due at maturity. Interest is payable semiannually at a rate of 4% of issue price per year through June 2008, after which interest at 4% annually will be accrued and added to the carrying value of the Notes. The Notes are redeemable at AFG's option at any time on or after June 2, 2008, at accreted value ranging from \$371.53 per Note to \$1,000 per Note at maturity. Generally, holders may convert each Note into 11.5016 shares of AFG Common Stock (at \$32.30 per share currently) (i) if the average market price of AFG Common Stock to be received upon conversion exceeds 120% of the accreted value (\$38.76 per share currently) for a specified period, (ii) if the credit rating of the Notes is significantly lowered, or, (iii) if AFG calls the notes for redemption. Based on the market price of AFG's Common Stock during the quarter ended September 30, 2006, the Notes are currently convertible through December 31, 2006. AFG has delivered cash in lieu of Common Stock upon conversion of the Notes and intends to continue to do so. Accordingly, shares issuable upon conversion of the Notes are not treated as dilutive.

F.

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

Stock Incentive Plans

Under AFG's 2005 Stock Incentive Plan, employees of AFG and its subsidiaries are eligible to receive equity awards in the form of stock options, stock appreciation rights, restricted stock awards, restricted stock units and stock awards. This plan replaced AFG's existing stock option plan in the first quarter of 2006.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

At September 30, 2006, there were 10.6 million shares of AFG Common Stock reserved for issuance under AFG's stock incentive plan. Options generally become exercisable at the rate of 20% per year commencing one year after grant; those granted to non-employee directors of AFG are fully exercisable upon grant. Options expire ten years after the date of grant. Data for stock options issued under AFG's stock incentive plans is presented below:

| | <u>Shares</u> | <u>Average Exercise Price</u> | <u>Average Remaining Contractual Term</u> | <u>Aggregate Intrinsic Value (in millions)</u> |
|------------------------------------|------------------|---------------------------------------|---|--|
| Outstanding at January 1, 2006 | 6,389,288 | \$28.14 | | |
| Granted | 971,450 | \$40.51 | | |
| Exercised | (1,027,618) | \$30.97 | | |
| | <u>(22,700)</u> | \$35.56 | | |
| Forfeited/Cancelled) | <u>6,310,420</u> | \$29.56 | 5.9 years | \$109.6 |
| Outstanding at September 30, 2006 | | | | |
| Options exercisable at | <u>3,656,430</u> | | 4.2 years | \$ 70.8 |
| September 30, 2006 | | \$27.57 | | |
| Options and other awards available | <u>4,298,366</u> | | | |

for grant at September 30, 2006

The total intrinsic value of options exercised during the nine months ended September 30, 2006 and 2005 was \$13.2 million and \$6.6 million, respectively. During the nine months ended September 30, 2006, AFG received \$25.6 million in cash and recognized a \$4.0 million tax benefit from the exercise of stock options.

AFG uses the Black-Scholes option pricing model to calculate the "fair value" of its option grants. Expected volatility is based on historical volatility (after consideration of other factors). AFG began using the SEC's simplified method of calculating expected term with its 2006 grants. The fair value of options granted in the first nine months of 2006 and 2005 was \$10.03 per share and \$9.66 per share, respectively, based on the following assumptions:

| | <u>2006</u> | <u>2005</u> |
|--------------------------|-------------|-------------|
| Expected dividend yield | 1-1/2% | 2% |
| Expected volatility | 19% | 28% |
| Expected term (in years) | 6.5 | 8.4 |
| Risk-free rate | 4.6% | 4.3% |

Total compensation expense related to stock incentive plans for the third quarter and first nine months of 2006 was \$2.6 million and \$7.4 million, respectively. Related tax benefits totaled \$520,000 for the quarter and \$1.5 million for the nine months. Included in these totals are \$777,000 for the quarter and \$2.2 million for the nine months in compensation expense and \$112,000 for the quarter and \$347,000 for the nine months in tax benefits related to stock incentive plans of two AFG subsidiaries. As of September 30, 2006, there was a total of \$19.5 million of total unrecognized compensation expense related to nonvested stock options granted under AFG's plans. That cost is expected to be recognized over a weighted average of 3.5 years.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

The following table illustrates the effect on net earnings (loss) (in thousands) and earnings (loss) per share for the third quarter and first nine months of 2005, had compensation cost been recognized and determined based on the "fair values" at grant dates consistent with the method used beginning in 2006.

| | Third Quarter <u>2005</u> | Nine Months <u>2005</u> |
|--|---------------------------------|-------------------------------|
| Net earnings (loss), as reported | (\$26,430) | \$118,070 |
| Pro forma stock option expense, net of tax | <u>(1,875)</u> | <u>(5,614)</u> |
| |) |) |
| Adjusted net earnings (loss) | <u>(\$28,305)</u> | <u>\$112,456</u> |
| Earnings (loss) per share (as reported): | | |
| Basic | (\$0.34) | \$1.53 |
| Diluted | (\$0.34) | \$1.51 |
| Earnings (loss) per share (adjusted): | | |
| Basic | (\$0.37) | \$1.46 |
| Diluted | (\$0.36) | \$1.45 |

Discontinued Operations In the second quarter of 2006, GAFRI sold Chatham Bars Inn, its resort-hotel property located on Cape Cod for \$166 million. In accordance with SFAS No. 144, "Accounting for the Impairment or Disposal of Long-lived Assets," the results of operations of this investment property and the gain on sale are presented as discontinued operations in the Statement of Operations. Operating results for a smaller hotel property that was sold in the fourth quarter of 2005 have been reclassified as discontinued operations to conform to the current year's presentation. Balance Sheet amounts prior to the hotel sale have not been reclassified.

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

| | Three months ended <u>September 30,</u> | | Nine months ended <u>September 30,</u> | |
|--|--|---------------|---|---------------|
| Operations: | <u>2006</u> | <u>2005</u> | <u>2006</u> | <u>2005</u> |
| Revenue | \$ - | \$16.9 | \$ 3.9 | \$33.4 |
| Pretax earnings (loss) | - | 4.0 | (1.0) | 5.2 |
| Provision (benefit) for income taxes | - | 1.3 | (.3) | 1.8 |
| Minority interest | <u>-</u> | <u>(.5)</u> | <u>-.1</u> | <u>(.6)</u> |
| |) | |) | |
| Earnings (loss) from discontinued operations | - | 2.2 | (.6) | 2.8 |
| Gain on sale, net of tax (*) | <u>-</u> | <u>-</u> | <u>25.8</u> | <u>-</u> |
| Discontinued operations, net of tax | <u>\$ -</u> | <u>\$ 2.2</u> | <u>\$25.2</u> | <u>\$ 2.8</u> |

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

H.

Commitments and Contingencies There have been no significant changes to the matters discussed and referred to in Note O - "Commitments and Contingencies" of AFG's 2005 Annual Report on Form 10-K.

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ITEM 2

Management's Discussion and Analysis

of Financial Condition and Results of Operations

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FORWARD-LOOKING STATEMENTS

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

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

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

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

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,

of Financial Condition and Results of Operations - Continued

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 September 30, 2006, AFG (parent) had approximately \$110 million in cash and securities and no amounts borrowed under its bank line of credit.

Results of Operations

Through the operations of its subsidiaries, AFG is engaged primarily in property and casualty insurance and in the sale of retirement annuities and supplemental insurance products.

AFG's net earnings for the third quarter and first nine months of 2006 were \$93.6 million (\$1.16 per share, diluted) and \$317.9 million (\$3.96 per share), respectively. These results include significantly higher earnings from AFG's insurance operations compared to the same periods a year earlier. AFG reported a net loss for the third quarter of 2005 of \$26.4 million (\$.34 per share), which included an aftertax charge of \$121.6 million (\$1.55 per share) to increase asbestos and environmental reserves ("A&E") within AFG's run-off operations. Net earnings for the first nine months of 2005 were \$118.1 million (\$1.51 per share).

CRITICAL ACCOUNTING POLICIES

Significant accounting policies are summarized in Note A to the financial statements. The preparation of financial statements 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 could 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 deferred acquisition costs,
- ◆ the establishment of asbestos and environmental reserves of former non-insurance operations, and
- ◆ the determination of "other-than-temporary" impairment on investments.

For a discussion of these policies, see *Management's Discussion and Analysis - "Critical Accounting Policies" in AFG's 2005 Form 10-K.*

LIQUIDITY AND CAPITAL RESOURCES

Ratios

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

| | September 30, | <u>December 31,</u> | |
|--------------------------------|---------------|---------------------|-------------|
| | <u>2006</u> | <u>2005</u> | <u>2004</u> |
| Long-term debt | \$ 924 | \$1,000 | \$1,106 |
| Total capital (*) | 3,996 | 3,703 | 3,575 |
| Ratio of debt to total capital | 23.1% | 27.0% | 30.9% |

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

AFG's ratio of earnings to fixed charges, including annuity benefits as a fixed charge, was 2.49 for the nine months ended September 30, 2006 and 1.77 (2.20 excluding A&E and other mass tort charges) for the entire year of 2005. Excluding annuity benefits, this ratio was 8.53 and 4.58 (6.60 excluding the A&E and other mass tort charges), respectively. 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.

Sources of Funds

Parent Holding Company Liquidity

Management believes AFG has sufficient resources to meet its liquidity requirements. If funds generated from operations, including dividends and tax payments from subsidiaries, are insufficient to meet fixed charges in any period, AFG would be required to utilize parent company cash and marketable securities (approximately \$110 million at September 30, 2006) or generate cash through borrowings, sales of other assets, or similar transactions.

In March 2006, AFG and GAFRI replaced their existing credit agreements with a new five-year revolving credit facility under which they can borrow a combined \$500 million. AFG and GAFRI have agreed not to borrow more than \$325 million and \$200 million, respectively, under the credit facility and AFG has agreed to guarantee amounts borrowed by GAFRI. Amounts borrowed bear interest at rates ranging from 0.5% to 1.25% over LIBOR based on AFG's credit rating. No amounts were outstanding under this agreement at September 30, 2006.

Under a currently effective shelf registration statement, AFG can offer additional equity or debt securities, including 2.3 million shares of common stock under an equity distribution agreement with UBS Securities LLC. The shelf registration provides AFG with greater flexibility to access the capital markets from time to time as market and other conditions permit.

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

Subsidiary Liquidity

As discussed above under "*Parent Company Liquidity*", in March 2006, AFG and GAFRI replaced their existing credit agreements. In addition, GAFRI can offer approximately \$250 million in additional equity or debt securities under a currently effective shelf registration.

During the first nine months of 2006, GAFRI repurchased \$66.4 million of its 6-7/8% Senior Notes due 2008 for \$68.7 million in cash.

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Management's Discussion and Analysis

of Financial Condition and Results of Operations - Continued

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

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.

Investments

AFG's investment portfolio at September 30, 2006, contained \$14.4 billion in "Fixed maturities" classified as available for sale and \$716 million in "Other stocks," all carried at fair value with unrealized gains and losses reported as a separate component of shareholders' equity on an after-tax basis. At September 30, 2006, AFG had pretax net unrealized losses of \$49.3 million on fixed maturities and pretax net unrealized gains of \$80.5 million on other stocks.

Approximately 94% of the fixed maturities held by AFG at September 30, 2006, were rated "investment grade" (credit rating of AAA to BBB) by nationally recognized rating agencies. Investment grade securities generally bear lower

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

Since fixed maturities and stocks are carried at fair value in the balance sheet, there is virtually no effect on financial condition upon the sale and ultimate realization of unrealized gains and losses.

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Management's Discussion and Analysis

of Financial Condition and Results of Operations - Continued

Summarized information for the unrealized gains and losses recorded in AFG's Balance Sheet at September 30, 2006, is shown in the following table (dollars in millions). Approximately \$154 million of available for sale "Fixed maturities" had no unrealized gains or losses at September 30, 2006.

| | Securities With Unrealized <u>Gains</u> | Securities With Unrealized <u>Losses</u> |
|--|--|---|
| <u>Available for sale Fixed Maturities</u> | | |
| Fair value of securities | \$5,086 | \$9,162 |
| Amortized cost of securities | \$4,940 | \$9,357 |
| Gross unrealized gain (loss) | \$ 146 | (\$ 195) |
| Fair value as % of amortized cost | 103% | 98% |
| Number of security positions | 1,284 | 1,461 |
| Number individually exceeding \$2 million gain or loss | 1 | 1 |
| Concentration of gains (losses) by type or industry (exceeding 5% of unrealized): | | |
| Mortgage-backed securities | \$21.6 | (\$84.2) |
| Banks, savings and credit institutions | 16.4 | (18.0) |
| U.S. Government and government agencies | 3.0 | (16.1) |
| Insurance companies | 8.9 | (10.8) |
| State and municipal | 7.1 | (10.1) |
| Gas and electric services | 16.5 | (10.1) |
| Air transportation and courier services | 12.0 | (0.4) |
| Percentage rated investment grade | 91% | 96% |

The table below sets forth the scheduled maturities of AFG's available for sale fixed maturity securities at September 30, 2006, based on their fair values. Asset-backed securities and other securities with sinking funds are reported at average maturity. Actual maturities may differ from contractual maturities because certain securities may be called or prepaid by the issuers.

| | Securities With Unrealized <u>Gains</u> | Securities With Unrealized <u>Losses</u> |
|------------------------------------|--|---|
| <u>Maturity</u> | | |
| One year or less | 5% | 1% |
| After one year through five years | 28 | 25 |
| After five years through ten years | 39 | 29 |
| After ten years | <u>11</u> | <u>4</u> |
| | 83 | 59 |
| Mortgage-backed securities | <u>17</u> | <u>41</u> |
| | <u>100</u> | <u>100</u> |
| | % | % |

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Management's Discussion and Analysis

of Financial Condition and Results of Operations - Continued

AFG realized aggregate losses of \$6.6 million during the first nine months of 2006 on \$149.1 million in sales of fixed maturity securities (five issues/issuers) that had individual unrealized losses greater than \$500,000 at December 31, 2005. These securities were "AAA" rated mortgage-backed securities that decreased in fair value by an aggregate of \$3.0 million from year-end 2005 to the sale date due to an increase in the general level of interest rates.

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.

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

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

Fixed Maturities at September 30, 2006

| | | | |
|------------------------------------|----------------|----------------|------|
| Securities with unrealized gains: | | | |
| Exceeding \$500,000 (64 issues) | \$ 617 | \$ 54 | 110% |
| Less than \$500,000 (1,220 issues) | <u>4,469</u> | <u>92</u> | 102 |
| | <u>\$5,086</u> | <u>\$146</u> | 103% |
| | | | |
| Securities with unrealized losses: | | | |
| Exceeding \$500,000 (84 issues) | \$1,868 | (\$ 70) | 96% |
| Less than \$500,000 (1,377 issues) | <u>7,294</u> | <u>(125)</u> | 98 |
| | <u>\$9,162</u> | <u>(\$195)</u> | 98% |

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

| | Aggregate Fair <u>Value</u> | Aggregate Unrealized <u>Gain (Loss)</u> | Fair Value as % of Cost <u>Basis</u> |
|--|-----------------------------------|---|---|
| <u>Fixed Maturities with Unrealized Losses at September 30, 2006</u> | | | |
| Investment grade with losses for: | | | |
| One year or less (582 issues) | \$3,381 | (\$ 40) | 99% |
| Greater than one year (787 issues) | <u>5,372</u> | <u>(143)</u> | 97 |
| | <u>\$8,753</u> | <u>(\$183)</u> | 98% |
| | | | |
| Non-investment grade with losses for: | | | |
| One year or less (58 issues) | \$ 200 | (\$ 7) | 97% |
| Greater than one year (34 issues) | <u>209</u> | <u>(5)</u> | 98 |
| | <u>\$ 409</u> | <u>(\$ 12)</u> | 97% |

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. A listing of factors considered and resources used is contained in the discussion of "Investments" under Management's Discussion and Analysis in AFG's 2005 Form 10-K.

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Management's Discussion and Analysis

of Financial Condition and Results of Operations - Continued

Based on its analysis, management believes (i) AFG will recover its cost basis in the securities with unrealized losses and (ii) that AFG has the ability and intent to hold the securities until they mature or recover in value. Should either of these beliefs change with regard to a particular security, a charge for impairment would likely be required. While it is not possible to accurately predict if or when a specific security will become impaired, charges for other than temporary impairment could be material to results of operations in a future period. Management believes it is not likely that future impairment charges will have a significant effect on AFG's liquidity.

Uncertainties

Management believes that the areas posing the greatest risk of material loss are the adequacy of its insurance reserves and American Premier's contingencies arising out of its former operations. See Management's Discussion and Analysis - "Uncertainties" in AFG's 2005 Form 10-K.

RESULTS OF OPERATIONS

General

Results of operations as shown in the accompanying financial statements are prepared in accordance with generally accepted accounting principles.

AFG reported operating earnings before income taxes of \$157.3 million for the third quarter of 2006 compared to an operating loss before income taxes of \$28.3 million in the 2005 third quarter. Results for the 2005 quarter included \$189 million in pretax charges resulting from strengthening A&E and other mass tort reserves within AFG's runoff operations, partially offset by a \$30.9 million pretax gain on the sale of coal assets. Excluding these items, a \$35.8 million improvement in property and casualty underwriting results and a \$19.1 million increase in investment income were partially offset by a \$13.2 million decline in realized gains on securities.

Excluding the third quarter 2005 A&E charge and gain on the sale of coal assets, nine-month pretax operating earnings improved \$91.4 million compared to 2005 as a \$76.6 million improvement in property and casualty underwriting results and a \$57.8 million increase in investment income were partially offset by lower realized gains and lower earnings in GAFRI's supplemental insurance operations during the first half of the year.

Property and Casualty Insurance - Underwriting

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AFG reports its Specialty insurance business in the following sub-segments: (i) Property and transportation, which includes inland and ocean marine, agricultural-related business and commercial automobile, (ii) Specialty casualty, which includes executive and professional liability, umbrella and excess liability and excess and surplus, (iii) Specialty financial, which includes fidelity and surety bonds and collateral protection, and (iv) California workers' compensation.

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" for the detail of AFG's operating profit by significant business segment.

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

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Management's Discussion and Analysis

of Financial Condition and Results of Operations - Continued

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

| | Three months ended | | Nine months ended | |
|--------------------------------------|--------------------|------------------|-------------------|------------------|
| | September 30. | | September 30. | |
| | 2006 | 2005 | 2006 | 2005 |
| <u>Gross Written Premiums (GAAP)</u> | | | | |
| Specialty: | | | | |
| Property and transportation | \$ 637.3 | \$ 496.8 | \$1,355.7 | \$1,087.1 |
| Specialty casualty | 371.3 | 359.6 | 1,113.3 | 1,080.7 |
| Specialty financial | 142.8 | 133.1 | 396.4 | 367.6 |
| California workers' compensation | 69.7 | 93.5 | 229.9 | 289.8 |
| Other | .3 | (2.5) | - | 1.2 |
| |) | | | |
| Total Specialty | <u>\$1,221.4</u> | <u>\$1,080.5</u> | <u>\$3,095.3</u> | <u>\$2,826.4</u> |

Net Written Premiums (GAAP)

Specialty:

| | | | | |
|----------------------------------|-----------------|-----------------|------------------|------------------|
| Property and transportation | \$ 332.1 | \$ 291.0 | \$ 830.9 | \$ 728.8 |
| Specialty casualty | 237.6 | 192.3 | 645.6 | 567.4 |
| Specialty financial | 115.7 | 107.9 | 313.1 | 294.7 |
| California workers' compensation | 65.8 | 84.2 | 217.0 | 260.5 |
| Other | <u>17.7</u> | <u>16.4</u> | <u>57.3</u> | <u>48.4</u> |
| | | | | |
| Total Specialty | <u>\$ 768.9</u> | <u>\$ 691.8</u> | <u>\$2,063.9</u> | <u>\$1,899.8</u> |

Combined Ratios (GAAP)

(a)

Specialty:

| | | | | |
|----------------------------------|-------|-------|-------|-------|
| Property and transportation (b) | 87.4% | 98.1% | 84.7% | 88.7% |
| Specialty casualty | 78.7 | 89.4 | 85.3 | 93.9 |
| Specialty financial (c) | 121.8 | 110.1 | 107.5 | 107.8 |
| California workers' compensation | 63.6 | 66.7 | 75.7 | 75.5 |
| Other | 116.6 | 110.6 | 105.5 | 104.6 |
| Total Specialty (d) | 88.7% | 93.3% | 88.1% | 91.8% |

- (a) AFG's aggregate combined ratio, including other (primarily runoff) lines, was 88.9% and 120.6% for the quarter ended September 30, 2006 and 2005 and 88.4% and 101.8% for the nine months ended September 30, 2006 and 2005, respectively. The aggregate ratio includes 27.5 points and 10.1 points, respectively, for the three and nine month periods of 2005 relating to the A&E charge.
- (b) Includes the effect of hurricane losses for the 2005 three and nine month periods of 10.8 points and 4.6 points, respectively.
- (c) Includes the effect of hurricane losses for the 2005 three and nine month periods of 7.1 points and 2.4 points, respectively.
- (d) Includes the effect of hurricane losses of 6.2% and 2.3%, respectively, for the three and nine month periods of 2005.

Net written premiums for the specialty insurance operations increased 11% for the third quarter and 9% for the nine months compared to the same periods in 2005. Significant premium growth from the Property and transportation and Specialty casualty groups were partially offset by a decline in the California workers' compensation premiums. The specialty insurance operations generated an underwriting profit of \$82.2 million in the 2006 third quarter, \$39.1 million higher than the 2005 quarter. The combined ratio was 88.7%, 4.6 points better than in the 2005 third quarter, which included approximately \$40.6 million (6.2 points) of catastrophe losses principally from hurricanes Katrina and Rita.

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Management's Discussion and Analysis

of Financial Condition and Results of Operations - Continued

Underwriting profit for the first nine months of 2006 was \$229 million, 56% above the 2005 period, reflecting premium growth, lower catastrophe losses, and the positive impact of favorable reserve development. These 2006 results include \$22.6 million (1.2 points) of catastrophe losses compared to \$48.4 million (2.7 points) in the same 2005 period. Net written premiums were 9% above the 2005 period.

Property and transportation

net written premiums for the third quarter and nine months of 2006 increased 14% over each of the 2005 periods due primarily to growth in the property and inland marine operations and new premium volume from the 2005 acquisition of Farmers Crop Insurance Alliance. The growth in net written premiums was less than the gross written premium growth due to the effect of crop reinsurance programs. This group's combined ratio for the 2005 third quarter included 10.8 points of hurricane losses. The 2006 third quarter underwriting results benefited from solid underwriting profit recorded within the crop insurance division and the absence of any significant catastrophe losses during the quarter. The combined ratio for the first nine months of 2006 improved 4.0 points compared to the 2005 period as underwriting results for 2006 include 2.6 points of catastrophe losses compared to 5.9 points in the same period in 2005. Nearly all of the lines of business in this group continue to report excellent profitability with continuing favorable prior year reserve development. The 2006 nine-month period results include 4.3 points of favorable reserve development compared to 2.1 points for the same 2005 period.

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

Specialty casualty

net written premiums for the 2006 third quarter and nine-month period were 24% and 14% higher than in the respective 2005 periods due primarily to volume growth and higher premium retention within several of the group's businesses as well as third quarter 2006 changes to reinsurance agreements within the specialized program business line, which resulted in the recapture of \$26 million in premiums previously ceded to reinsurers. This group's combined

ratio improved 10.7 points for the third quarter, reflecting improvement across all businesses in the group. Results for the 2006 quarter included about 4.8 points of favorable reserve development whereas the prior year period included 1.4 points of unfavorable reserve development. Through the first nine months of this year, this group's combined ratio has improved 8.6 points compared with the same prior year period.

Specialty financial

net written premiums for the three and nine month periods of 2006 increased 7% and 6%, respectively, above the 2005 periods reflecting premium growth principally in the surety and financial institutions businesses. The group experienced disappointing results in the 2006 third quarter resulting from losses within the automobile residual value business ("RVI"), which is in run-off. These losses were primarily attributable to lower than expected proceeds from the sale (at auction) of certain luxury cars and sport utility

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Management's Discussion and Analysis

of Financial Condition and Results of Operations - Continued

vehicles at lease-end. Excluding the effect of the RVI business, this group's third quarter combined ratio was 88%, as the group's other operations are generating underwriting profits.

California workers' compensation

net written premiums for the third quarter and first nine months of 2006 were 22% and 17% below the 2005 periods, reflecting the effect of significantly lower rates, partly offset by new volume growth. This business continued to report excellent profitability in the 2006 third quarter with a 3.1 point improvement in the combined ratio compared to the 2005 quarter. This business experienced \$16 million of favorable prior year reserve development in the quarter, compared to \$9 million in the 2005 third quarter. The underwriting results reflect the effects of the California workers' compensation reforms that have resulted in lower workers' compensation costs for employers and lower premium levels. However, due to the long-tail nature of this business, reserving is somewhat conservative until a higher percentage of claims have been paid and the ultimate impact of reforms can be determined.

Asbestos and Environmental and Other Mass Tort Reserve Charges

As a result of a comprehensive study of its asbestos and environmental exposures relating primarily to the run-off operations of its property and casualty group, AFG recorded a 2005 third quarter pre-tax charge of \$169 million, net of \$32 million in reinsurance recoverables. This charge resulted in an increase in asbestos reserves of \$124 million and environmental reserves of \$45 million. In connection with the review of A&E reserves in 2005, AFG reviewed its other mass tort exposures and recorded a \$10 million pre-tax charge. Management expects to conduct another study in 2007.

Life, Accident and Health Premiums and Benefits

The decrease in life, accident and health premiums and benefits is due primarily to the January 2006 sale of Great American Life of Puerto Rico ("GAPR"). Excluding the effect of the sale, premiums increased \$18.5 million for the third quarter and \$23.4 million for the nine

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months and benefits increased \$6.6 million for the third quarter and \$17.7 million for the nine months of 2006 compared to the 2005 periods due primarily to the August 2006 acquisition of Ceres. Life, accident and health benefits for the third quarter of 2006 were reduced by \$3.4 million due to favorable development in GAFRI's Medicare supplement business. For the nine months, this favorable development was more than offset by an increase in loss experience in GAFRI's supplemental insurance business during the first half of 2006. GAFRI expects the supplemental insurance loss ratio to decrease as a result of rate increases and the acquisition of Ceres. The acquisition broadens GAFRI's distribution in both the independent agent and captive agent channels. Prior to the Ceres acquisition, GAFRI's supplemental insurance products were sold through relatively few national marketing organizations.

Investment Income

The increase in investment income for the third quarter and nine months of 2006 compared to the 2005 periods reflects a 7% increase in average cash and investments for the quarter and nine months.

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Management's Discussion and Analysis

of Financial Condition and Results of Operations - Continued

Realized Gains (Losses)

Realized capital gains have been an important part of the return on investments. Individual assets are sold creating gains and losses as market opportunities exist. Realized gains for 2006 includes a \$23.6 million pretax gain in the first quarter on the sale of AFG's interest in The Cincinnati Reds.

Realized gains (losses) on securities include provisions for other than temporary impairment of securities still held as follows: third quarter of 2006 and 2005 - \$7.1 million and \$3.9 million; nine months of 2006 and 2005 - \$12.9 million and \$11.5 million, respectively.

Real Estate Operations

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

| | <u>Three months ended</u> | | <u>Nine months ended</u> | |
|--------------------------------------|---------------------------|-------------|--------------------------|-------------|
| | <u>September 30.</u> | | <u>September 30.</u> | |
| | <u>2006</u> | <u>2005</u> | <u>2006</u> | <u>2005</u> |
| Other income | \$20.7 | \$48.9 | \$65.8 | \$91.1 |
| Other operating and general expenses | 18.7 | 14.9 | 50.2 | 43.8 |

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| | | | | |
|------------------------------------|----|----|-----|-----|
| Interest charges on borrowed money | .9 | .4 | 1.6 | 1.4 |
| Minority interest expense, net | .1 | .1 | 2.3 | 1.0 |

Income from real estate operations for 2005 includes a third quarter pretax gain of \$30.9 million on the sale of coal reserves. Other income also includes net pretax gains on the sale of other real estate assets of \$1.1 million in the third quarter and \$14.2 million in the first nine months of 2006 and \$1.1 million and \$10.1 million for the 2005 periods.

Real Estate Operations - Discontinued

In June 2006, GAFRI sold Chatham Bars Inn, a resort hotel located on Cape Cod, Massachusetts, for \$166 million. After sales expenses, contingencies and the write-off of certain deferred acquisition costs on annuities associated with the gain recognition, GAFRI recognized a pre-tax gain of approximately \$48.7 million. The operating results and gain on the sale of Chatham are included in discontinued operations in the Statement of Operations. See Note G - "Discontinued Operations."

Fourth Quarter Real Estate Sales

AFG has entered into a definitive agreement to sell certain of its New York real estate assets and expects to record a pretax gain of approximately \$45 million in the 2006 fourth quarter. In addition, on October 3, 2006, an 80%-owned subsidiary sold an apartment building and expects to recognize a pretax gain of approximately \$8 million.

Annuity Benefits

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

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Management's Discussion and Analysis

of Financial Condition and Results of Operations - Continued

Annuity benefits for the third quarter and nine months of 2006 increased compared to the 2005 periods as the effect of internal growth and the acquisition of Old Standard Life fixed annuity business were partially offset by lower average effective crediting rates and the sale of GAPR.

Significant changes in projected investment yields could result in charges (or credits) to earnings in the period the projections are modified.

Annuity and Supplemental Insurance Acquisition Expenses

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Annuity and supplemental insurance acquisition expenses include amortization of annuity, supplemental insurance and run-off life business deferred policy acquisition costs ("DPAC") as well as a portion of commissions on sales of insurance products. Annuity and supplemental insurance acquisition expenses also include amortization of the present value of future profits of businesses acquired. The \$6.7 million and \$2.2 million increases in annuity and supplemental insurance acquisition expenses for the third quarter and nine months of 2006, respectively, compared to the 2005 periods reflects the effect of the Ceres and Old Standard Life acquisitions and growth in the annuity and supplemental insurance businesses, partially offset by the January 2006 sale of GAPR.

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

Interest Expense

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

Interest expense decreased \$1.7 million (8%) for the third quarter and \$5.7 million (10%) for the nine months due primarily to the retirement of debt during the first nine months of 2006 and late 2005.

Other Operating and General Expenses

Other operating and general expenses for the third quarter of 2005 include a \$9.5 million pretax charge to increase reserves related to environmental liabilities at GAFRI's former manufacturing operations. Other operating and general expenses also include \$7.2 million and \$1 million in losses on retirement of debt in the first nine months of 2006 and 2005, respectively.

Income Taxes

Income tax expense for the first nine months of 2006 reflects a \$8.7 million benefit in the second quarter related to the favorable resolution of certain tax issues.

Recent Account Standards

Income Taxes

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

of Financial Condition and Results of Operations - Continued

Proposed Accounting Standard

Convertible Notes

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

ITEM 3

Quantitative and Qualitative Disclosure of Market Risk

As of September 30, 2006, there were no material changes to the information provided in Item 7A - "Quantitative and Qualitative Disclosure of Market Risk" of AFG's 2005 Form 10-K.

ITEM 4

Controls and Procedures

AFG's management, with participation of its Co-Chief Executive Officers and its principal financial officer, has evaluated AFG's disclosure controls and procedures (as defined in Exchange Act Rule 13a-15) as of the end of the period covered by this report. Based on that evaluation, AFG's Co-CEOs and principal financial officer concluded that these disclosure controls and procedures were effective. On August 7, 2006, Great American Financial Resources acquired Ceres Group, Inc. Ceres has been excluded from management's assessment of internal control over financial reporting.

In the ordinary course of business, AFG and its subsidiaries routinely enhance their information systems by either upgrading current systems or implementing new systems. There has been no change in AFG's business processes and procedures during the third fiscal quarter of 2006 that has materially affected, or is reasonably likely to materially affect, AFG's internal controls over financial reporting.

AMERICAN FINANCIAL GROUP, INC. 10-Q

PART II

OTHER INFORMATION

ITEM 2

Unregistered Sales of Equity Securities and Use of Proceeds

Issuer Purchases of Equity Securities

Under AFG's shareholder-approved Stock Option Plan, 17,288 shares of AFG Common Stock were tendered in connection with the exercise of stock options in the third quarter of 2006 (13,116 at \$46.33 in August and 4,172 at \$47.93 in September).

ITEM 6

Exhibits

| <u>Number</u> | <u>Exhibit Description</u> |
|---------------|---|
| <u>12</u> | Computation of ratios of earnings to fixed charges. |
| <u>31(a)</u> | Certification of the Co-Chief Executive Officer pursuant to section 302(a) of the Sarbanes-Oxley Act of 2002. |
| <u>31(b)</u> | Certification of the Co-Chief Executive Officer pursuant to section 302(a) of the Sarbanes-Oxley Act of 2002. |
| <u>31(c)</u> | Certification of the Chief Financial Officer pursuant to section 302(a) of the Sarbanes-Oxley Act of 2002. |
| <u>32</u> | Certification of the Co-Chief Executive Officers and Chief Financial Officer pursuant to section 906 of the Sarbanes-Oxley Act of 2002. |

Signature

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

American Financial Group, Inc.

November 8, 2006

BY: s/Keith A. Jensen
Keith A. Jensen
Senior Vice President
(principal financial and
accounting officer)

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