

AMERICAN FINANCIAL GROUP INC

Form 10-Q

November 08, 2013

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the Quarterly Period Ended September 30, 2013

Commission File No. 1-13653

AMERICAN FINANCIAL GROUP, INC.

Incorporated under the Laws of Ohio

301 East Fourth Street, Cincinnati, Ohio 45202

(513) 579-2121

IRS Employer I.D. No. 31-1544320

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

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

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

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

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

As of November 1, 2013, there were 89,365,096 shares of the Registrant's Common Stock outstanding, excluding 14.9 million shares owned by subsidiaries.

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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 Millions)

|                                                                                             | September 30,<br>2013 | December 31,<br>2012 |
|---------------------------------------------------------------------------------------------|-----------------------|----------------------|
| Assets:                                                                                     |                       |                      |
| Cash and cash equivalents                                                                   | \$ 1,331              | \$ 1,705             |
| Investments:                                                                                |                       |                      |
| Fixed maturities, available for sale at fair value (amortized cost — \$24,436 and \$22,083) | 25,674                | 24,118               |
| Fixed maturities, trading at fair value                                                     | 290                   | 321                  |
| Equity securities, at fair value (cost — \$956 and \$778)                                   | 1,143                 | 939                  |
| Mortgage loans                                                                              | 611                   | 607                  |
| Policy loans                                                                                | 240                   | 228                  |
| Real estate and other investments                                                           | 632                   | 531                  |
| Total cash and investments                                                                  | 29,921                | 28,449               |
| Recoverables from reinsurers                                                                | 3,138                 | 3,750                |
| Prepaid reinsurance premiums                                                                | 662                   | 471                  |
| Agents' balances and premiums receivable                                                    | 801                   | 636                  |
| Deferred policy acquisition costs                                                           | 867                   | 550                  |
| Assets of managed investment entities                                                       | 2,779                 | 3,225                |
| Other receivables                                                                           | 1,078                 | 539                  |
| Variable annuity assets (separate accounts)                                                 | 629                   | 580                  |
| Other assets                                                                                | 887                   | 786                  |
| Goodwill                                                                                    | 185                   | 185                  |
| Total assets                                                                                | \$ 40,947             | \$ 39,171            |
| Liabilities and Equity:                                                                     |                       |                      |
| Unpaid losses and loss adjustment expenses                                                  | \$ 6,441              | \$ 6,845             |
| Unearned premiums                                                                           | 2,047                 | 1,651                |
| Annuity benefits accumulated                                                                | 19,785                | 17,609               |
| Life, accident and health reserves                                                          | 2,011                 | 2,059                |
| Payable to reinsurers                                                                       | 601                   | 475                  |
| Liabilities of managed investment entities                                                  | 2,429                 | 2,892                |
| Long-term debt                                                                              | 913                   | 953                  |
| Variable annuity liabilities (separate accounts)                                            | 629                   | 580                  |
| Other liabilities                                                                           | 1,381                 | 1,359                |
| Total liabilities                                                                           | 36,237                | 34,423               |
| Shareholders' equity:                                                                       |                       |                      |
| Common Stock, no par value                                                                  |                       |                      |
| — 200,000,000 shares authorized                                                             | 89                    | 89                   |
| — 89,223,607 and 88,979,303 shares outstanding                                              |                       |                      |
| Capital surplus                                                                             | 1,109                 | 1,063                |
| Retained earnings:                                                                          |                       |                      |
| Appropriated — managed investment entities                                                  | 45                    | 75                   |
| Unappropriated                                                                              | 2,729                 | 2,520                |
| Accumulated other comprehensive income, net of tax                                          | 570                   | 831                  |

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|                              |           |           |
|------------------------------|-----------|-----------|
| Total shareholders' equity   | 4,542     | 4,578     |
| Noncontrolling interests     | 168       | 170       |
| Total equity                 | 4,710     | 4,748     |
| Total liabilities and equity | \$ 40,947 | \$ 39,171 |

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## AMERICAN FINANCIAL GROUP, INC. 10-Q

AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENT OF EARNINGS (UNAUDITED)

(In Millions, Except Per Share Data)

|                                                                    | Three months ended<br>September 30, |         | Nine months ended<br>September 30, |         |
|--------------------------------------------------------------------|-------------------------------------|---------|------------------------------------|---------|
|                                                                    | 2013                                | 2012    | 2013                               | 2012    |
| Revenues:                                                          |                                     |         |                                    |         |
| Property and casualty insurance net earned premiums                | \$949                               | \$848   | \$2,345                            | \$2,091 |
| Life, accident and health net earned premiums                      | 29                                  | 80      | 87                                 | 290     |
| Net investment income                                              | 338                                 | 326     | 996                                | 972     |
| Realized gains on:                                                 |                                     |         |                                    |         |
| Securities (*)                                                     | 56                                  | 85      | 154                                | 145     |
| Subsidiaries                                                       | —                                   | 156     | —                                  | 155     |
| Income (loss) of managed investment entities:                      |                                     |         |                                    |         |
| Investment income                                                  | 32                                  | 31      | 98                                 | 92      |
| Gain (loss) on change in fair value of assets/liabilities          | 15                                  | (13     | ) (21                              | ) (63   |
| Other income                                                       | 24                                  | 25      | 71                                 | 67      |
| Total revenues                                                     | 1,443                               | 1,538   | 3,730                              | 3,749   |
| Costs and Expenses:                                                |                                     |         |                                    |         |
| Property and casualty insurance:                                   |                                     |         |                                    |         |
| Losses and loss adjustment expenses                                | 680                                 | 610     | 1,503                              | 1,317   |
| Commissions and other underwriting expenses                        | 261                                 | 254     | 772                                | 697     |
| Annuity benefits                                                   | 140                                 | 140     | 394                                | 417     |
| Life, accident and health benefits                                 | 42                                  | 66      | 120                                | 238     |
| Annuity and supplemental insurance acquisition expenses            | 40                                  | 46      | 128                                | 138     |
| Interest charges on borrowed money                                 | 18                                  | 19      | 54                                 | 57      |
| Expenses of managed investment entities                            | 22                                  | 19      | 68                                 | 58      |
| Other expenses                                                     | 98                                  | 99      | 248                                | 260     |
| Total costs and expenses                                           | 1,301                               | 1,253   | 3,287                              | 3,182   |
| Earnings before income taxes                                       | 142                                 | 285     | 443                                | 567     |
| Provision for income taxes                                         | 44                                  | 74      | 155                                | 184     |
| Net earnings, including noncontrolling interests                   | 98                                  | 211     | 288                                | 383     |
| Less: Net earnings (loss) attributable to noncontrolling interests | 15                                  | (15     | ) (25                              | ) (55   |
| Net Earnings Attributable to Shareholders                          | \$83                                | \$226   | \$313                              | \$438   |
| Earnings Attributable to Shareholders per Common Share:            |                                     |         |                                    |         |
| Basic                                                              | \$.94                               | \$2.43  | \$3.51                             | \$4.58  |
| Diluted                                                            | \$.92                               | \$2.39  | \$3.44                             | \$4.50  |
| Average number of Common Shares:                                   |                                     |         |                                    |         |
| Basic                                                              | 89.1                                | 92.9    | 89.4                               | 95.7    |
| Diluted                                                            | 91.0                                | 94.6    | 91.2                               | 97.4    |
| Cash dividends per Common Share                                    | \$0.195                             | \$0.175 | \$0.585                            | \$0.525 |
| (*) Consists of the following:                                     |                                     |         |                                    |         |
| Realized gains before impairments                                  | \$61                                | \$93    | \$160                              | \$164   |

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|                                                                    |      |      |       |       |   |
|--------------------------------------------------------------------|------|------|-------|-------|---|
| Losses on securities with impairment                               | (5   | ) (8 | ) (6  | ) (20 | ) |
| Non-credit portion recognized in other comprehensive income (loss) | —    | —    | —     | 1     |   |
| Impairment charges recognized in earnings                          | (5   | ) (8 | ) (6  | ) (19 | ) |
| Total realized gains on securities                                 | \$56 | \$85 | \$154 | \$145 |   |

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## AMERICAN FINANCIAL GROUP, INC. 10-Q

## AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES

## CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME (UNAUDITED)

(In Millions)

|                                                                            | Three months ended<br>September 30, |       | Nine months ended<br>September 30, |       |
|----------------------------------------------------------------------------|-------------------------------------|-------|------------------------------------|-------|
|                                                                            | 2013                                | 2012  | 2013                               | 2012  |
| Net earnings, including noncontrolling interests                           | \$98                                | \$211 | \$288                              | \$383 |
| Other comprehensive income (loss), net of tax:                             |                                     |       |                                    |       |
| Net unrealized gains (losses) on securities:                               |                                     |       |                                    |       |
| Unrealized holding gains (losses) on securities arising during the period  | 4                                   | 228   | (162                               | ) 464 |
| Reclassification adjustment for realized gains included in net earnings    | (36                                 | ) (56 | ) (99                              | ) (96 |
| Reclassification adjustment for unrealized gains of subsidiaries sold      | —                                   | (18   | ) —                                | (18   |
| Total net unrealized gains (losses) on securities                          | (32                                 | ) 154 | (261                               | ) 350 |
| Foreign currency translation adjustments                                   | 3                                   | 10    | (6                                 | ) 9   |
| Pension and other postretirement plans adjustments                         | —                                   | —     | —                                  | 1     |
| Other comprehensive income (loss), net of tax                              | (29                                 | ) 164 | (267                               | ) 360 |
| Total comprehensive income, net of tax                                     | 69                                  | 375   | 21                                 | 743   |
| Less: Comprehensive income (loss) attributable to noncontrolling interests | 15                                  | (10   | ) (31                              | ) (47 |
| Comprehensive income attributable to shareholders                          | \$54                                | \$385 | \$52                               | \$790 |

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## AMERICAN FINANCIAL GROUP, INC. 10-Q

## AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES

## CONSOLIDATED STATEMENT OF CHANGES IN EQUITY (UNAUDITED)

(Dollars in Millions)

|                                                     | Common<br>Shares | Shareholders' Equity<br>Common Stock<br>and Capital<br>Surplus | Retained Earnings<br>Approp. | Unapprop. | Accumulated<br>Other Comp<br>Inc. (Loss) | Total   | Noncon-<br>trolling<br>Interests | Total<br>Equity |
|-----------------------------------------------------|------------------|----------------------------------------------------------------|------------------------------|-----------|------------------------------------------|---------|----------------------------------|-----------------|
| Balance at December 31, 2012                        | 88,979,303       | \$1,152                                                        | \$75                         | \$ 2,520  | \$ 831                                   | \$4,578 | \$170                            | \$4,748         |
| Net earnings                                        | —                | —                                                              | —                            | 313       | —                                        | 313     | (25 )                            | 288             |
| Other comprehensive income                          | —                | —                                                              | —                            | —         | (261 )                                   | (261 )  | (6 )                             | (267 )          |
| Allocation of losses of managed investment entities | —                | —                                                              | (30 )                        | —         | —                                        | (30 )   | 30                               | —               |
| Dividends on Common Stock                           | —                | —                                                              | —                            | (52 )     | —                                        | (52 )   | —                                | (52 )           |
| Shares issued:                                      |                  |                                                                |                              |           |                                          |         |                                  |                 |
| Exercise of stock options                           | 1,350,551        | 44                                                             | —                            | —         | —                                        | 44      | —                                | 44              |
| Other benefit plans                                 | 376,574          | 6                                                              | —                            | —         | —                                        | 6       | —                                | 6               |
| Dividend reinvestment plan                          | 10,514           | —                                                              | —                            | —         | —                                        | —       | —                                | —               |
| Stock-based compensation expense                    | —                | 15                                                             | —                            | —         | —                                        | 15      | —                                | 15              |
| Shares acquired and retired                         | (1,448,156 )     | (19 )                                                          | —                            | (51 )     | —                                        | (70 )   | —                                | (70 )           |
| Shares exchanged — benefit plans                    | (45,179 )        | —                                                              | —                            | (1 )      | —                                        | (1 )    | —                                | (1 )            |
| Other                                               | —                | —                                                              | —                            | —         | —                                        | —       | (1 )                             | (1 )            |
| Balance at September 30, 2013                       | 89,223,607       | \$1,198                                                        | \$45                         | \$ 2,729  | \$ 570                                   | \$4,542 | \$168                            | \$4,710         |
| Balance at December 31, 2011                        | 97,846,402       | \$1,219                                                        | \$173                        | \$ 2,439  | \$ 580                                   | \$4,411 | \$146                            | \$4,557         |
| Net earnings                                        | —                | —                                                              | —                            | 438       | —                                        | 438     | (55 )                            | 383             |
| Other comprehensive income                          | —                | —                                                              | —                            | —         | 352                                      | 352     | 8                                | 360             |
| Allocation of losses of managed investment entities | —                | —                                                              | (64 )                        | —         | —                                        | (64 )   | 64                               | —               |
| Dividends on Common Stock                           | —                | —                                                              | —                            | (50 )     | —                                        | (50 )   | —                                | (50 )           |
| Shares issued:                                      |                  |                                                                |                              |           |                                          |         |                                  |                 |
| Exercise of stock options                           | 1,009,714        | 27                                                             | —                            | —         | —                                        | 27      | —                                | 27              |
| Other benefit plans                                 | 291,610          | 6                                                              | —                            | —         | —                                        | 6       | —                                | 6               |
| Dividend reinvestment plan                          | 11,697           | —                                                              | —                            | —         | —                                        | —       | —                                | —               |
|                                                     | —                | 15                                                             | —                            | —         | —                                        | 15      | —                                | 15              |

Stock-based compensation  
expense

|                                  |              |         |       |          |        |         |       |         |
|----------------------------------|--------------|---------|-------|----------|--------|---------|-------|---------|
| Shares acquired and retired      | (8,288,776 ) | (105 )  | —     | (210 )   | —      | (315 )  | —     | (315 )  |
| Shares exchanged — benefit plans | (23,685 )    | —       | —     | —        | —      | —       | —     | —       |
| Other                            | —            | —       | —     | (40 )    | (1 )   | (41 )   | 22    | (19 )   |
| Balance at September 30, 2012    | 90,846,962   | \$1,162 | \$109 | \$ 2,577 | \$ 931 | \$4,779 | \$185 | \$4,964 |

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## AMERICAN FINANCIAL GROUP, INC. 10-Q

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

|                                                    | Nine months ended<br>September 30, |         |
|----------------------------------------------------|------------------------------------|---------|
|                                                    | 2013                               | 2012    |
| Operating Activities:                              |                                    |         |
| Net earnings, including noncontrolling interests   | \$288                              | \$383   |
| Adjustments:                                       |                                    |         |
| Depreciation and amortization                      | 110                                | 118     |
| Annuity benefits                                   | 394                                | 417     |
| Realized gains on investing activities             | (162)                              | (299)   |
| Net sales of trading securities                    | 20                                 | 27      |
| Deferred annuity and life policy acquisition costs | (148)                              | (177)   |
| Change in:                                         |                                    |         |
| Reinsurance and other receivables                  | (288)                              | (1,387) |
| Other assets                                       | (108)                              | 6       |
| Insurance claims and reserves                      | (7)                                | 1,275   |
| Payable to reinsurers                              | 126                                | 181     |
| Other liabilities                                  | 161                                | (56)    |
| Managed investment entities' assets/liabilities    | (23)                               | (13)    |
| Other operating activities, net                    | 25                                 | 12      |
| Net cash provided by operating activities          | 388                                | 487     |
| Investing Activities:                              |                                    |         |
| Purchases of:                                      |                                    |         |
| Fixed maturities                                   | (4,903)                            | (3,240) |
| Equity securities                                  | (334)                              | (231)   |
| Mortgage loans                                     | (100)                              | (178)   |
| Real estate, property and equipment                | (43)                               | (61)    |
| Proceeds from:                                     |                                    |         |
| Maturities and redemptions of fixed maturities     | 2,356                              | 1,617   |
| Repayments of mortgage loans                       | 97                                 | 10      |
| Sales of fixed maturities                          | 257                                | 495     |
| Sales of equity securities                         | 278                                | 235     |
| Sales of subsidiaries                              | —                                  | 302     |
| Cash and cash equivalents of businesses sold       | —                                  | (34)    |
| Managed investment entities:                       |                                    |         |
| Purchases of investments                           | (1,061)                            | (1,246) |
| Proceeds from sales and redemptions of investments | 1,515                              | 1,429   |
| Other investing activities, net                    | 25                                 | (36)    |
| Net cash used in investing activities              | (1,913)                            | (938)   |
| Financing Activities:                              |                                    |         |
| Annuity receipts                                   | 2,852                              | 2,431   |
| Annuity surrenders, benefits and withdrawals       | (1,157)                            | (1,127) |
| Net transfers from variable annuity assets         | 25                                 | 31      |
| Additional long-term borrowings                    | —                                  | 344     |

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|                                                        |         |         |   |
|--------------------------------------------------------|---------|---------|---|
| Reductions of long-term debt                           | (40     | ) (323  | ) |
| Issuances of managed investment entities' liabilities  | 747     | 456     |   |
| Retirement of managed investment entities' liabilities | (1,196  | ) (704  | ) |
| Issuances of Common Stock                              | 45      | 27      |   |
| Repurchases of Common Stock                            | (70     | ) (315  | ) |
| Cash dividends paid on Common Stock                    | (52     | ) (50   | ) |
| Other financing activities, net                        | (3      | ) (17   | ) |
| Net cash provided by financing activities              | 1,151   | 753     |   |
| Net Change in Cash and Cash Equivalents                | (374    | ) 302   |   |
| Cash and cash equivalents at beginning of period       | 1,705   | 1,324   |   |
| Cash and cash equivalents at end of period             | \$1,331 | \$1,626 |   |

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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A. Accounting Policies

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

Certain reclassifications have been made to prior periods to conform to the current year's presentation, primarily the reclassification of investment expenses and real estate income and expenses to net investment income. All significant intercompany balances and transactions have been eliminated. The results of operations of companies since their formation or acquisition are included in the consolidated financial statements. Events or transactions occurring subsequent to September 30, 2013, and prior to the filing date of this Form 10-Q, have been evaluated for potential recognition or disclosure herein.

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

**Accounting Standards Adopted in 2013** Effective January 1, 2013, AFG prospectively adopted Accounting Standards Update ("ASU") 2013-02, which requires companies to disclose, in a single location within the financial statements or footnotes, reclassifications out of accumulated other comprehensive income ("AOCI") separately for each component of other comprehensive income. For significant reclassifications, the disclosure is required to include the respective line items in net earnings affected by the reclassification. Disclosures required by the guidance are included in Note K — "Shareholders' Equity." This new disclosure requirement had no impact on AFG's results of operations or financial position.

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

nonrecurring fair value measurements of nonfinancial assets and liabilities in the first nine months of 2013 or 2012.

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

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

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — CONTINUED

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

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

**Goodwill** Goodwill represents the excess of cost of subsidiaries over AFG's equity in their underlying net assets. Goodwill is not amortized, but is subject to an impairment test at least annually. An entity is not required to complete the quantitative annual goodwill impairment test on a reporting unit if the entity elects to perform a qualitative analysis and determines that it is more likely than not that the reporting unit's fair value exceeds its carrying amount.

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

A subsidiary cedes life insurance policies to a third party on a funds withheld basis whereby the subsidiary retains the assets (securities) associated with the reinsurance contract. Interest is credited to the reinsurer based on the actual investment performance of the retained assets. This reinsurance contract is considered to contain an embedded derivative (that must be adjusted to fair value) because the yield on the payable is based on a specific block of the ceding company's assets, rather than the overall creditworthiness of the ceding company. AFG determined that changes in the fair value of the underlying portfolio of fixed maturity securities is an appropriate measure of the value of the embedded derivative. The securities related to this contract are classified as "trading." The adjustment to fair value on the embedded derivative offsets the investment income recorded on the adjustment to fair value of the related trading portfolio.

**Deferred Policy Acquisition Costs ("DPAC")** Policy acquisition costs (principally commissions, premium taxes and certain underwriting and policy issuance costs) directly related to the successful acquisition or renewal of an insurance contract are deferred. DPAC also includes capitalized costs associated with sales inducements offered to fixed annuity

policyholders such as enhanced interest rates and premium and persistency bonuses.

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

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

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adjustments to the amortization of DPAC related to annuities, such adjustments are reflected as components of realized gains (losses) on securities.

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. See Note A, “Accounting Policies — Life, Accident and Health Reserves” for details on the impact of loss recognition on the accounting for traditional life and health insurance contracts.

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

DPAC and certain other balance sheet amounts related to annuity, long-term care and life businesses are also adjusted, net of tax, for the change in expense that would have been recorded if the unrealized gains (losses) from securities had actually been realized. These adjustments are included in unrealized gains (losses) on marketable securities, a component of AOCI in AFG’s Balance Sheet.

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

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

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

The net gain or loss from accounting for the CLO assets and liabilities at fair value is separately presented in AFG’s Statement of Earnings. CLO earnings attributable to AFG’s shareholders represent the change in fair value of AFG’s investments in the CLOs (including distributions) and management fees earned. All other CLO earnings (losses) are not attributable to AFG’s shareholders and will ultimately inure to the benefit of the CLO debt holders. As a result, such CLO earnings (losses) are included in net earnings (loss) attributable to noncontrolling interests in AFG’s Statement of Earnings and in appropriated retained earnings — managed investment entities in the Balance Sheet. As the CLOs approach maturity (2016 to 2025), it is expected that losses attributable to noncontrolling interests will reduce

appropriated retained earnings towards zero as the fair values of the assets and liabilities converge and the CLO assets are used to pay the CLO debt.

At September 30, 2013, assets and liabilities of managed investment entities included \$193 million in assets and \$147 million in liabilities of a temporary warehousing entity that was established in connection with the formation of a new CLO that is expected to close in the fourth quarter of 2013. Upon closing, all warehoused assets are expected to be transferred to the new CLO and the liabilities will be repaid. At December 31, 2012, assets and liabilities of managed investment entities included \$107 million in assets and \$87 million in liabilities of a temporary warehousing entity that was established in connection with the formation of a new CLO. All warehoused assets were transferred to that new CLO and the liabilities were repaid when the CLO formation was completed and the CLO issued securities in April 2013.

**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

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — CONTINUED

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

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

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

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

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

**Unearned Revenue** Certain upfront policy charges on annuities are deferred as unearned revenue (included in other liabilities) and recognized in net earnings using the same assumptions and estimated gross profits used to amortize DPAC.

**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 unless a loss recognition event (premium deficiency) occurs. Claim reserves and liabilities established for accident and health claims are modified as necessary to reflect actual experience and developing trends.

For long-duration contracts (such as traditional life and long-term care policies), loss recognition occurs when, based on current expectations as of the measurement date, existing contract liabilities plus the present value of future premiums (including reasonably expected rate increases) are not expected to cover the present value of future claims payments and related settlement and maintenance costs (excluding overhead) as well as unamortized acquisition costs. If a block of business is determined to be in loss recognition, a charge is recorded in earnings in an amount equal to the excess of the present value of expected future claims costs and unamortized acquisition costs over existing reserves plus the present value of expected future premiums (with no provision for adverse deviation). The charge is recorded first to reduce unamortized acquisition costs and then as an additional reserve (if unamortized acquisition costs have been reduced to zero).

In addition, reserves for traditional life and long-term care policies are subject to adjustment for loss recognition charges that would have been recorded if the unrealized gains from securities had actually been realized. This adjustment is included in unrealized gains (losses) on marketable securities, a component of AOCI in AFG's Balance Sheet.

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

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

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

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

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

AFG recognizes the tax benefits of uncertain tax positions only when the position is more likely than not to be sustained under examination by the appropriate taxing authority. Interest and penalties on AFG's reserve for uncertain tax positions are recognized as a component of tax expense.

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

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

**Earnings Per Share** Although basic earnings per share only considers shares of common stock outstanding during the period, the calculation of diluted earnings per share includes the following adjustments to weighted average common shares related to stock-based compensation plans: third quarter of 2013 and 2012 — 1.9 million and 1.7 million; first nine months of 2013 and 2012 — 1.8 million and 1.7 million, respectively.

AFG's weighted average diluted shares outstanding excludes the following anti-dilutive potential common shares related to stock compensation plans: third quarter of 2013 and 2012 — 1.0 million and 1.9 million; first nine months of 2013 and 2012 — 1.3 million and 1.8 million, respectively. Adjustments to net earnings attributable to shareholders in the calculation of diluted earnings per share were nominal in the 2013 and 2012 periods.

**Statement of Cash Flows** For cash flow purposes, "investing activities" are defined as making and collecting loans and acquiring and disposing of debt or equity instruments and property and equipment. "Financing activities" include

obtaining resources from owners and providing them with a return on their investments, borrowing money and repaying amounts borrowed. Annuity receipts, surrenders, 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.

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## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — CONTINUED

## B. Acquisitions and Sales of Subsidiaries

**Medicare Supplement and Critical Illness Segment** In August 2012, AFG completed the sale of its Medicare supplement and critical illness businesses, which included Loyal American Life Insurance Company and four other insurance companies, to Cigna Corporation for \$326 million in cash resulting in a pretax gain of \$170 million (including fourth quarter 2012 post-closing adjustments, which increased cash proceeds by \$19 million and the pretax gain by \$15 million). Since the transaction includes the ongoing cessions of certain business to Cigna, the operations sold are not reported as discontinued operations. Summarized Statement of Earnings information for the Medicare supplement and critical illness segment for the third quarter and first nine months of 2012 is shown below (in millions):

|                              | Three months<br>ended<br>September 30,<br>2012 | Nine months<br>ended<br>September 30,<br>2012 |
|------------------------------|------------------------------------------------|-----------------------------------------------|
| Total revenues               | \$53                                           | \$212                                         |
| Total costs and expenses     | 43                                             | 184                                           |
| Earnings before income taxes | \$10                                           | \$28                                          |

During the third quarter of 2012, AFG acquired the outstanding 28% of Marketform, its London-based Lloyd's property and casualty insurance operation that it did not already own for \$17 million and sold an additional small annuity company for \$7 million.

## C. Segments of Operations

AFG manages its business as five segments: (i) Property and casualty insurance, (ii) Annuity, (iii) Run-off long-term care and life, (iv) Medicare supplement and critical illness (sold in August 2012) and (v) Other, which includes holding company costs, and the operations attributable to the noncontrolling interests of the managed investment entities.

AFG reports its property and casualty insurance business in the following Specialty sub-segments: (i) Property and transportation, which includes physical damage and liability coverage for buses, trucks and recreational vehicles, inland and ocean marine, agricultural-related products and other property coverages, (ii) Specialty casualty, which includes primarily excess and surplus, general liability, executive liability, umbrella and excess liability, customized programs for small to mid-sized businesses and workers' compensation, and (iii) Specialty financial, which includes risk management insurance programs for leasing and financing institutions (including collateral and lender-placed mortgage property insurance), surety and fidelity products and trade credit insurance. AFG's annuity business markets traditional fixed and fixed-indexed annuities in the retail, financial institutions and education markets. AFG's reportable segments and their components were determined based primarily upon similar economic characteristics, products and services.

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## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — CONTINUED

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

|                                                       | Three months ended<br>September 30, |         | Nine months ended<br>September 30, |         |
|-------------------------------------------------------|-------------------------------------|---------|------------------------------------|---------|
|                                                       | 2013                                | 2012    | 2013                               | 2012    |
| Revenues                                              |                                     |         |                                    |         |
| Property and casualty insurance:                      |                                     |         |                                    |         |
| Premiums earned:                                      |                                     |         |                                    |         |
| Specialty                                             |                                     |         |                                    |         |
| Property and transportation                           | \$517                               | \$487   | \$1,111                            | \$1,040 |
| Specialty casualty                                    | 289                                 | 243     | 825                                | 699     |
| Specialty financial                                   | 121                                 | 100     | 350                                | 301     |
| Other specialty                                       | 22                                  | 18      | 59                                 | 51      |
| Total premiums earned                                 | 949                                 | 848     | 2,345                              | 2,091   |
| Net investment income                                 | 65                                  | 67      | 196                                | 206     |
| Other income                                          | 1                                   | 6       | 10                                 | 17      |
| Total property and casualty insurance                 | 1,015                               | 921     | 2,551                              | 2,314   |
| Annuity:                                              |                                     |         |                                    |         |
| Net investment income                                 | 259                                 | 249     | 764                                | 722     |
| Other income                                          | 17                                  | 14      | 46                                 | 39      |
| Total annuity                                         | 276                                 | 263     | 810                                | 761     |
| Run-off long-term care and life                       | 50                                  | 50      | 147                                | 146     |
| Medicare supplement and critical illness (a)          | —                                   | 53      | —                                  | 212     |
| Other                                                 | 46                                  | 10      | 68                                 | 16      |
| Total revenues before realized gains                  | 1,387                               | 1,297   | 3,576                              | 3,449   |
| Realized gains on securities                          | 56                                  | 85      | 154                                | 145     |
| Realized gains on subsidiaries                        | —                                   | 156     | —                                  | 155     |
| Total revenues                                        | \$1,443                             | \$1,538 | \$3,730                            | \$3,749 |
| Earnings Before Income Taxes                          |                                     |         |                                    |         |
| Property and casualty insurance:                      |                                     |         |                                    |         |
| Underwriting:                                         |                                     |         |                                    |         |
| Specialty                                             |                                     |         |                                    |         |
| Property and transportation                           | \$16                                | \$—     | \$(5                               | ) \$33  |
| Specialty casualty                                    | 19                                  | 8       | 70                                 | 45      |
| Specialty financial                                   | 22                                  | 1       | 50                                 | 28      |
| Other specialty                                       | 5                                   | 7       | 16                                 | 10      |
| Other lines (b)                                       | (54                                 | ) (32   | ) (61                              | ) (39   |
| Total underwriting                                    | 8                                   | (16     | ) 70                               | 77      |
| Investment and other income, net                      | 53                                  | 58      | 169                                | 173     |
| Total property and casualty insurance                 | 61                                  | 42      | 239                                | 250     |
| Annuity (c)                                           | 78                                  | 69      | 231                                | 188     |
| Run-off long-term care and life                       | (4                                  | ) 2     | (7                                 | ) 8     |
| Medicare supplement and critical illness (a)          | —                                   | 10      | —                                  | 28      |
| Other (d)                                             | (49                                 | ) (79   | ) (174                             | ) (207  |
| Total earnings before realized gains and income taxes | 86                                  | 44      | 289                                | 267     |
| Realized gains on securities                          | 56                                  | 85      | 154                                | 145     |

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|                                    |        |        |        |        |
|------------------------------------|--------|--------|--------|--------|
| Realized gains on subsidiaries     | —      | 156    | —      | 155    |
| Total earnings before income taxes | \$ 142 | \$ 285 | \$ 443 | \$ 567 |

(a) Sold in August 2012.

(b) Includes special charges of \$54 million and \$31 million in the third quarter of 2013 and 2012, respectively, to increase asbestos and environmental (“A&E”) reserves.

(c) Includes a \$5 million charge in the second quarter of 2013 to cover expected assessments from state guaranty funds related to the insolvency and liquidation of an unaffiliated life insurance company.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — CONTINUED

(d) Includes holding company expenses and earnings (losses) of managed investment entities attributable to noncontrolling interest of \$12 million and (\$18) million for the third quarter and (\$30) million and (\$64) million for the first nine months of 2013 and 2012, respectively. Holding company expenses for the third quarter of 2013 includes special charges totaling \$22 million to increase A&E reserves related to AFG's former railroad and manufacturing operations. Holding company expenses for the third quarter of 2012 include an \$8 million loss on retirement of debt and a \$15 million charge for a labor matter related to AFG's former railroad operations.

D. Fair Value Measurements

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

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

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

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

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

verifying, on a test basis, the inputs used by the service to value specific securities.

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

|                                                   | Level 1 | Level 2  | Level 3 | Total    |
|---------------------------------------------------|---------|----------|---------|----------|
| September 30, 2013                                |         |          |         |          |
| Assets:                                           |         |          |         |          |
| Available for sale (“AFS”) fixed maturities:      |         |          |         |          |
| U.S. Government and government agencies           | \$163   | \$143    | \$19    | \$325    |
| States, municipalities and political subdivisions | —       | 5,014    | 62      | 5,076    |
| Foreign government                                | —       | 230      | —       | 230      |
| Residential MBS                                   | —       | 3,955    | 321     | 4,276    |
| Commercial MBS                                    | —       | 2,742    | 28      | 2,770    |
| Asset-backed securities (“ABS”)                   | —       | 2,102    | 186     | 2,288    |
| Corporate and other                               | 15      | 10,404   | 290     | 10,709   |
| Total AFS fixed maturities                        | 178     | 24,590   | 906     | 25,674   |
| Trading fixed maturities                          | —       | 290      | —       | 290      |
| Equity securities                                 | 964     | 122      | 57      | 1,143    |
| Assets of managed investment entities (“MIE”)     | 224     | 2,524    | 31      | 2,779    |
| Variable annuity assets (separate accounts) (a)   | —       | 629      | —       | 629      |
| Other investments — derivatives                   | —       | 197      | —       | 197      |
| Total assets accounted for at fair value          | \$1,366 | \$28,352 | \$994   | \$30,712 |
| Liabilities:                                      |         |          |         |          |
| Liabilities of managed investment entities        | \$105   | \$—      | \$2,324 | \$2,429  |
| Derivatives in annuity benefits accumulated       | —       | —        | 653     | 653      |
| Other liabilities — derivatives                   | —       | 10       | —       | 10       |
| Total liabilities accounted for at fair value     | \$105   | \$10     | \$2,977 | \$3,092  |
| December 31, 2012                                 |         |          |         |          |
| Assets:                                           |         |          |         |          |
| Available for sale fixed maturities:              |         |          |         |          |
| U.S. Government and government agencies           | \$227   | \$141    | \$20    | \$388    |
| States, municipalities and political subdivisions | —       | 4,410    | 58      | 4,468    |
| Foreign government                                | —       | 260      | —       | 260      |
| Residential MBS                                   | —       | 3,833    | 371     | 4,204    |
| Commercial MBS                                    | —       | 2,896    | 22      | 2,918    |
| Asset-backed securities                           | —       | 1,387    | 253     | 1,640    |
| Corporate and other                               | 5       | 9,999    | 236     | 10,240   |
| Total AFS fixed maturities                        | 232     | 22,926   | 960     | 24,118   |
| Trading fixed maturities                          | —       | 321      | —       | 321      |
| Equity securities                                 | 781     | 121      | 37      | 939      |
| Assets of managed investment entities             | 256     | 2,929    | 40      | 3,225    |
| Variable annuity assets (separate accounts) (a)   | —       | 580      | —       | 580      |
| Other investments — derivatives                   | —       | 133      | —       | 133      |
| Total assets accounted for at fair value          | \$1,269 | \$27,010 | \$1,037 | \$29,316 |
| Liabilities:                                      |         |          |         |          |
| Liabilities of managed investment entities        | \$147   | \$—      | \$2,745 | \$2,892  |
| Derivatives in annuity benefits accumulated       | —       | —        | 465     | 465      |

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|                                               |       |      |         |         |
|-----------------------------------------------|-------|------|---------|---------|
| Other liabilities — derivatives               | —     | 17   | —       | 17      |
| Total liabilities accounted for at fair value | \$147 | \$17 | \$3,210 | \$3,374 |

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

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## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — CONTINUED

During the three months and nine months ended September 30, 2013, six and eleven preferred stocks with an aggregate fair value of \$46 million and \$57 million, respectively, and one common stock with an aggregate fair value of \$16 million, were transferred from Level 2 to Level 1 due to increases in trade frequency, resulting in trade data sufficient to warrant classification in Level 1. During the first nine months of 2013 (in the third quarter), there was one preferred stock with a fair value of \$10 million transferred from Level 1 to Level 2 due to a decrease in trade frequency, resulting in lack of available trade data sufficient to warrant classification in Level 1. During the first nine months of 2012 (all in the first quarter), six preferred stocks with an aggregate fair value of \$35 million were transferred from Level 1 to Level 2 due to decreases in trade frequency, resulting in lack of available trade data sufficient to warrant classification in Level 1. During the first nine months 2012, there were no transfers from Level 2 to Level 1. Approximately 3% of the total assets carried at fair value on September 30, 2013, were Level 3 assets. Approximately 79% of the Level 3 assets were priced using non-binding broker quotes, for which there is a lack of transparency as to the inputs used to determine fair value. Details as to the quantitative inputs are neither provided by the brokers nor otherwise reasonably obtainable by AFG. Since internally developed Level 3 asset fair values represent less than one-half of 1% of the total assets measured at fair value and less than 3% of AFG's shareholders' equity, changes in unobservable inputs used to determine internally developed fair values would not have a material impact on AFG's financial position.

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

The only significant Level 3 assets or liabilities carried at fair value in the financial statements that were not measured using broker quotes are the derivatives embedded in AFG's fixed-indexed annuity liabilities, which are measured using a discounted cash flow approach and had a fair value of \$653 million at September 30, 2013. The following table presents information about the unobservable inputs used by management in determining fair value of these embedded derivatives. See Note F — "Derivatives."

| Unobservable Input                                | Range                                 |
|---------------------------------------------------|---------------------------------------|
| Adjustment for insurance subsidiary's credit risk | 0.50% – 2.00% over the risk free rate |
| Risk margin for uncertainty in cash flows         | 0.4% reduction in the discount rate   |
| Surrenders                                        | 4% – 20% of indexed account value     |
| Partial surrenders                                | 2% – 5% of indexed account value      |
| Annuitizations                                    | 1% – 2% of indexed account value      |
| Deaths                                            | 1% – 2.5% of indexed account value    |
| Budgeted option costs                             | 2.5% – 4.0% of indexed account value  |

The range of adjustments for insurance subsidiary's credit risk reflects credit spread variations across the yield curve. The range of projected surrender rates reflects the specific surrender charges and other features of AFG's individual fixed-indexed annuity products with an expected range of 5% to 12% in the majority of future calendar years (4% to 20% over all periods). Increasing the budgeted option cost or risk margin for uncertainty in cash flows assumptions in the table above would increase the fair value of the fixed-indexed annuity embedded derivatives, while increasing any of the other unobservable inputs in the table above would decrease the fair value of the embedded derivatives.



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## AMERICAN FINANCIAL GROUP, INC. 10-Q

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — CONTINUED

Changes in balances of Level 3 financial assets and liabilities carried at fair value during the third quarter and first nine months of 2013 and 2012 are presented below (in millions). The transfers into and out of Level 3 were due to changes in the availability of market observable inputs. All transfers are reflected in the table at fair value as of the end of the reporting period.

|                         | Balance at<br>June 30,<br>2013 | Total<br>realized/unrealized<br>gains (losses) included<br>in<br>Net<br>income | Other<br>comprehensive<br>income (loss) | Purchases<br>and<br>issuances | Sales and<br>settlements | Transfer<br>into<br>Level 3 | Transfer<br>out of<br>Level 3 | Balance at<br>September<br>30, 2013 |
|-------------------------|--------------------------------|--------------------------------------------------------------------------------|-----------------------------------------|-------------------------------|--------------------------|-----------------------------|-------------------------------|-------------------------------------|
| AFS fixed maturities:   |                                |                                                                                |                                         |                               |                          |                             |                               |                                     |
| U.S. government agency  | \$20                           | \$—                                                                            | \$ (1 )                                 | \$—                           | \$—                      | \$—                         | \$—                           | \$19                                |
| State and municipal     | 63                             | —                                                                              | (1 )                                    | —                             | —                        | —                           | —                             | 62                                  |
| Residential MBS         | 329                            | 1                                                                              | 8                                       | —                             | (13 )                    | 43                          | (47 )                         | 321                                 |
| Commercial MBS          | 28                             | 1                                                                              | (1 )                                    | —                             | —                        | —                           | —                             | 28                                  |
| Asset-backed securities | 180                            | —                                                                              | —                                       | —                             | (4 )                     | 11                          | (1 )                          | 186                                 |
| Corporate and other     | 295                            | —                                                                              | (4 )                                    | 6                             | (3 )                     | —                           | (4 )                          | 290                                 |
| Equity securities       | 78                             | (2 )                                                                           | —                                       | —                             | —                        | —                           | (19 )                         | 57                                  |
| Assets of MIE           | 31                             | —                                                                              | —                                       | —                             | —                        | —                           | —                             | 31                                  |
| Liabilities of MIE (*)  | (2,482 )                       | 17                                                                             | —                                       | (95 )                         | 236                      | —                           | —                             | (2,324 )                            |
| Embedded derivatives    | (577 )                         | (33 )                                                                          | —                                       | (53 )                         | 10                       | —                           | —                             | (653 )                              |

(\*) Total realized/unrealized loss included in net income includes gains of \$20 million related to liabilities outstanding as of September 30, 2013. See Note H — “Managed Investment Entities.”

|                         | Balance at<br>June 30,<br>2012 | Total<br>realized/unrealized<br>gains (losses) included<br>in<br>Net<br>income | Other<br>comprehensive<br>income (loss) | Purchases<br>and<br>issuances | Sales and<br>settlements | Transfer<br>into<br>Level 3 | Transfer<br>out of<br>Level 3 | Balance at<br>September<br>30, 2012 |
|-------------------------|--------------------------------|--------------------------------------------------------------------------------|-----------------------------------------|-------------------------------|--------------------------|-----------------------------|-------------------------------|-------------------------------------|
| AFS fixed maturities:   |                                |                                                                                |                                         |                               |                          |                             |                               |                                     |
| U.S. government agency  | \$20                           | \$—                                                                            | \$ —                                    | \$—                           | \$—                      | \$—                         | \$—                           | \$20                                |
| State and municipal     | 86                             | —                                                                              | 2                                       | —                             | (6 )                     | 4                           | (28 )                         | 58                                  |
| Residential MBS         | 320                            | 3                                                                              | 7                                       | 15                            | (11 )                    | 86                          | (53 )                         | 367                                 |
| Commercial MBS          | 20                             | 1                                                                              | —                                       | —                             | —                        | —                           | —                             | 21                                  |
| Asset-backed securities | 240                            | 1                                                                              | 3                                       | 22                            | (9 )                     | 1                           | (8 )                          | 250                                 |
| Corporate and other     | 297                            | 1                                                                              | 3                                       | 45                            | (10 )                    | —                           | (91 )                         | 245                                 |

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|                          |        |       |     |     |      |     |     |        |   |
|--------------------------|--------|-------|-----|-----|------|-----|-----|--------|---|
| Trading fixed maturities | 1      | —     | —   | —   | —    | —   | —   | 1      |   |
| Equity securities        | 41     | —     | —   | 4   | —    | 9   | (18 | ) 36   |   |
| Assets of MIE            | 54     | —     | —   | —   | (1   | ) — | (18 | ) 35   |   |
| Liabilities of MIE (*)   | (2,429 | ) (52 | ) — | (97 | ) 72 | —   | —   | (2,506 | ) |
| Embedded derivatives     | (444   | ) (40 | ) — | (20 | ) 7  | —   | —   | (497   | ) |

(\*) Total realized/unrealized loss included in net income includes losses of \$49 million related to liabilities outstanding as of September 30, 2012. See Note H — “Managed Investment Entities.”

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## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — CONTINUED

|                         | Balance at<br>December<br>31, 2012 | Total<br>realized/unrealized<br>gains (losses) included<br>in<br>Net<br>income | Other<br>comprehensive<br>income (loss) | Purchases<br>and<br>issuances | Sales and<br>settlements | Transfer<br>into<br>Level 3 | Transfer<br>out of<br>Level 3 | Balance at<br>September<br>30, 2013 |
|-------------------------|------------------------------------|--------------------------------------------------------------------------------|-----------------------------------------|-------------------------------|--------------------------|-----------------------------|-------------------------------|-------------------------------------|
| AFS fixed maturities:   |                                    |                                                                                |                                         |                               |                          |                             |                               |                                     |
| U.S. government agency  | \$20                               | \$—                                                                            | \$ (1 )                                 | \$—                           | \$—                      | \$—                         | \$—                           | \$19                                |
| State and municipal     | 58                                 | —                                                                              | (2 )                                    | 10                            | —                        | —                           | (4 )                          | 62                                  |
| Residential MBS         | 371                                | 5                                                                              | 7                                       | 6                             | (42 )                    | 68                          | (94 )                         | 321                                 |
| Commercial MBS          | 22                                 | —                                                                              | (1 )                                    | —                             | —                        | 7                           | —                             | 28                                  |
| Asset-backed securities | 253                                | 3                                                                              | (2 )                                    | 12                            | (49 )                    | 11                          | (42 )                         | 186                                 |
| Corporate and other     | 236                                | —                                                                              | (14 )                                   | 61                            | (9 )                     | 24                          | (8 )                          | 290                                 |
| Equity securities       | 37                                 | (2 )                                                                           | 2                                       | 48                            | —                        | —                           | (28 )                         | 57                                  |
| Assets of MIE           | 40                                 | (3 )                                                                           | —                                       | 6                             | (6 )                     | —                           | (6 )                          | 31                                  |
| Liabilities of MIE (*)  | (2,745 )                           | (22 )                                                                          | —                                       | (501 )                        | 925                      | —                           | 19                            | (2,324 )                            |
| Embedded derivatives    | (465 )                             | (110 )                                                                         | —                                       | (102 )                        | 24                       | —                           | —                             | (653 )                              |

(\*) Total realized/unrealized loss included in net income includes gains of \$2 million related to liabilities outstanding as of September 30, 2013. See Note H — “Managed Investment Entities.”

|                          | Balance at<br>December<br>31, 2011 | Total<br>realized/unrealized<br>gains (losses) included<br>in<br>Net<br>income | Other<br>comprehensive<br>income (loss) | Purchases<br>and<br>issuances | Sales and<br>settlements | Transfer<br>into<br>Level 3 | Transfer<br>out of<br>Level 3 | Balance at<br>September<br>30, 2012 |
|--------------------------|------------------------------------|--------------------------------------------------------------------------------|-----------------------------------------|-------------------------------|--------------------------|-----------------------------|-------------------------------|-------------------------------------|
| AFS fixed maturities:    |                                    |                                                                                |                                         |                               |                          |                             |                               |                                     |
| U.S. government agency   | \$—                                | \$—                                                                            | \$ —                                    | \$20                          | \$—                      | \$—                         | \$—                           | \$20                                |
| State and municipal      | 83                                 | —                                                                              | 4                                       | 19                            | (7 )                     | 9                           | (50 )                         | 58                                  |
| Residential MBS          | 361                                | 5                                                                              | 11                                      | 86                            | (29 )                    | 167                         | (234 )                        | 367                                 |
| Commercial MBS           | 19                                 | 1                                                                              | 1                                       | —                             | —                        | —                           | —                             | 21                                  |
| Asset-backed securities  | 220                                | 6                                                                              | 8                                       | 40                            | (23 )                    | 14                          | (15 )                         | 250                                 |
| Corporate and other      | 299                                | 3                                                                              | 10                                      | 84                            | (34 )                    | 15                          | (132 )                        | 245                                 |
| Trading fixed maturities | 1                                  | —                                                                              | —                                       | —                             | —                        | —                           | —                             | 1                                   |
| Equity securities        | 11                                 | —                                                                              | —                                       | 30                            | —                        | 13                          | (18 )                         | 36                                  |
| Assets of MIE            | 44                                 | —                                                                              | —                                       | 13                            | (13 )                    | 14                          | (23 )                         | 35                                  |
| Liabilities of MIE (*)   | (2,593 )                           | (155 )                                                                         | —                                       | (463 )                        | 705                      | —                           | —                             | (2,506 )                            |

|                         |      |   |     |   |   |     |   |    |   |   |      |   |
|-------------------------|------|---|-----|---|---|-----|---|----|---|---|------|---|
| Embedded<br>derivatives | (361 | ) | (97 | ) | — | (57 | ) | 18 | — | — | (497 | ) |
|-------------------------|------|---|-----|---|---|-----|---|----|---|---|------|---|

(\*) Total realized/unrealized loss included in net income includes losses of \$99 million related to liabilities outstanding as of September 30, 2012. See Note H — “Managed Investment Entities.”

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## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — CONTINUED

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

|                                                             | Carrying<br>Value | Fair<br>Value | Level 1 | Level 2 | Level 3  |
|-------------------------------------------------------------|-------------------|---------------|---------|---------|----------|
| September 30, 2013                                          |                   |               |         |         |          |
| Financial assets:                                           |                   |               |         |         |          |
| Cash and cash equivalents                                   | \$1,331           | \$1,331       | \$1,331 | \$—     | \$—      |
| Mortgage loans                                              | 611               | 613           | —       | —       | 613      |
| Policy loans                                                | 240               | 240           | —       | —       | 240      |
| Total financial assets not accounted for at fair value      | \$2,182           | \$2,184       | \$1,331 | \$—     | \$853    |
| Financial liabilities:                                      |                   |               |         |         |          |
| Annuity benefits accumulated (*)                            | \$19,584          | \$18,659      | \$—     | \$—     | \$18,659 |
| Long-term debt                                              | 913               | 992           | —       | 916     | 76       |
| Total financial liabilities not accounted for at fair value | \$20,497          | \$19,651      | \$—     | \$916   | \$18,735 |
| December 31, 2012                                           |                   |               |         |         |          |
| Financial assets:                                           |                   |               |         |         |          |
| Cash and cash equivalents                                   | \$1,705           | \$1,705       | \$1,705 | \$—     | \$—      |
| Mortgage loans                                              | 607               | 613           | —       | —       | 613      |
| Policy loans                                                | 228               | 228           | —       | —       | 228      |
| Total financial assets not accounted for at fair value      | \$2,540           | \$2,546       | \$1,705 | \$—     | \$841    |
| Financial liabilities:                                      |                   |               |         |         |          |
| Annuity benefits accumulated (*)                            | \$17,405          | \$17,422      | \$—     | \$—     | \$17,422 |
| Long-term debt                                              | 953               | 1,086         | —       | 990     | 96       |
| Total financial liabilities not accounted for at fair value | \$18,358          | \$18,508      | \$—     | \$990   | \$17,518 |

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

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

## E. Investments

Available for sale fixed maturities and equity securities at September 30, 2013, and December 31, 2012, consisted of the following (in millions):

|                                         | September 30, 2013 |               |                |                      | December 31, 2012 |               |                |                      |
|-----------------------------------------|--------------------|---------------|----------------|----------------------|-------------------|---------------|----------------|----------------------|
|                                         | Amortized<br>Cost  | Fair<br>Value | Gross<br>Gains | Unrealized<br>Losses | Amortized<br>Cost | Fair<br>Value | Gross<br>Gains | Unrealized<br>Losses |
| Fixed maturities:                       |                    |               |                |                      |                   |               |                |                      |
| U.S. Government and government agencies | \$316              | \$325         | \$9            | \$—                  | \$373             | \$388         | \$15           | \$—                  |

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|                                                   |          |          |         |          |          |          |         |         |
|---------------------------------------------------|----------|----------|---------|----------|----------|----------|---------|---------|
| States, municipalities and political subdivisions | 4,995    | 5,076    | 181     | (100 )   | 4,144    | 4,468    | 329     | (5 )    |
| Foreign government                                | 219      | 230      | 11      | —        | 242      | 260      | 18      | —       |
| Residential MBS                                   | 3,943    | 4,276    | 369     | (36 )    | 3,921    | 4,204    | 337     | (54 )   |
| Commercial MBS                                    | 2,557    | 2,770    | 216     | (3 )     | 2,583    | 2,918    | 335     | —       |
| Asset-backed securities                           | 2,270    | 2,288    | 34      | (16 )    | 1,590    | 1,640    | 52      | (2 )    |
| Corporate and other                               | 10,136   | 10,709   | 658     | (85 )    | 9,230    | 10,240   | 1,015   | (5 )    |
| Total fixed maturities                            | \$24,436 | \$25,674 | \$1,478 | \$(240 ) | \$22,083 | \$24,118 | \$2,101 | \$(66 ) |
| Common stocks                                     | \$725    | \$914    | \$195   | \$(6 )   | \$600    | \$749    | \$157   | \$(8 )  |
| Perpetual preferred stocks                        | \$231    | \$229    | \$8     | \$(10 )  | \$178    | \$190    | \$13    | \$(1 )  |

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## AMERICAN FINANCIAL GROUP, INC. 10-Q

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — CONTINUED

The non-credit related portion of other-than-temporary impairment charges is included in other comprehensive income. Cumulative non-credit charges taken for securities still owned at September 30, 2013 and December 31, 2012, respectively, were \$226 million and \$227 million; these charges relate to residential MBS.

The following tables show gross unrealized losses (in millions) on fixed maturities and equity securities by investment category and length of time that individual securities have been in a continuous unrealized loss position at September 30, 2013 and December 31, 2012.

|                                                   | Less Than Twelve Months |            |           | Twelve Months or More |            |           |     |   |
|---------------------------------------------------|-------------------------|------------|-----------|-----------------------|------------|-----------|-----|---|
|                                                   | Unrealized Loss         | Fair Value | % of Cost | Unrealized Loss       | Fair Value | % of Cost |     |   |
| September 30, 2013                                |                         |            |           |                       |            |           |     |   |
| Fixed maturities:                                 |                         |            |           |                       |            |           |     |   |
| U.S. Government and government agencies           | \$—                     | \$33       | 100       | %                     | \$—        | \$—       | —   | % |
| States, municipalities and political subdivisions | (99                     | ) 1,824    | 95        | %                     | (1         | ) 26      | 96  | % |
| Residential MBS                                   | (9                      | ) 487      | 98        | %                     | (27        | ) 252     | 90  | % |
| Commercial MBS                                    | (3                      | ) 73       | 96        | %                     | —          | —         | —   | % |
| Asset-backed securities                           | (15                     | ) 1,013    | 99        | %                     | (1         | ) 28      | 97  | % |
| Corporate and other                               | (83                     | ) 2,150    | 96        | %                     | (2         | ) 34      | 94  | % |
| Total fixed maturities                            | \$(209                  | ) \$5,580  | 96        | %                     | \$(31      | ) \$340   | 92  | % |
| Common stocks                                     | \$(6                    | ) \$98     | 94        | %                     | \$—        | \$—       | —   | % |
| Perpetual preferred stocks                        | \$(7                    | ) \$84     | 92        | %                     | \$(3       | ) \$23    | 88  | % |
| December 31, 2012                                 |                         |            |           |                       |            |           |     |   |
| Fixed maturities:                                 |                         |            |           |                       |            |           |     |   |
| U.S. Government and government agencies           | \$—                     | \$22       | 100       | %                     | \$—        | \$—       | —   | % |
| States, municipalities and political subdivisions | (5                      | ) 285      | 98        | %                     | —          | 24        | 100 | % |
| Residential MBS                                   | (3                      | ) 146      | 98        | %                     | (51        | ) 411     | 89  | % |
| Commercial MBS                                    | —                       | 16         | 100       | %                     | —          | —         | —   | % |
| Asset-backed securities                           | —                       | 146        | 100       | %                     | (2         | ) 57      | 97  | % |
| Corporate and other                               | (3                      | ) 237      | 99        | %                     | (2         | ) 51      | 96  | % |
| Total fixed maturities                            | \$(11                   | ) \$852    | 99        | %                     | \$(55      | ) \$543   | 91  | % |
| Common stocks                                     | \$(8                    | ) \$88     | 92        | %                     | \$—        | \$—       | —   | % |
| Perpetual preferred stocks                        | \$—                     | \$7        | 100       | %                     | \$(1       | ) \$25    | 96  | % |

At September 30, 2013, the gross unrealized losses on fixed maturities of \$240 million relate to approximately 1,100 securities. Investment grade securities (as determined by nationally recognized rating agencies) represented approximately 83% of the gross unrealized loss and 88% of the fair value.

AFG analyzes its MBS securities for other-than-temporary impairment each quarter based upon expected future cash flows. Management estimates expected future cash flows based upon its knowledge of the MBS market, cash flow projections (which reflect loan to collateral values, subordination, vintage and geographic concentration) received from independent sources, implied cash flows inherent in security ratings and analysis of historical payment data. In the first nine months of 2013, AFG recorded less than \$1 million in other-than-temporary impairment charges related to its residential MBS.

Management believes AFG will recover its cost basis in the securities with unrealized losses and that AFG has the ability to hold the securities until they recover in value and had no intent to sell them at September 30, 2013.

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## AMERICAN FINANCIAL GROUP, INC. 10-Q

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — CONTINUED

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

|                                      | 2013  | 2012  |
|--------------------------------------|-------|-------|
| Balance at June 30                   | \$191 | \$191 |
| Additional credit impairments on:    |       |       |
| Previously impaired securities       | —     | —     |
| Securities without prior impairments | —     | —     |
| Reductions — disposals               | —     | —     |
| Balance at September 30              | \$191 | \$191 |
| Balance at January 1                 | \$192 | \$187 |
| Additional credit impairments on:    |       |       |
| Previously impaired securities       | —     | 4     |
| Securities without prior impairments | —     | —     |
| Reductions — disposals               | (1    | ) —   |
| Balance at September 30              | \$191 | \$191 |

The table below sets forth the scheduled maturities of available for sale fixed maturities as of September 30, 2013 (in millions). 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.

|                                                 | Amortized<br>Cost | Fair Value<br>Amount | %   |   |
|-------------------------------------------------|-------------------|----------------------|-----|---|
| Maturity                                        |                   |                      |     |   |
| One year or less                                | \$965             | \$983                | 4   | % |
| After one year through five years               | 4,626             | 4,970                | 19  | % |
| After five years through ten years              | 7,010             | 7,307                | 29  | % |
| After ten years                                 | 3,065             | 3,080                | 12  | % |
|                                                 | 15,666            | 16,340               | 64  | % |
| ABS (average life of approximately 4 1/2 years) | 2,270             | 2,288                | 9   | % |
| MBS (average life of approximately 4 years)     | 6,500             | 7,046                | 27  | % |
| Total                                           | \$24,436          | \$25,674             | 100 | % |

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

There were no investments in individual issuers that exceeded 10% of Shareholders' Equity at September 30, 2013 or December 31, 2012.

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## AMERICAN FINANCIAL GROUP, INC. 10-Q

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — CONTINUED

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

|                                    | Pretax  | Deferred Tax and<br>Amounts<br>Attributable<br>to Noncontrolling<br>Interests | Net     |
|------------------------------------|---------|-------------------------------------------------------------------------------|---------|
| September 30, 2013                 |         |                                                                               |         |
| Unrealized gain on:                |         |                                                                               |         |
| Fixed maturities                   | \$1,238 | \$ (441 )                                                                     | \$797   |
| Equity securities                  | 187     | (68 )                                                                         | 119     |
| Deferred policy acquisition costs  | (413 )  | ) 145                                                                         | (268 )  |
| Annuity benefits accumulated       | (84 )   | ) 29                                                                          | (55 )   |
| Life, accident and health reserves | (68 )   | ) 24                                                                          | (44 )   |
| Other liabilities                  | 29      | (10 )                                                                         | 19      |
|                                    | \$889   | \$ (321 )                                                                     | \$568   |
| December 31, 2012                  |         |                                                                               |         |
| Unrealized gain on:                |         |                                                                               |         |
| Fixed maturities                   | \$2,035 | \$ (726 )                                                                     | \$1,309 |
| Equity securities                  | 161     | (57 )                                                                         | 104     |
| Deferred policy acquisition costs  | (710 )  | ) 247                                                                         | (463 )  |
| Annuity benefits accumulated       | (136 )  | ) 48                                                                          | (88 )   |
| Life, accident and health reserves | (117 )  | ) 41                                                                          | (76 )   |
| Other liabilities                  | 57      | (20 )                                                                         | 37      |
|                                    | \$1,290 | \$ (467 )                                                                     | \$823   |

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## AMERICAN FINANCIAL GROUP, INC. 10-Q

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — CONTINUED

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

|                                      | Fixed<br>Maturities | Equity<br>Securities | Mortgage<br>Loans<br>and Other<br>Investments | Other (a) | Tax<br>Effects | Noncon-<br>trolling<br>Interests | Total  |
|--------------------------------------|---------------------|----------------------|-----------------------------------------------|-----------|----------------|----------------------------------|--------|
| Quarter ended September 30, 2013     |                     |                      |                                               |           |                |                                  |        |
| Realized before impairments          | \$ 6                | \$ 54                | \$ —                                          | \$ 1      | \$(22)         | \$(1)                            | \$ 38  |
| Realized — impairments               | —                   | (5)                  | —                                             | —         | 2              | —                                | (3)    |
| Change in unrealized                 | (57)                | (28)                 | —                                             | 37        | 16             | —                                | (32)   |
| Quarter ended September 30, 2012     |                     |                      |                                               |           |                |                                  |        |
| Realized before impairments          | \$ 20               | \$ 77                | \$ —                                          | \$(4)     | \$(33)         | \$—                              | \$ 60  |
| Realized — impairments               | (1)                 | (9)                  | —                                             | 2         | 3              | —                                | (5)    |
| Change in unrealized                 | 378                 | (18)                 | —                                             | (122)     | (84)           | (4)                              | 150    |
| Nine months ended September 30, 2013 |                     |                      |                                               |           |                |                                  |        |
| Realized before impairments          | \$ 33               | \$ 125               | \$ 2                                          | \$—       | \$(57)         | \$(2)                            | \$ 101 |
| Realized — impairments               | —                   | (5)                  | (1)                                           | —         | 2              | —                                | (4)    |
| Change in unrealized                 | (797)               | 26                   | —                                             | 370       | 140            | 6                                | (255)  |
| Nine months ended September 30, 2012 |                     |                      |                                               |           |                |                                  |        |
| Realized before impairments          | \$ 40               | \$ 133               | \$(3)                                         | \$(6)     | \$(58)         | \$(1)                            | \$ 105 |
| Realized — impairments               | (5)                 | (19)                 | —                                             | 5         | 7              | —                                | (12)   |
| Change in unrealized                 | 741                 | 22                   | —                                             | (224)     | (189)          | (7)                              | 343    |

(a) Primarily adjustments to deferred policy acquisition costs and reserves related to annuities and long-term care business.

Realized gains (losses) on securities includes net gains of \$1 million in the third quarter and less than \$1 million in the first nine months of 2013 compared to net gains of \$1 million in the third quarter and \$4 million in the first nine months of 2012 from the mark-to-market of certain MBS, primarily interest-only securities with interest rates that float inversely with short-term rates. Gross realized gains and losses (excluding impairment writedowns and mark-to-market of derivatives) on available for sale fixed maturity and equity security investment transactions included in the Statement of Cash Flows consisted of the following (in millions):

|                    | Nine months ended<br>September 30, |       |
|--------------------|------------------------------------|-------|
|                    | 2013                               | 2012  |
| Fixed maturities:  |                                    |       |
| Gross gains        | \$ 36                              | \$ 37 |
| Gross losses       | (4)                                | (2)   |
| Equity securities: |                                    |       |
| Gross gains        | 126                                | 136   |
| Gross losses       | (6)                                | (3)   |



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## AMERICAN FINANCIAL GROUP, INC. 10-Q

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — CONTINUED

## F. Derivatives

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

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

| Derivative                                    | Balance Sheet Line           | September 30, 2013 |           | December 31, 2012 |           |
|-----------------------------------------------|------------------------------|--------------------|-----------|-------------------|-----------|
|                                               |                              | Asset              | Liability | Asset             | Liability |
| MBS with embedded derivatives                 | Fixed maturities             | \$126              | \$—       | \$110             | \$—       |
| Public company warrants                       | Equity securities            | 16                 | —         | —                 | —         |
| Interest rate swaptions                       | Other investments            | 2                  | —         | 1                 | —         |
| Fixed-indexed annuities (embedded derivative) | Annuity benefits accumulated | —                  | 653       | —                 | 465       |
| Equity index call options                     | Other investments            | 195                | —         | 132               | —         |
| Reinsurance contracts (embedded derivative)   | Other liabilities            | —                  | 10        | —                 | 17        |
|                                               |                              | \$339              | \$663     | \$243             | \$482     |

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

Warrants to purchase shares of publicly traded companies, which represent a small component of AFG’s overall investment portfolio, are considered to be derivatives that must be marked to market through earnings.

AFG has \$600 million notional amount of pay-fixed interest rate swaptions (options to enter into pay-fixed/receive floating interest rate swaps at future dates expiring between 2013 and 2015) outstanding at September 30, 2013 which are used to mitigate interest rate risk in its annuity operations. AFG paid \$18 million to purchase these swaptions, which represents its maximum potential economic loss over the life of the contracts.

AFG’s fixed-indexed annuities, which represented approximately 45% of annuity benefits accumulated at September 30, 2013, provide policyholders with a crediting rate tied, in part, to the performance of an existing stock market index. AFG attempts to mitigate the risk in the index-based component of these products through the purchase of call options on the appropriate index. AFG’s strategy is designed so that an increase in the liabilities, due to an increase in the market index, will be generally offset by unrealized and realized gains on the call options purchased by AFG. Both the index-based component of the annuities and the related call options are considered derivatives.

As discussed under “Reinsurance” in Note A, certain reinsurance contracts are considered to contain embedded derivatives.

The following table summarizes the gain (loss) included in the Statement of Earnings for changes in the fair value of these derivatives for the third quarter and first nine months of 2013 and 2012 (in millions):

| Three months ended<br>September 30, | Nine months ended<br>September 30, |
|-------------------------------------|------------------------------------|
|-------------------------------------|------------------------------------|

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| Derivative                                    | Statement of Earnings Line   | 2013 | 2012  | 2013   | 2012  |   |
|-----------------------------------------------|------------------------------|------|-------|--------|-------|---|
| MBS with embedded derivatives                 | Realized gains on securities | \$1  | \$1   | \$—    | \$4   |   |
| Public company warrants                       | Realized gains on securities | —    | —     | 1      | —     |   |
| Interest rate swaptions                       | Realized gains on securities | —    | (1    | ) 1    | (4    | ) |
| Fixed-indexed annuities (embedded derivative) | Annuity benefits             | (33  | ) (40 | ) (110 | ) (97 | ) |
| Equity index call options                     | Annuity benefits             | 32   | 31    | 125    | 67    |   |
| Reinsurance contracts (embedded derivative)   | Net investment income        | 2    | (4    | ) 7    | (7    | ) |
|                                               |                              | \$2  | \$(13 | ) \$24 | \$(37 | ) |

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## AMERICAN FINANCIAL GROUP, INC. 10-Q

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — CONTINUED

## G. Deferred Policy Acquisition Costs

A progression of deferred policy acquisition costs is presented below (in millions):

|                               | P&C      | Annuity and Other (*) |             |                               |            |        |              |
|-------------------------------|----------|-----------------------|-------------|-------------------------------|------------|--------|--------------|
|                               | Deferred | Deferred              | Sales       | Present                       |            |        | Consolidated |
|                               | Costs    | Costs                 | Inducements | Value<br>of Future<br>Profits | Unrealized | Total  | Total        |
| Balance at June 30, 2013      | \$208    | \$797                 | \$ 159      | \$92                          | \$ (438 )  | \$610  | \$818        |
| Additions                     | 118      | 65                    | 4           | —                             | —          | 69     | 187          |
| Periodic amortization         | (119 )   | (32 )                 | (8 )        | (3 )                          | —          | (43 )  | (162 )       |
| Foreign currency translation  | (1 )     | —                     | —           | —                             | —          | —      | (1 )         |
| Change in unrealized          | —        | —                     | —           | —                             | 25         | 25     | 25           |
| Balance at September 30, 2013 | \$206    | \$830                 | \$ 155      | \$89                          | \$ (413 )  | \$661  | \$867        |
| Balance at June 30, 2012      | \$198    | \$971                 | \$ 184      | \$135                         | \$ (642 )  | \$648  | \$846        |
| Additions                     | 113      | 48                    | 4           | —                             | —          | 52     | 165          |
| Amortization:                 |          |                       |             |                               |            |        |              |
| Periodic amortization         | (111 )   | (34 )                 | (8 )        | (5 )                          | —          | (47 )  | (158 )       |
| Included in realized gains    | —        | (2 )                  | —           | —                             | —          | (2 )   | (2 )         |
| Sale of subsidiaries          | —        | (92 )                 | —           | (16 )                         | —          | (108 ) | (108 )       |
| Change in unrealized          | —        | —                     | —           | —                             | (122 )     | (122 ) | (122 )       |
| Balance at September 30, 2012 | \$200    | \$891                 | \$ 180      | \$114                         | \$ (764 )  | \$421  | \$621        |
| Balance at December 31, 2012  | \$204    | \$787                 | \$ 170      | \$99                          | \$ (710 )  | \$346  | \$550        |
| Additions                     | 360      | 148                   | 8           | —                             | —          | 156    | 516          |
| Periodic amortization         | (356 )   | (105 )                | (23 )       | (10 )                         | —          | (138 ) | (494 )       |
| Foreign currency translation  | (2 )     | —                     | —           | —                             | —          | —      | (2 )         |
| Change in unrealized          | —        | —                     | —           | —                             | 297        | 297    | 297          |
| Balance at September 30, 2013 | \$206    | \$830                 | \$ 155      | \$89                          | \$ (413 )  | \$661  | \$867        |
| Balance at December 31, 2011  | \$189    | \$916                 | \$ 189      | \$144                         | \$ (537 )  | \$712  | \$901        |
| Additions                     | 334      | 177                   | 15          | —                             | —          | 192    | 526          |
| Amortization:                 |          |                       |             |                               |            |        |              |
| Periodic amortization         | (323 )   | (109 )                | (24 )       | (14 )                         | —          | (147 ) | (470 )       |
| Included in realized gains    | —        | (1 )                  | —           | —                             | —          | (1 )   | (1 )         |
| Sale of subsidiaries          | —        | (92 )                 | —           | (16 )                         | —          | (108 ) | (108 )       |
| Change in unrealized          | —        | —                     | —           | —                             | (227 )     | (227 ) | (227 )       |
| Balance at September 30, 2012 | \$200    | \$891                 | \$ 180      | \$114                         | \$ (764 )  | \$421  | \$621        |

(\*) Includes AFG's run-off long-term care and life segment and Medicare supplement and critical illness segment (sold in August 2012).

The PVFP amounts in the table above are net of \$194 million and \$184 million of accumulated amortization at September 30, 2013 and December 31, 2012, respectively.

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## AMERICAN FINANCIAL GROUP, INC. 10-Q

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — CONTINUED

## H. Managed Investment Entities

AFG is the investment manager and its subsidiaries have investments ranging from 7.5% to 51.2% of the most subordinate debt tranche of ten collateralized loan obligation entities or “CLOs,” which are considered variable interest entities. AFG’s subsidiaries also own portions of the senior debt tranches of certain of these CLOs. Upon formation between 2004 and 2013, these entities issued securities in various senior and subordinate classes and invested the proceeds primarily in secured bank loans, which serve as collateral for the debt securities issued by each particular CLO. None of the collateral was purchased from AFG. AFG’s investments in the subordinate debt tranches of these entities receive residual income from the CLOs only after the CLOs pay expenses (including management fees to AFG), and interest on and returns of capital to senior levels of debt securities. There are no contractual requirements for AFG to provide additional funding for these entities. AFG has not provided and does not intend to provide any financial support to these entities.

AFG’s maximum exposure to economic loss on its CLOs is limited to its investment in the CLOs, which had an aggregate fair value of \$303 million (including \$120 million invested in the most subordinate debt tranches) at September 30, 2013, and \$257 million at December 31, 2012.

In April 2013, AFG formed a new CLO, which issued \$417 million face amount of liabilities (including \$23 million face amount purchased by subsidiaries of AFG). During the first nine months of 2013, AFG subsidiaries also purchased \$94 million face amount of senior debt tranches of existing CLOs for \$89 million.

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

|                                                                   | Three months ended<br>September 30,<br>2013 |   | September 30,<br>2012 |   | Nine months ended<br>September 30,<br>2013 |   | September 30,<br>2012 |   |
|-------------------------------------------------------------------|---------------------------------------------|---|-----------------------|---|--------------------------------------------|---|-----------------------|---|
| Gains (losses) on change in fair value of assets/liabilities (a): |                                             |   |                       |   |                                            |   |                       |   |
| Assets                                                            | \$ (2                                       | ) | \$ 39                 |   | \$ 1                                       |   | \$ 92                 |   |
| Liabilities                                                       | 17                                          |   | (52                   | ) | (22                                        | ) | (155                  | ) |
| Management fees paid to AFG                                       | 4                                           |   | 6                     |   | 12                                         |   | 14                    |   |
| CLO earnings (losses) attributable to (b):                        |                                             |   |                       |   |                                            |   |                       |   |
| AFG shareholders                                                  | 9                                           |   | 11                    |   | 27                                         |   | 21                    |   |
| Noncontrolling interests                                          | 12                                          |   | (18                   | ) | (30                                        | ) | (64                   | ) |

(a) Included in Revenues in AFG’s Statement of Earnings.

(b) Included in Earnings before income taxes in AFG’s Statement of Earnings.

The aggregate unpaid principal balance of the CLOs’ fixed maturity investments exceeded the fair value of the investments by \$22 million and \$29 million at September 30, 2013 and December 31, 2012. The aggregate unpaid principal balance of the CLOs’ debt exceeded its fair value by \$105 million and \$123 million at those dates. The CLO assets include \$1 million and \$5 million in loans (aggregate unpaid principal balance of \$2 million and \$12 million, respectively) at September 30, 2013 and December 31, 2012, for which the CLOs are not accruing interest because the loans are in default.

## I. Goodwill and Other Intangibles

There were no changes in the goodwill balance of \$185 million during the first nine months of 2013. Included in other assets in AFG's Balance Sheet is \$18 million at September 30, 2013 and \$28 million at December 31, 2012 in amortizable intangible assets related to property and casualty insurance acquisitions. These amounts are net of accumulated amortization of \$71 million and \$61 million, respectively. Amortization of these intangibles was \$3 million in each of the third quarters of 2013 and 2012 and \$10 million in each of the first nine months of 2013 and 2012, respectively. Other assets also include \$8 million in non-amortizable intangible assets related to property and casualty insurance acquisitions.

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## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — CONTINUED

## J. Long-Term Debt

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

|                                                            | September 30,<br>2013 | December 31,<br>2012 |
|------------------------------------------------------------|-----------------------|----------------------|
| Direct obligations of AFG:                                 |                       |                      |
| 9-7/8% Senior Notes due June 2019                          | \$ 350                | \$ 350               |
| 6-3/8% Senior Notes due June 2042                          | 230                   | 230                  |
| 5-3/4% Senior Notes due August 2042                        | 125                   | 125                  |
| 7% Senior Notes due September 2050                         | 132                   | 132                  |
| Other                                                      | 3                     | 3                    |
|                                                            | 840                   | 840                  |
| Subsidiaries:                                              |                       |                      |
| Notes payable secured by real estate due 2013 through 2016 | 61                    | 62                   |
| Secured borrowings (\$16 guaranteed by AFG)                | —                     | 19                   |
| National Interstate bank credit facility                   | 12                    | 12                   |
|                                                            | 73                    | 93                   |
| Payable to Subsidiary Trusts:                              |                       |                      |
| AAG Holding Variable Rate Subordinated Debentures          | —                     | 20                   |
|                                                            | \$ 913                | \$ 953               |

Scheduled principal payments on debt for the balance of 2013 and the subsequent five years were as follows: 2013 — less than \$1 million; 2014 — \$2 million; 2015 — \$14 million; 2016 — \$45 million; 2017 — \$12 million and 2018 — none.

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

|                                    | September 30,<br>2013 | December 31,<br>2012 |
|------------------------------------|-----------------------|----------------------|
| Unsecured obligations              | \$ 852                | \$ 872               |
| Obligations secured by real estate | 61                    | 62                   |
| Other secured borrowings           | —                     | 19                   |
|                                    | \$ 913                | \$ 953               |

AFG can borrow up to \$500 million under its revolving credit facility which expires in December 2016. Amounts borrowed under this agreement bear interest at rates ranging from 1.00% to 1.875% (currently 1.375%) over LIBOR based on AFG's credit rating. No amounts were borrowed under this facility at September 30, 2013 or December 31, 2012.

National Interstate can borrow up to \$100 million under its unsecured credit agreement, which expires in November 2017. At September 30, 2013 there was \$12 million outstanding under this agreement, bearing interest at 1.14% (six-month LIBOR plus 0.875%).

In August 2013, AAG Holding redeemed its Variable Rate Subordinated Debentures at par value. In September 2013, an AFG subsidiary paid off its remaining secured borrowing balance at maturity.

K. Shareholders' Equity

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

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## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — CONTINUED

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

|                                                                                      | Other Comprehensive Income   |         |         |                  |                                                   |                                    |              |                           |
|--------------------------------------------------------------------------------------|------------------------------|---------|---------|------------------|---------------------------------------------------|------------------------------------|--------------|---------------------------|
|                                                                                      | AOCI<br>Beginning<br>Balance | Pretax  | Tax     | Net<br>of<br>tax | Attributable<br>to<br>noncontrolling<br>interests | Attributable<br>to<br>shareholders | Other<br>(c) | AOCI<br>Ending<br>Balance |
| Quarter ended September 30, 2013                                                     |                              |         |         |                  |                                                   |                                    |              |                           |
| Net unrealized gains on securities:                                                  |                              |         |         |                  |                                                   |                                    |              |                           |
| Unrealized holding gains on securities arising during the period                     |                              | \$8     | \$(4 )  | \$4              | \$(1 )                                            | \$3                                |              |                           |
| Reclassification adjustment for realized gains (losses) included in net earnings (a) |                              | (56 )   | 20      | (36 )            | 1                                                 | (35 )                              |              |                           |
| Total net unrealized gains on securities (b)                                         | \$600                        | (48 )   | 16      | (32 )            | —                                                 | (32 )                              | \$—          | \$568                     |
| Foreign currency translation adjustments                                             | 5                            | 3       | —       | 3                | —                                                 | 3                                  | —            | 8                         |
| Pension and other postretirement plans adjustments                                   | (6 )                         | —       | —       | —                | —                                                 | —                                  | —            | (6 )                      |
| Total                                                                                | \$599                        | \$(45 ) | \$16    | \$(29 )          | \$—                                               | \$(29 )                            | \$—          | \$570                     |
| Quarter ended September 30, 2012                                                     |                              |         |         |                  |                                                   |                                    |              |                           |
| Net unrealized gains on securities                                                   | \$771                        | \$238   | \$(84 ) | \$154            | \$(4 )                                            | \$150                              | \$—          | \$921                     |
| Foreign currency translation adjustments                                             | 9                            | 10      | —       | 10               | (1 )                                              | 9                                  | (1 )         | 17                        |
| Pension and other postretirement plans adjustments                                   | (7 )                         | —       | —       | —                | —                                                 | —                                  | —            | (7 )                      |
| Total                                                                                | \$773                        | \$248   | \$(84 ) | \$164            | \$(5 )                                            | \$159                              | \$(1 )       | \$931                     |
| Nine months ended September 30, 2013                                                 |                              |         |         |                  |                                                   |                                    |              |                           |
| Net unrealized gains on securities:                                                  |                              |         |         |                  |                                                   |                                    |              |                           |
| Unrealized holding gains (losses) on securities arising during the period            |                              | \$(248) | \$86    | \$(162)          | \$4                                               | \$(158 )                           |              |                           |
| Reclassification adjustment for realized gains (losses) included in net earnings (a) |                              | (153 )  | 54      | (99 )            | 2                                                 | (97 )                              |              |                           |
| Total net unrealized gains on securities (b)                                         | \$823                        | (401 )  | 140     | (261 )           | 6                                                 | (255 )                             | \$—          | \$568                     |
|                                                                                      | 14                           | (6 )    | —       | (6 )             | —                                                 | (6 )                               | —            | 8                         |

Foreign currency translation  
adjustments

|                                                    |       |   |         |       |         |     |         |     |       |
|----------------------------------------------------|-------|---|---------|-------|---------|-----|---------|-----|-------|
| Pension and other postretirement plans adjustments | (6    | ) | —       | —     | —       | —   | —       | (6  | )     |
| Total                                              | \$831 |   | \$(407) | \$140 | \$(267) | \$6 | \$(261) | \$— | \$570 |

Nine months ended September 30,  
2012

|                                                    |       |       |         |       |       |   |        |      |       |       |
|----------------------------------------------------|-------|-------|---------|-------|-------|---|--------|------|-------|-------|
| Net unrealized gains on securities                 | \$578 | \$539 | \$(189) | \$350 | \$ (7 | ) | \$ 343 | \$—  | \$921 |       |
| Foreign currency translation adjustments           | 10    | 9     | —       | 9     | (1    | ) | 8      | (1   | ) 17  |       |
| Pension and other postretirement plans adjustments | (8    | ) 1   | —       | 1     | —     |   | 1      | —    | (7    | )     |
| Total                                              | \$580 | \$549 | \$(189) | \$360 | \$ (8 | ) | \$ 352 | \$(1 | )     | \$931 |

(a) The reclassification adjustment out of net unrealized gains on securities affected the following lines in AFG's Consolidated Statement of Earnings:

|                                          |                                                              |
|------------------------------------------|--------------------------------------------------------------|
| OCI component                            | Affected line in the Consolidated Statement of Earnings      |
| Pretax                                   | Realized gains on securities                                 |
| Tax                                      | Provision for income taxes                                   |
| Attributable to noncontrolling interests | Net earnings (loss) attributable to noncontrolling interests |

Includes net unrealized gains of \$47 million at September 30, 2013, \$42 million at June 30, 2013 and \$33 million (b) at December 31, 2012 related to securities for which only the credit portion of an other-than-temporary impairment has been recorded in earnings.

(c) Other relates to the third quarter 2012 acquisition of noncontrolling interest in a subsidiary.

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## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — CONTINUED

**Stock Incentive Plans** Under AFG's Stock Incentive Plans, employees of AFG and its subsidiaries are eligible to receive equity awards in the form of stock options, stock appreciation rights, restricted stock awards, restricted stock units and stock awards. In the first nine months of 2013, AFG issued 249,411 shares of restricted Common Stock (fair value of \$44.01 per share) and granted stock options for 1.0 million shares of Common Stock (at an average exercise price of \$44.01) under the Stock Incentive Plan. In addition, AFG issued 88,602 shares of Common Stock (fair value of \$47.12 per share) in the first quarter of 2013 under the Equity Bonus Plan.

AFG uses the Black-Scholes option pricing model to calculate the fair value of its option grants. Expected volatility is based on historical volatility over a period equal to the expected term. The expected term was estimated based on historical exercise patterns and post vesting cancellations. The weighted average fair value of options granted during 2013 was \$15.10 per share based on the following assumptions: expected dividend yield — 1.8%; expected volatility — 38.8%; expected term — 7.3 years; risk-free rate — 1.4%.

Total compensation expense related to stock incentive plans of AFG and its subsidiaries was \$10 million and \$5 million in the third quarter and \$30 million and \$20 million in the first nine months of 2013 and 2012, respectively.

**L. Income Taxes**

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

|                                                                  | Three months ended September 30, |          |    |        |          |   | Nine months ended September 30, |          |     |        |          |    |     |   |    |    |
|------------------------------------------------------------------|----------------------------------|----------|----|--------|----------|---|---------------------------------|----------|-----|--------|----------|----|-----|---|----|----|
|                                                                  | 2013                             |          |    | 2012   |          |   | 2013                            |          |     | 2012   |          |    |     |   |    |    |
|                                                                  | Amount                           | % of EBT |    | Amount | % of EBT |   | Amount                          | % of EBT |     | Amount | % of EBT |    |     |   |    |    |
| Earnings before income taxes (“EBT”)                             | \$142                            |          |    | \$285  |          |   | \$443                           |          |     | \$567  |          |    |     |   |    |    |
| Income taxes at statutory rate                                   | \$50                             | 35       | %  | \$99   | 35       | % | \$155                           | 35       | %   | \$198  | 35       | %  |     |   |    |    |
| Effect of:                                                       |                                  |          |    |        |          |   |                                 |          |     |        |          |    |     |   |    |    |
| Tax exempt interest                                              | (5                               | )        | (3 | %)     | (6       | ) | (2                              | %)       | (16 | )      | (4       | %) | (18 | ) | (3 | %) |
| Losses of managed investment entities                            | (4                               | )        | (3 | %)     | 6        |   | 2                               | %        | 11  |        | 3        | %  | 22  |   | 4  | %  |
| Subsidiaries not in AFG’s tax return                             | 1                                |          | 1  | %      | 2        |   | 1                               | %        | 1   |        | —        | %  | 4   |   | —  | %  |
| Tax case resolution                                              | —                                |          | —  | %      | (28      | ) | (10                             | %)       | —   |        | —        | %  | (28 | ) | (5 | %) |
| Other                                                            | 2                                |          | 1  | %      | 1        |   | —                               | %        | 4   |        | 1        | %  | 6   |   | 1  | %  |
| Provision for income taxes as shown on the Statement of Earnings | \$44                             | 31       | %  | \$74   | 26       | % | \$155                           | 35       | %   | \$184  | 32       | %  |     |   |    |    |

As discussed in Note L — "Income Taxes," in AFG's 2012 Form 10-K, AFG recorded a \$28 million tax benefit in the third quarter of 2012 from the resolution of tax litigation with the IRS. During the first nine months of 2013, there were no material changes to AFG's liability for uncertain tax positions, which relate to the timing of investment income and the deductibility of certain financing expenses. As a result of discussions with the IRS Appeals Office during the third quarter of 2013, AFG believes that its liability for uncertain tax positions may be reduced by up to \$19 million within the coming year due to a settlement with the IRS. The majority of the reduction in this liability would result in

offsetting adjustments to AFG's deferred tax liability. Accordingly, the resolution of these items will not have a material impact on AFG's effective tax rate.

M. Contingencies

As previously disclosed, AFG paid \$124 million in the second quarter of 2013 related to the settlement of the A.P. Green asbestos claim in its property and casualty operations that had been accrued in prior years. Except for the payment of this claim and the \$76 million in pretax charges to increase asbestos and environmental reserves discussed in Management's Discussion and Analysis — "Results of Operations — Special Asbestos and Environmental Reserve Charges," there have been no significant changes to the matters discussed and referred to in Note M — "Contingencies" of AFG's 2012 Form 10-K, which covers property and casualty insurance reserves for claims related to environmental exposures, asbestos and other mass tort claims, as well as environmental and occupational injury and disease claims of former subsidiary railroad and manufacturing operations.

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ITEM 2

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

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FORWARD-LOOKING STATEMENTS

The Private Securities Litigation Reform Act of 1995 provides a safe harbor for forward-looking statements. Some of the forward-looking statements can be identified by the use of words such as “anticipates”, “believes”, “expects”, “projects”, “estimates”, “intends”, “plans”, “seeks”, “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 long-term care, asbestos, environmental pollution and mass tort claims; rate changes; and improved loss experience.

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

- changes in financial, political and economic conditions, including changes in interest and inflation rates, currency fluctuations and extended economic recessions or expansions in the U.S. and/or abroad;
- performance of securities markets;
- AFG's ability to estimate accurately the likelihood, magnitude and timing of any losses in connection with investments in the non-agency residential mortgage market;
- new legislation or declines in credit quality or credit ratings that could have a material impact on the valuation of securities in AFG's investment portfolio;
- the availability of capital;
- regulatory actions (including changes in statutory accounting rules);
- changes in the legal environment affecting AFG or its customers;
- tax law and accounting changes;
- levels of natural catastrophes and severe weather, terrorist activities (including any nuclear, biological, chemical or radiological events), incidents of war or losses resulting from civil unrest and other major losses;
-

development of insurance loss reserves and establishment of other reserves, particularly with respect to amounts associated with asbestos and environmental claims and AFG's run-off long-term care business;

- availability of reinsurance and ability of reinsurers to pay their obligations;
- trends in persistency, mortality and morbidity;
- competitive pressures, including those in the annuity distribution channels;
- the ability to obtain adequate rates and policy terms; and

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

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

OVERVIEW

Financial Condition

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

Results of Operations

Through the operations of its subsidiaries, AFG is engaged primarily in property and casualty insurance, focusing on specialized commercial products for businesses and in the sale of fixed and fixed-indexed annuities in the retail, financial institutions and education markets.

Net earnings attributable to AFG's shareholders were \$83 million (\$0.92 per share, diluted) for the third quarter of 2013 compared to \$226 million (\$2.39 per share) in the third quarter of 2012. Significantly higher profits in the Specialty property and casualty businesses and increased earnings in the annuity segment were more than offset by higher special charges in 2013 to strengthen asbestos and environmental ("A&E") reserves and lower realized gains on securities. In addition, results for the third quarter of 2012 include an after tax gain of \$101 million (\$1.01 per share) on the sale of AFG's Medicare supplement and critical illness businesses and a \$28 million (\$0.30 per share) tax benefit related to the favorable resolution of certain tax litigation.

Net earnings attributable to AFG's shareholders for the first nine months of 2013 were \$313 million (\$3.44 per share) compared to \$438 million (\$4.50 per share) for the comparable 2012 period. Significantly higher profits in the annuity segment were more than offset by higher special A&E charges and the absence of earnings from the Medicare supplement and critical illness businesses, which were sold in August 2012. The gain on the sale of those businesses and the impact of the favorable resolution of certain tax litigation are reflected in the 2012 results.

CRITICAL ACCOUNTING POLICIES

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

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

For a discussion of these policies, see Management's Discussion and Analysis — "Critical Accounting Policies" in AFG's 2012 Form 10-K.

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## Management's Discussion and Analysis of Financial Condition and Results of Operations — Continued

## LIQUIDITY AND CAPITAL RESOURCES

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

|                                       | September 30, December 31, |        |        |   |  |
|---------------------------------------|----------------------------|--------|--------|---|--|
|                                       | 2013                       | 2012   | 2011   |   |  |
| Long-term debt                        | \$913                      | \$953  | \$934  |   |  |
| Total capital                         | 5,129                      | 4,907  | 4,860  |   |  |
| Ratio of debt to total capital:       |                            |        |        |   |  |
| Including debt secured by real estate | 17.8                       | % 19.4 | % 19.2 | % |  |
| Excluding debt secured by real estate | 16.8                       | % 18.4 | % 18.2 | % |  |

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

AFG's ratio of earnings to fixed charges, including annuity benefits as a fixed charge, was 2.02 for the nine months ended September 30, 2013 and 1.98 for the year ended December 31, 2012. Excluding annuity benefits, this ratio was 7.96 and 7.16, respectively. Although the ratio excluding annuity benefits is not required or encouraged to be disclosed under Securities and Exchange Commission rules, it is presented because interest credited to annuity policyholder accounts is not always considered a borrowing cost for an insurance company.

## Condensed Consolidated Cash Flows

AFG's cash flows from operating, investing and financing activities as detailed in its Consolidated Statement of Cash Flows are shown below (in millions):

|                                           | Nine months ended<br>September 30, |         |   |
|-------------------------------------------|------------------------------------|---------|---|
|                                           | 2013                               | 2012    |   |
| Net cash provided by operating activities | \$388                              | \$487   |   |
| Net cash used in investing activities     | (1,913)                            | (938)   | ) |
| Net cash provided by financing activities | 1,151                              | 753     |   |
| Net change in cash and cash equivalents   | \$(374)                            | ) \$302 |   |

AFG's principal sources of cash include insurance premiums, income from its investment portfolio and proceeds from the maturities, redemptions and sales of investments. Insurance premiums in excess of acquisition expenses and operating costs are invested until they are needed to meet policyholder obligations or made available to the parent company through dividends to cover debt obligations and corporate expenses, and to provide returns to shareholders through share repurchases and dividends.

Net cash provided by operating activities was \$388 million for the first nine months of 2013 compared to \$487 million in the first nine months of 2012, a decrease of \$99 million. AFG's property and casualty insurance operations typically produce positive net operating cash flows as premiums collected and investment income exceed policy acquisition costs, claims payments and operating expenses. AFG's net cash provided by operating activities is impacted by the level and timing of property and casualty premiums, claim and expense payments and recoveries from reinsurers. AFG's annuity operations typically produce positive net operating cash flows as investment income exceeds

acquisition costs and operating expenses. Interest credited on annuity policyholder funds is a non-cash increase in AFG's annuity benefits accumulated liability and annuity premiums, benefits and withdrawals are considered financing activities due to the deposit-type nature of annuities. The \$99 million decrease in net cash provided by operating activities reflects the second quarter of 2013 payment of a \$124 million asbestos claim related to a large settlement in the property and casualty operations, which had been accrued for in prior years.

Net cash used in investing activities was \$1.91 billion for the first nine months of 2013 compared to \$938 million in the first nine months of 2012, an increase of \$975 million. AFG's investing activities consist primarily of the investment of funds provided by its property and casualty and annuity products. The \$385 million increase in net cash flows from annuity policyholders in the first nine months of 2013 as compared to the 2012 period (discussed below under net cash provided by

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financing activities) increased the amount of cash available for investment in the first nine months of 2013 compared to the 2012 period. During the first nine months of 2012, cash on hand in the annuity and run-off long-term care and life segments increased by \$363 million from year-end 2011 as net cash flows from annuity policyholders outpaced the investment of the funds received. The increase in net cash used in investing activities also reflects the use of cash and cash equivalents held in the property and casualty operations to purchase fixed maturity and equity securities during the second quarter of 2013. Investing activities also include the purchase and disposal of managed investment entity investments (collateralized loan obligations), which are presented separately in AFG's Balance Sheet. Net investment activity in the managed investment entities was a \$454 million source of cash in the first nine months of 2013 compared to a \$183 million source of cash in the 2012 period. See Managed Investment Entities in Note A — "Accounting Policies" and Note H — "Managed Investment Entities".

Net cash provided by financing activities was \$1.15 billion for the first nine months of 2013 compared to \$753 million in the first nine months of 2012, an increase of \$398 million. AFG's financing activities consist primarily of transactions with annuity policyholders, issuances and retirements of long-term debt, repurchases of common stock and dividend payments. Annuity receipts exceeded annuity surrenders, benefits, withdrawals and transfers by \$1.72 billion in the first nine months of 2013 compared to \$1.34 billion in the 2012 period, resulting in a \$385 million increase in net cash provided by financing activities in the 2013 period compared to the 2012 period. Cash flows from financing activities for the first nine months of 2012 include \$344 million in net proceeds from the issuances of long-term debt in June and August of 2012. The proceeds from the debt offerings were used primarily to retire higher interest rate debt in the third quarter of 2012. During the first nine months of 2013, AFG repurchased 1.4 million shares of its Common Stock for \$70 million compared to 8.3 million shares repurchased in the first nine months of 2012 for \$315 million, which accounted for a \$245 million increase in net cash provided by financing activities in the 2013 period compared to the 2012 period. Financing activities also include the issuance and retirement of managed investment entity liabilities, which are nonrecourse to AFG and presented separately in AFG's Balance Sheet. The retirement of managed investment entity liabilities exceed issuances by \$449 million in the first nine months of 2013 compared to \$248 million in the first nine months of 2012, representing a \$201 million decrease in net cash provided by financing activities in the 2013 period compared to the 2012 period. See Managed Investment Entities in Note A — "Accounting Policies" and Note H — "Managed Investment Entities".

Parent and Subsidiary Liquidity

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

In December 2012, AFG replaced its bank credit facility with a four-year, \$500 million revolving credit line. Amounts borrowed under this agreement bear interest at rates ranging from 1.00% to 1.875% (currently 1.375%) over LIBOR based on AFG's credit rating. There were no borrowings under the agreement, or under any other parent company short-term borrowing arrangements, during 2012 or the first nine months of 2013.

During the first nine months of 2013, AFG repurchased 1.4 million shares of its Common Stock for \$70 million (primarily in the second quarter). During 2012, AFG repurchased 10.9 million shares of its Common Stock for \$415 million.

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

**Subsidiary Liquidity** Great American Life Insurance Company ("GALIC"), a wholly-owned annuity subsidiary, is a member of the Federal Home Loan Bank of Cincinnati ("FHLB"). The FHLB makes advances and provides other banking services to member institutions, which provides the annuity operations with a substantial additional source of liquidity. These advances further the FHLB's mission of improving access to housing by increasing liquidity in the residential mortgage-backed securities market. In the second quarter of 2013, the FHLB advanced GALIC \$200 million, increasing the total amount advanced to \$440 million at September 30, 2013 (included in annuity benefits accumulated). The interest rates on the advances range from 0.02% to 0.23% over LIBOR (average rate of 0.33% at September 30, 2013). While these advances must be repaid between 2016 and 2018, GALIC has the option to prepay all or a portion of the advances. GALIC has invested the proceeds from the advances in fixed maturity securities for the purpose of earning a spread over the interest payments due to the FHLB.

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In November 2012, National Interstate Corporation ("NATL"), a 52%-owned property and casualty insurance subsidiary, replaced its \$50 million bank credit facility with a five-year, \$100 million unsecured credit agreement. There was \$12 million borrowed under this agreement at September 30, 2013, bearing interest at 1.14% (six-month LIBOR plus 0.875%).

The liquidity requirements of AFG's insurance subsidiaries relate primarily to the liabilities associated with their products as well as operating costs and expenses, payments of dividends and taxes to AFG and contributions of capital to their subsidiaries. Historically, cash flows from premiums and investment income have generally provided more than sufficient funds to meet these requirements. Funds received in excess of cash requirements are generally invested in additional marketable securities. In addition, the insurance subsidiaries generally hold a significant amount of highly liquid, short-term investments.

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

In the annuity business, where profitability is largely dependent on earning a "spread" between invested assets and annuity liabilities, the duration of investments is generally maintained close to that of liabilities. In a rising interest rate environment, significant protection from withdrawals exists in the form of temporary and permanent surrender charges on AFG's annuity products. With declining rates, AFG receives some protection (from spread compression) due to the ability to lower crediting rates, subject to contractually guaranteed minimum interest rates ("GMIRs"). AFG began selling policies with GMIRs below 2% in 2003; almost all new business since late 2010 has been issued with a 1% GMIR. At September 30, 2013, AFG could reduce the average crediting rate of its \$15 billion of traditional and fixed-indexed deferred annuities without guaranteed withdrawal benefits by approximately 43 basis points (on a weighted average basis).

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

**Investments** AFG's investment portfolio at September 30, 2013, contained \$25.67 billion in "Fixed maturities" classified as available for sale and \$1.14 billion in "Equity securities," all carried at fair value with unrealized gains and losses included in a separate component of shareholders' equity on an after-tax basis. In addition, \$290 million in fixed maturities were classified as trading with changes in unrealized holding gains or losses included in net investment income.

Fair values for AFG's portfolio are determined by AFG's internal investment professionals using data from nationally recognized pricing services as well as non-binding broker quotes. Fair values of equity securities are generally based on closing prices obtained from the pricing services. For mortgage-backed securities ("MBS"), which comprise approximately 27% of AFG's fixed maturities, prices for each security are generally obtained from both pricing services and broker quotes. For the remainder of AFG's fixed maturity portfolio, approximately 88% are priced using pricing services and the balance is priced primarily by using non-binding broker quotes. When prices obtained for the same security vary, AFG's internal investment professionals select the price they believe is most indicative of an exit price.

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

Valuation techniques utilized by pricing services and prices obtained from external sources are reviewed by AFG's internal investment professionals who are familiar with the securities being priced and the markets in which they trade to ensure the fair value determination is representative of an exit price. To validate the appropriateness of the prices obtained, these investment managers consider widely published indices (as benchmarks), recent trades, changes in interest rates, general economic conditions and the credit quality of the specific issuers. In addition, AFG communicates directly with pricing services regarding the methods and assumptions used in pricing, including verifying, on a test basis, the inputs used by the services to value specific securities.

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## Management's Discussion and Analysis of Financial Condition and Results of Operations — Continued

In general, the fair value of AFG's fixed maturity investments is inversely correlated to changes in interest rates. The following table demonstrates the sensitivity of such fair values to reasonably likely changes in interest rates by illustrating the estimated effect on AFG's fixed maturity portfolio that an immediate increase of 100 basis points in the interest rate yield curve would have at September 30, 2013 (dollars in millions). Increases or decreases from the 100 basis points illustrated would be approximately proportional.

|                                                                   |            |
|-------------------------------------------------------------------|------------|
| Fair value of fixed maturity portfolio                            | \$25,964   |
| Pretax impact on fair value of 100 bps increase in interest rates | \$(1,168 ) |
| Pretax impact as % of total fixed maturity portfolio              | (4.5 %)    |

Approximately 86% of the fixed maturities held by AFG at September 30, 2013, were rated "investment grade" (credit rating of AAA to BBB) by nationally recognized rating agencies. Investment grade securities generally bear lower yields and lower degrees of risk than those that are unrated and non-investment grade. Management believes that the high quality investment portfolio should generate a stable and predictable investment return.

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

Summarized information for AFG's MBS (including those classified as trading) at September 30, 2013, is shown (in millions) in the table below. Agency-backed securities are those issued by a U.S. government-backed agency; Alt-A mortgages are those with risk profiles between prime and subprime. The majority of the Alt-A securities and substantially all of the subprime securities are backed by fixed-rate mortgages. The average life of both the residential and commercial MBS is approximately 4 years.

|                  | Amortized<br>Cost | Fair Value | Fair Value as<br>% of Cost | Unrealized<br>Gain (Loss) | % Rated<br>Investment<br>Grade |   |
|------------------|-------------------|------------|----------------------------|---------------------------|--------------------------------|---|
| Collateral type  |                   |            |                            |                           |                                |   |
| Residential:     |                   |            |                            |                           |                                |   |
| Agency-backed    | \$244             | \$251      | 103                        | % \$7                     | 100                            | % |
| Non-agency prime | 1,913             | 2,099      | 110                        | % 186                     | 43                             | % |
| Alt-A            | 912               | 993        | 109                        | % 81                      | 22                             | % |
| Subprime         | 886               | 945        | 107                        | % 59                      | 18                             | % |
| Commercial       | 2,565             | 2,778      | 108                        | % 213                     | 99                             | % |
|                  | \$6,520           | \$7,066    | 108                        | % \$546                   | 60                             | % |

The National Association of Insurance Commissioners ("NAIC") assigns creditworthiness designations on a scale of 1 to 6 with 1 being the highest quality and 6 being the lowest quality. The NAIC retains third-party investment management firms to assist in the determination of appropriate NAIC designations for mortgage-backed securities based not only on the probability of loss (which is the primary basis of ratings by the major ratings firms), but also on the severity of loss and statutory carrying value. At September 30, 2013, 96% (based on statutory carrying value of \$6.43 billion) of AFG's MBS securities had an NAIC designation of 1 or 2.

Municipal bonds represented approximately 20% of AFG's fixed maturity portfolio at September 30, 2013. AFG's municipal bond portfolio is high quality, with 99% of the securities rated investment grade at that date. The portfolio is well diversified across the states of issuance and individual issuers. At September 30, 2013, approximately 75% of the municipal bond portfolio was held in revenue bonds, with the remaining 25% held in general obligation bonds. General obligation securities of California, Illinois, Michigan, New Jersey, New York and Puerto Rico collectively represented approximately 1% of this portfolio.

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Summarized information for the unrealized gains and losses recorded in AFG's Balance Sheet at September 30, 2013, is shown in the following table (dollars in millions). Approximately \$151 million of available for sale "Fixed maturities" and \$100 million of "Equity securities" had no unrealized gains or losses at September 30, 2013.

|                                                                                   | Securities<br>With<br>Unrealized<br>Gains |   | Securities<br>With<br>Unrealized<br>Losses |   |
|-----------------------------------------------------------------------------------|-------------------------------------------|---|--------------------------------------------|---|
| Available for Sale Fixed Maturities                                               |                                           |   |                                            |   |
| Fair value of securities                                                          | \$19,603                                  |   | \$5,920                                    |   |
| Amortized cost of securities                                                      | \$18,125                                  |   | \$6,160                                    |   |
| Gross unrealized gain (loss)                                                      | \$1,478                                   |   | \$(240)                                    | ) |
| Fair value as % of amortized cost                                                 | 108                                       | % | 96                                         | % |
| Number of security positions                                                      | 3,778                                     |   | 1,076                                      |   |
| Number individually exceeding \$2 million gain or loss                            | 128                                       |   | 8                                          |   |
| Concentration of gains (losses) by type or industry (exceeding 5% of unrealized): |                                           |   |                                            |   |
| States and municipalities                                                         | \$181                                     |   | \$(100)                                    | ) |
| Mortgage-backed securities                                                        | 585                                       |   | (39)                                       | ) |
| Banks, savings and credit institutions                                            | 111                                       |   | (16)                                       | ) |
| Asset-backed securities                                                           | 34                                        |   | (16)                                       | ) |
| Gas and electric services                                                         | 125                                       |   | (3)                                        | ) |
| Percentage rated investment grade                                                 | 85                                        | % | 88                                         | % |
| Equity Securities                                                                 |                                           |   |                                            |   |
| Fair value of securities                                                          | \$838                                     |   | \$205                                      |   |
| Cost of securities                                                                | \$635                                     |   | \$221                                      |   |
| Gross unrealized gain (loss)                                                      | \$203                                     |   | \$(16)                                     | ) |
| Fair value as % of cost                                                           | 132                                       | % | 93                                         | % |
| Number of security positions                                                      | 177                                       |   | 57                                         |   |
| Number individually exceeding \$2 million gain or loss                            | 37                                        |   | 1                                          |   |

The table below sets forth the scheduled maturities of AFG's available for sale fixed maturity securities at September 30, 2013, based on their fair values. 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<br>With<br>Unrealized<br>Gains |   | Securities<br>With<br>Unrealized<br>Losses |   |
|---------------------------------------------------------------------|-------------------------------------------|---|--------------------------------------------|---|
| Maturity                                                            |                                           |   |                                            |   |
| One year or less                                                    | 5                                         | % | 1                                          | % |
| After one year through five years                                   | 23                                        | % | 7                                          | % |
| After five years through ten years                                  | 27                                        | % | 35                                         | % |
| After ten years                                                     | 8                                         | % | 26                                         | % |
|                                                                     | 63                                        | % | 69                                         | % |
| Asset-backed securities (average life of approximately 4 1/2 years) | 6                                         | % | 17                                         | % |
| Mortgage-backed securities (average life of approximately 4 years)  | 31                                        | % | 14                                         | % |
|                                                                     | 100                                       | % | 100                                        | % |



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## Management's Discussion and Analysis of Financial Condition and Results of Operations — Continued

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

|                                        | Aggregate<br>Fair<br>Value | Aggregate<br>Unrealized<br>Gain (Loss) | Fair<br>Value as<br>% of Cost<br>Basis |   |
|----------------------------------------|----------------------------|----------------------------------------|----------------------------------------|---|
| Fixed Maturities at September 30, 2013 |                            |                                        |                                        |   |
| Securities with unrealized gains:      |                            |                                        |                                        |   |
| Exceeding \$500,000 (867 securities)   | \$9,926                    | \$1,059                                | 112                                    | % |
| \$500,000 or less (2,911 securities)   | 9,677                      | 419                                    | 105                                    | % |
|                                        | \$19,603                   | \$1,478                                | 108                                    | % |
| Securities with unrealized losses:     |                            |                                        |                                        |   |
| Exceeding \$500,000 (126 securities)   | \$1,543                    | \$(129)                                | 92                                     | % |
| \$500,000 or less (950 securities)     | 4,377                      | (111)                                  | 98                                     | % |
|                                        | \$5,920                    | \$(240)                                | 96                                     | % |

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

|                                                         | Aggregate<br>Fair<br>Value | Aggregate<br>Unrealized<br>Loss | Fair<br>Value as<br>% of Cost<br>Basis |   |
|---------------------------------------------------------|----------------------------|---------------------------------|----------------------------------------|---|
| Securities with Unrealized Losses at September 30, 2013 |                            |                                 |                                        |   |
| Investment grade fixed maturities with losses for:      |                            |                                 |                                        |   |
| Less than one year (803 securities)                     | \$5,057                    | \$(193)                         | 96                                     | % |
| One year or longer (42 securities)                      | 137                        | (5)                             | 96                                     | % |
|                                                         | \$5,194                    | \$(198)                         | 96                                     | % |
| Non-investment grade fixed maturities with losses for:  |                            |                                 |                                        |   |
| Less than one year (125 securities)                     | \$523                      | \$(16)                          | 97                                     | % |
| One year or longer (106 securities)                     | 203                        | (26)                            | 89                                     | % |
|                                                         | \$726                      | \$(42)                          | 95                                     | % |
| Common equity securities with losses for:               |                            |                                 |                                        |   |
| Less than one year (26 securities)                      | \$98                       | \$(6)                           | 94                                     | % |
| One year or longer (3 securities)                       | —                          | —                               | —                                      | % |
|                                                         | \$98                       | \$(6)                           | 94                                     | % |
| Perpetual preferred equity securities with losses for:  |                            |                                 |                                        |   |
| Less than one year (19 securities)                      | \$84                       | \$(7)                           | 92                                     | % |
| One year or longer (9 securities)                       | 23                         | (3)                             | 88                                     | % |
|                                                         | \$107                      | \$(10)                          | 91                                     | % |

When a decline in the value of a specific investment is considered to be “other-than-temporary,” a provision for impairment is charged to earnings (accounted for as a realized loss) and the cost basis of that investment is reduced by the amount of the charge. The determination of whether unrealized losses are “other-than-temporary” requires judgment based on subjective as well as objective factors as detailed in AFG’s 2012 Form 10-K under Management’s Discussion and Analysis — “Investments.”

Based on its analysis, management believes AFG will recover its cost basis in the securities with unrealized losses and that AFG has the ability to hold the securities until they recover in value and had no intent to sell them at September 30, 2013. Although AFG has the ability to continue holding its investments with unrealized losses, its intent to hold them may change due to deterioration in the issuers' creditworthiness, decisions to lessen exposure to a particular issuer or industry, asset/liability management decisions, market movements, changes in views about appropriate asset allocation or the desire to offset taxable realized gains. Should AFG's ability or intent change with regard to a particular security, a charge for impairment would likely be required. While it is not possible to accurately predict if or when a specific security will become impaired, charges for other-than-temporary impairment could be material to results of operations in future periods. Significant declines in the fair value of AFG's investment portfolio could have a significant adverse effect on AFG's liquidity.

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

**Uncertainties** Management believes that the areas posing the greatest risk of material loss are the adequacy of its insurance reserves and contingencies arising out of its former railroad and manufacturing operations. See Management's Discussion and Analysis — "Uncertainties" in AFG's 2012 Form 10-K. AFG has periodically conducted comprehensive studies of its asbestos and environmental reserves, generally every two years, with the aid of specialty actuarial, engineering and consulting firms and outside counsel. An in-depth internal review is performed during the intervening years. See Results of Operations — "Special Asbestos and Environmental Reserve Charges."

**MANAGED INVESTMENT ENTITIES**

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

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## AMERICAN FINANCIAL GROUP, INC. 10-Q

## Management's Discussion and Analysis of Financial Condition and Results of Operations — Continued

## CONDENSED CONSOLIDATING BALANCE SHEET

|                                                                  | Before CLO<br>Consolidation | Managed<br>Investment<br>Entities | Consol.<br>Entries |     | Consolidated<br>As Reported |
|------------------------------------------------------------------|-----------------------------|-----------------------------------|--------------------|-----|-----------------------------|
| September 30, 2013                                               |                             |                                   |                    |     |                             |
| Assets:                                                          |                             |                                   |                    |     |                             |
| Cash and investments                                             | \$30,224                    | \$—                               | \$(303 )           | (a) | \$ 29,921                   |
| Assets of managed investment entities                            | —                           | 2,779                             | —                  |     | 2,779                       |
| Other assets                                                     | 8,249                       | —                                 | (2 )               | (a) | 8,247                       |
| Total assets                                                     | \$38,473                    | \$ 2,779                          | \$(305 )           |     | \$ 40,947                   |
| Liabilities:                                                     |                             |                                   |                    |     |                             |
| Unpaid losses and loss adjustment expenses and unearned premiums | \$8,488                     | \$—                               | \$—                |     | \$ 8,488                    |
| Annuity, life, accident and health benefits and reserves         | 21,796                      | —                                 | —                  |     | 21,796                      |
| Liabilities of managed investment entities                       | —                           | 2,688                             | (259 )             | (a) | 2,429                       |
| Long-term debt and other liabilities                             | 3,524                       | —                                 | —                  |     | 3,524                       |
| Total liabilities                                                | 33,808                      | 2,688                             | (259 )             |     | 36,237                      |
| Shareholders' equity:                                            |                             |                                   |                    |     |                             |
| Common Stock and Capital surplus                                 | 1,198                       | 45                                | (45 )              |     | 1,198                       |
| Retained earnings:                                               |                             |                                   |                    |     |                             |
| Appropriated — managed investment entities                       | —                           | 46                                | (1 )               |     | 45                          |
| Unappropriated                                                   | 2,729                       | —                                 | —                  |     | 2,729                       |
| Accumulated other comprehensive income, net of tax               | 570                         | —                                 | —                  |     | 570                         |
| Total shareholders' equity                                       | 4,497                       | 91                                | (46 )              |     | 4,542                       |
| Noncontrolling interests                                         | 168                         | —                                 | —                  |     | 168                         |
| Total equity                                                     | 4,665                       | 91                                | (46 )              |     | 4,710                       |
| Total liabilities and equity                                     | \$38,473                    | \$ 2,779                          | \$(305 )           |     | \$ 40,947                   |
| December 31, 2012                                                |                             |                                   |                    |     |                             |
| Assets:                                                          |                             |                                   |                    |     |                             |
| Cash and investments                                             | \$28,706                    | \$—                               | \$(257 )           | (a) | \$ 28,449                   |
| Assets of managed investment entities                            | —                           | 3,225                             | —                  |     | 3,225                       |
| Other assets                                                     | 7,498                       | —                                 | (1 )               | (a) | 7,497                       |
| Total assets                                                     | \$36,204                    | \$ 3,225                          | \$(258 )           |     | \$ 39,171                   |
| Liabilities:                                                     |                             |                                   |                    |     |                             |
| Unpaid losses and loss adjustment expenses and unearned premiums | \$8,496                     | \$—                               | \$—                |     | \$ 8,496                    |
| Annuity, life, accident and health benefits and reserves         | 19,668                      | —                                 | —                  |     | 19,668                      |
| Liabilities of managed investment entities                       | —                           | 3,130                             | (238 )             | (a) | 2,892                       |
| Long-term debt and other liabilities                             | 3,367                       | —                                 | —                  |     | 3,367                       |
| Total liabilities                                                | 31,531                      | 3,130                             | (238 )             |     | 34,423                      |
| Shareholders' equity:                                            |                             |                                   |                    |     |                             |
| Common Stock and Capital surplus                                 | 1,152                       | 20                                | (20 )              |     | 1,152                       |
| Retained earnings:                                               |                             |                                   |                    |     |                             |
| Appropriated — managed investment entities                       | —                           | 75                                | —                  |     | 75                          |
| Unappropriated                                                   | 2,520                       | —                                 | —                  |     | 2,520                       |

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|                                                    |          |         |          |           |
|----------------------------------------------------|----------|---------|----------|-----------|
| Accumulated other comprehensive income, net of tax | 831      | —       | —        | 831       |
| Total shareholders' equity                         | 4,503    | 95      | (20 )    | 4,578     |
| Noncontrolling interests                           | 170      | —       | —        | 170       |
| Total equity                                       | 4,673    | 95      | (20 )    | 4,748     |
| Total liabilities and equity                       | \$36,204 | \$3,225 | \$(258 ) | \$ 39,171 |

(a) Elimination of the fair value of AFG's investment in CLOs and related accrued interest.

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## AMERICAN FINANCIAL GROUP, INC. 10-Q

## Management's Discussion and Analysis of Financial Condition and Results of Operations — Continued

## CONDENSED CONSOLIDATING STATEMENT OF EARNINGS

|                                                                    | Before CLO<br>Consolidation (a) | Managed<br>Investment<br>Entities | Consol.<br>Entries | Consolidated<br>As Reported |
|--------------------------------------------------------------------|---------------------------------|-----------------------------------|--------------------|-----------------------------|
| Three months ended September 30, 2013                              |                                 |                                   |                    |                             |
| Revenues:                                                          |                                 |                                   |                    |                             |
| Insurance net earned premiums                                      | \$ 978                          | \$—                               | \$—                | \$ 978                      |
| Net investment income                                              | 347                             | —                                 | (9 ) (b)           | 338                         |
| Realized gains on securities                                       | 56                              | —                                 | —                  | 56                          |
| Income (loss) of managed investment entities:                      |                                 |                                   |                    |                             |
| Investment income                                                  | —                               | 32                                | —                  | 32                          |
| Gain on change in fair value of assets/liabilities                 | —                               | 14                                | 1 (b)              | 15                          |
| Other income                                                       | 28                              | —                                 | (4 ) (c)           | 24                          |
| Total revenues                                                     | 1,409                           | 46                                | (12 )              | 1,443                       |
| Costs and Expenses:                                                |                                 |                                   |                    |                             |
| Insurance benefits and expenses                                    | 1,163                           | —                                 | —                  | 1,163                       |
| Expenses of managed investment entities                            | —                               | 32                                | (10 ) (b)(c)       | 22                          |
| Interest charges on borrowed money and other expenses              | 116                             | —                                 | —                  | 116                         |
| Total costs and expenses                                           | 1,279                           | 32                                | (10 )              | 1,301                       |
| Earnings before income taxes                                       | 130                             | 14                                | (2 )               | 142                         |
| Provision for income taxes                                         | 44                              | —                                 | —                  | 44                          |
| Net earnings, including noncontrolling interests                   | 86                              | 14                                | (2 )               | 98                          |
| Less: Net earnings (loss) attributable to noncontrolling interests | 3                               | —                                 | 12 (d)             | 15                          |
| Net Earnings Attributable to Shareholders                          | \$ 83                           | \$ 14                             | \$(14 )            | \$ 83                       |
| Three months ended September 30, 2012                              |                                 |                                   |                    |                             |
| Revenues:                                                          |                                 |                                   |                    |                             |
| Insurance net earned premiums                                      | \$ 928                          | \$—                               | \$—                | \$ 928                      |
| Net investment income                                              | 337                             | —                                 | (11 ) (b)          | 326                         |
| Realized gains on securities                                       | 85                              | —                                 | —                  | 85                          |
| Realized gains on subsidiaries                                     | 156                             | —                                 | —                  | 156                         |
| Income (loss) of managed investment entities:                      |                                 |                                   |                    |                             |
| Investment income                                                  | —                               | 31                                | —                  | 31                          |
| Loss on change in fair value of assets/liabilities                 | —                               | (18 )                             | 5 (b)              | (13 )                       |
| Other income                                                       | 31                              | —                                 | (6 ) (c)           | 25                          |
| Total revenues                                                     | 1,537                           | 13                                | (12 )              | 1,538                       |
| Costs and Expenses:                                                |                                 |                                   |                    |                             |
| Insurance benefits and expenses                                    | 1,116                           | —                                 | —                  | 1,116                       |
| Expenses of managed investment entities                            | —                               | 31                                | (12 ) (b)(c)       | 19                          |
| Interest charges on borrowed money and other expenses              | 118                             | —                                 | —                  | 118                         |
| Total costs and expenses                                           | 1,234                           | 31                                | (12 )              | 1,253                       |
| Earnings before income taxes                                       | 303                             | (18 )                             | —                  | 285                         |
| Provision for income taxes                                         | 74                              | —                                 | —                  | 74                          |
| Net earnings, including noncontrolling interests                   | 229                             | (18 )                             | —                  | 211                         |
|                                                                    | 3                               | —                                 | (18 ) (d)          | (15 )                       |

Less: Net earnings (loss) attributable to noncontrolling interests

|                                           |        |         |       |        |
|-------------------------------------------|--------|---------|-------|--------|
| Net Earnings Attributable to Shareholders | \$ 226 | \$(18 ) | \$ 18 | \$ 226 |
|-------------------------------------------|--------|---------|-------|--------|

Includes \$9 million and \$11 million for the third quarter of 2013 and 2012, respectively, in net investment income (a) representing the change in fair value of AFG's CLO investments plus \$4 million and \$6 million in 2013 and 2012, respectively, in CLO management fees earned.

(b) Elimination of the change in fair value of AFG's investments in the CLOs, including \$6 million in both the third quarters of 2013 and 2012 in distributions recorded as interest expense by the CLOs.

(c) Elimination of management fees earned by AFG.

(d) Allocate earnings (losses) of CLOs attributable to other debt holders to noncontrolling interests.

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## AMERICAN FINANCIAL GROUP, INC. 10-Q

## Management's Discussion and Analysis of Financial Condition and Results of Operations — Continued

## CONDENSED CONSOLIDATING STATEMENT OF EARNINGS

|                                                                    | Before CLO<br>Consolidation (a) | Managed<br>Investment<br>Entities | Consol.<br>Entries | Consolidated<br>As Reported |
|--------------------------------------------------------------------|---------------------------------|-----------------------------------|--------------------|-----------------------------|
| Nine months ended September 30, 2013                               |                                 |                                   |                    |                             |
| Revenues:                                                          |                                 |                                   |                    |                             |
| Insurance net earned premiums                                      | \$ 2,432                        | \$—                               | \$—                | \$ 2,432                    |
| Net investment income                                              | 1,023                           | —                                 | (27 ) (b)          | 996                         |
| Realized gains on securities                                       | 154                             | —                                 | —                  | 154                         |
| Income (loss) of managed investment entities:                      |                                 |                                   |                    |                             |
| Investment income                                                  | —                               | 98                                | —                  | 98                          |
| Loss on change in fair value of assets/liabilities                 | —                               | (25 ) 4                           | (b)                | (21 )                       |
| Other income                                                       | 83                              | —                                 | (12 ) (c)          | 71                          |
| Total revenues                                                     | 3,692                           | 73                                | (35 )              | 3,730                       |
| Costs and Expenses:                                                |                                 |                                   |                    |                             |
| Insurance benefits and expenses                                    | 2,917                           | —                                 | —                  | 2,917                       |
| Expenses of managed investment entities                            | —                               | 99                                | (31 ) (b)(c)       | 68                          |
| Interest charges on borrowed money and other expenses              | 302                             | —                                 | —                  | 302                         |
| Total costs and expenses                                           | 3,219                           | 99                                | (31 )              | 3,287                       |
| Earnings before income taxes                                       | 473                             | (26 ) 4                           | ( )                | 443                         |
| Provision for income taxes                                         | 155                             | —                                 | —                  | 155                         |
| Net earnings, including noncontrolling interests                   | 318                             | (26 ) 4                           | ( )                | 288                         |
| Less: Net earnings (loss) attributable to noncontrolling interests | 5                               | —                                 | (30 ) (d)          | (25 )                       |
| Net Earnings Attributable to Shareholders                          | \$ 313                          | \$(26 )                           | \$26               | \$ 313                      |
| Nine months ended September 30, 2012                               |                                 |                                   |                    |                             |
| Revenues:                                                          |                                 |                                   |                    |                             |
| Insurance net earned premiums                                      | \$ 2,381                        | \$—                               | \$—                | \$ 2,381                    |
| Net investment income                                              | 993                             | —                                 | (21 ) (b)          | 972                         |
| Realized gains on securities                                       | 145                             | —                                 | —                  | 145                         |
| Realized gains on subsidiaries                                     | 155                             | —                                 | —                  | 155                         |
| Income (loss) of managed investment entities:                      |                                 |                                   |                    |                             |
| Investment income                                                  | —                               | 92                                | —                  | 92                          |
| Loss on change in fair value of assets/liabilities                 | —                               | (72 ) 9                           | (b)                | (63 )                       |
| Other income                                                       | 81                              | —                                 | (14 ) (c)          | 67                          |
| Total revenues                                                     | 3,755                           | 20                                | (26 )              | 3,749                       |
| Costs and Expenses:                                                |                                 |                                   |                    |                             |
| Insurance benefits and expenses                                    | 2,807                           | —                                 | —                  | 2,807                       |
| Expenses of managed investment entities                            | —                               | 84                                | (26 ) (b)(c)       | 58                          |
| Interest charges on borrowed money and other expenses              | 317                             | —                                 | —                  | 317                         |
| Total costs and expenses                                           | 3,124                           | 84                                | (26 )              | 3,182                       |
| Earnings before income taxes                                       | 631                             | (64 )                             | —                  | 567                         |
| Provision for income taxes                                         | 184                             | —                                 | —                  | 184                         |
| Net earnings, including noncontrolling interests                   | 447                             | (64 )                             | —                  | 383                         |
|                                                                    | 9                               | —                                 | (64 ) (d)          | (55 )                       |

Less: Net earnings (loss) attributable to noncontrolling interests

|                                           |        |         |      |        |
|-------------------------------------------|--------|---------|------|--------|
| Net Earnings Attributable to Shareholders | \$ 438 | \$(64 ) | \$64 | \$ 438 |
|-------------------------------------------|--------|---------|------|--------|

Includes \$27 million and \$21 million for the first nine months of 2013 and 2012, respectively, in net investment (a) income representing the change in fair value of AFG's CLO investments plus \$12 million and \$14 million in 2013 and 2012, respectively, in CLO management fees earned.

(b) Elimination of the change in fair value of AFG's investments in the CLOs, including \$19 million and \$12 million in the first nine months of 2013 and 2012, respectively, in distributions recorded as interest expense by the CLOs.

(c) Elimination of management fees earned by AFG.

(d) Allocate losses of CLOs attributable to other debt holders to noncontrolling interests.

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## Management's Discussion and Analysis of Financial Condition and Results of Operations — Continued

## RESULTS OF OPERATIONS

General Results of operations as shown in the accompanying financial statements are prepared in accordance with GAAP.

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

|                                                              | Three months ended<br>September 30, |        | Nine months ended<br>September 30, |        |
|--------------------------------------------------------------|-------------------------------------|--------|------------------------------------|--------|
|                                                              | 2013                                | 2012   | 2013                               | 2012   |
| Core net operating earnings                                  | \$97                                | \$78   | \$268                              | \$253  |
| Gain on sale of Medicare supplement and critical illness (*) | —                                   | 101    | —                                  | 101    |
| Other realized gains (*)                                     | 35                                  | 55     | 97                                 | 92     |
| Special A&E charges (*)                                      | (49                                 | ) (21  | ) (49                              | ) (21  |
| ELNY guaranty fund assessments (*)                           | —                                   | —      | (3                                 | ) —    |
| AFG tax case resolution                                      | —                                   | 28     | —                                  | 28     |
| Other (*)                                                    | —                                   | (15    | ) —                                | (15    |
| Net earnings attributable to shareholders                    | \$83                                | \$226  | \$313                              | \$438  |
| Diluted per share amounts:                                   |                                     |        |                                    |        |
| Core net operating earnings                                  | \$1.06                              | \$.82  | \$2.94                             | \$2.59 |
| Gain on sale of Medicare supplement and critical illness     | —                                   | 1.07   | —                                  | 1.04   |
| Other realized gains                                         | .40                                 | .59    | 1.08                               | .95    |
| Special A&E charges                                          | (.54                                | ) (.23 | ) (.54                             | ) (.22 |
| ELNY guaranty fund assessments                               | —                                   | —      | (.04                               | ) —    |
| AFG tax case resolution                                      | —                                   | .30    | —                                  | .29    |
| Other                                                        | —                                   | (.16   | ) —                                | (.15   |
| Net earnings attributable to shareholders                    | \$.92                               | \$2.39 | \$3.44                             | \$4.50 |

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

|                                                          |     |       |       |       |
|----------------------------------------------------------|-----|-------|-------|-------|
| Gain on sale of Medicare supplement and critical illness | \$— | \$(54 | ) \$— | \$(54 |
| Other realized gains                                     | (20 | ) (31 | ) (55 | ) (52 |
| Special A&E charges                                      | 27  | 12    | 27    | 12    |
| ELNY guaranty fund assessments                           | —   | —     | 2     | —     |
| Other                                                    | —   | 8     | —     | 8     |

In addition, other realized gains are shown net of noncontrolling interests as follows (in millions):

|                          |      |       |      |        |
|--------------------------|------|-------|------|--------|
| Noncontrolling interests | \$(1 | ) \$— | \$(2 | ) \$(1 |
|--------------------------|------|-------|------|--------|

Net earnings attributable to shareholders decreased in the third quarter and first nine months of 2013 compared to the same periods in 2012 due primarily to the \$101 million after tax gain on the sale of AFG's Medicare supplement and critical illness businesses and the favorable impact of AFG's tax case resolution, both of which occurred in the third quarter of 2012. Net earnings attributable to shareholders were also impacted by special A&E charges, which were higher in the third quarter of 2013 compared to the third quarter of 2012.

Core net operating earnings increased \$19 million in the third quarter of 2013 compared to the same period in 2012 with significantly higher profits in the Specialty property and casualty insurance operations and increased earnings in the annuity segment as the primary drivers of the improved quarterly results. For the first nine months of 2013, the \$15 million increase in core net operating earnings as compared to the 2012 period reflects significantly higher profits in the annuity segment and higher underwriting profit in the property and casualty insurance segment, partially offset by the absence of earnings from the Medicare supplement and critical illness segment, which was sold in August 2012, a decline in the results of the run-off long-term care and life segment and lower net investment income in the property and casualty insurance segment.

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## Management's Discussion and Analysis of Financial Condition and Results of Operations — Continued

Earnings per share amounts for the third quarter and first nine months of 2013 also reflect the favorable impact of share repurchases since the beginning of 2012.

## RESULTS OF OPERATIONS — QUARTERS ENDED SEPTEMBER 30, 2013 AND 2012

**Segmented Statement of Earnings** AFG reports its business as five segments: (i) Property and casualty insurance ("P&C"), (ii) Annuity, (iii) Run-off long-term care and life, (iv) Medicare supplement and critical illness (sold in August 2012) and (v) Other, which includes holding company costs and operations attributable to the noncontrolling interests of the managed investment entities ("MIEs").

AFG's net earnings attributable to shareholders, determined in accordance with GAAP, include certain items that may not be indicative of its ongoing core operations. The following tables for the quarters ended September 30, 2013 and 2012 identify such items by segment and reconcile net earnings attributable to shareholders to core net operating earnings, a non-GAAP financial measure that AFG believes is a useful tool for investors and analysts in analyzing ongoing operating trends (in millions):

|                                                         | P&C   | Annuity | Run-off<br>long-term<br>care<br>and life | Consol.<br>MIEs | Other<br>Holding<br>Co.,<br>other<br>and<br>unallocated | Total | Non-core<br>reclass | GAAP<br>Total |
|---------------------------------------------------------|-------|---------|------------------------------------------|-----------------|---------------------------------------------------------|-------|---------------------|---------------|
| Quarter ended September 30, 2013                        |       |         |                                          |                 |                                                         |       |                     |               |
| Revenues:                                               |       |         |                                          |                 |                                                         |       |                     |               |
| Property and casualty insurance net earned premiums     | \$949 | \$—     | \$—                                      | \$—             | \$—                                                     | \$949 | \$—                 | \$949         |
| Life, accident and health net earned premiums           | —     | —       | 29                                       | —               | —                                                       | 29    | —                   | 29            |
| Net investment income                                   | 65    | 259     | 20                                       | (9 )            | 3                                                       | 338   | —                   | 338           |
| Realized gains on securities                            | —     | —       | —                                        | —               | —                                                       | —     | 56                  | 56            |
| Income (loss) of MIEs:                                  |       |         |                                          |                 |                                                         |       |                     |               |
| Investment income                                       | —     | —       | —                                        | 32              | —                                                       | 32    | —                   | 32            |
| Gain on change in fair value of assets/liabilities      | —     | —       | —                                        | 15              | —                                                       | 15    | —                   | 15            |
| Other income                                            | 1     | 17      | 1                                        | (4 )            | 9                                                       | 24    | —                   | 24            |
| Total revenues                                          | 1,015 | 276     | 50                                       | 34              | 12                                                      | 1,387 | 56                  | 1,443         |
| Costs and Expenses:                                     |       |         |                                          |                 |                                                         |       |                     |               |
| Property and casualty insurance:                        |       |         |                                          |                 |                                                         |       |                     |               |
| Losses and loss adjustment expenses                     | 626   | —       | —                                        | —               | —                                                       | 626   | 54                  | 680           |
| Commissions and other underwriting expenses             | 261   | —       | —                                        | —               | —                                                       | 261   | —                   | 261           |
| Annuity benefits                                        | —     | 140     | —                                        | —               | —                                                       | 140   | —                   | 140           |
| Life, accident and health benefits                      | —     | —       | 42                                       | —               | —                                                       | 42    | —                   | 42            |
| Annuity and supplemental insurance acquisition expenses | —     | 35      | 5                                        | —               | —                                                       | 40    | —                   | 40            |
| Interest charges on borrowed money                      | 1     | —       | —                                        | —               | 17                                                      | 18    | —                   | 18            |
| Expenses of MIEs                                        | —     | —       | —                                        | 22              | —                                                       | 22    | —                   | 22            |
| Other expenses                                          | 12    | 23      | 7                                        | —               | 34                                                      | 76    | 22                  | 98            |
| Total costs and expenses                                | 900   | 198     | 54                                       | 22              | 51                                                      | 1,225 | 76                  | 1,301         |
| Earnings before income taxes                            | 115   | 78      | (4 )                                     | 12              | (39 )                                                   | 162   | (20 )               | 142           |

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|                                                                    |      |      |       |   |     |       |   |      |     |    |      |
|--------------------------------------------------------------------|------|------|-------|---|-----|-------|---|------|-----|----|------|
| Provision for income taxes                                         | 38   | 26   | (2    | ) | —   | (11   | ) | 51   | (7  | )  | 44   |
| Net earnings, including noncontrolling interests                   | 77   | 52   | (2    | ) | 12  | (28   | ) | 111  | (13 | )  | 98   |
| Less: Net earnings (loss) attributable to noncontrolling interests | 2    | —    | —     |   | 12  | —     |   | 14   | 1   |    | 15   |
| Core Net Operating Earnings                                        | 75   | 52   | (2    | ) | —   | (28   | ) | 97   |     |    |      |
| Non-core earnings attributable to shareholders (a):                |      |      |       |   |     |       |   |      |     |    |      |
| Realized gains on securities, net of tax                           | —    | —    | —     |   | —   | 35    |   | 35   | (35 | )  | —    |
| Special A&E charges, net of tax                                    | (35  | )    | —     |   | —   | (14   | ) | (49  | )   | 49 | —    |
| Net Earnings Attributable to Shareholders                          | \$40 | \$52 | \$ (2 | ) | \$— | \$ (7 | ) | \$83 | \$— |    | \$83 |

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## Management's Discussion and Analysis of Financial Condition and Results of Operations — Continued

|                                                                      | P&C   | Run-off<br>Annuity<br>and<br>life | Medicare<br>supplement<br>and<br>critical<br>illness | Other<br>Consol.<br>MIEs | Holding<br>Co.,<br>other<br>and<br>unallocated | Total | Non-GAAP<br>reclassified | GAAP<br>Total |
|----------------------------------------------------------------------|-------|-----------------------------------|------------------------------------------------------|--------------------------|------------------------------------------------|-------|--------------------------|---------------|
| Quarter ended September 30, 2012                                     |       |                                   |                                                      |                          |                                                |       |                          |               |
| Revenues:                                                            |       |                                   |                                                      |                          |                                                |       |                          |               |
| Property and casualty insurance net earned premiums                  | \$848 | \$—                               | \$—                                                  | \$—                      | \$—                                            | \$—   | \$848                    | \$— \$848     |
| Life, accident and health net earned premiums                        | —     | —                                 | 30                                                   | 50                       | —                                              | —     | 80                       | — 80          |
| Net investment income                                                | 67    | 249                               | 19                                                   | 2                        | (11)                                           | —     | 326                      | — 326         |
| Realized gains on securities                                         | —     | —                                 | —                                                    | —                        | —                                              | —     | —                        | 85 85         |
| Realized gains on subsidiaries                                       | —     | —                                 | —                                                    | —                        | —                                              | —     | —                        | 156 156       |
| Income (loss) of MIEs:                                               |       |                                   |                                                      |                          |                                                |       |                          |               |
| Investment income                                                    | —     | —                                 | —                                                    | —                        | 31                                             | —     | 31                       | — 31          |
| Loss on change in fair value of assets/liabilities                   | —     | —                                 | —                                                    | —                        | (13)                                           | —     | (13 )                    | — (13 )       |
| Other income                                                         | 6     | 14                                | 1                                                    | 1                        | (6 )                                           | 9     | 25                       | — 25          |
| Total revenues                                                       | 921   | 263                               | 50                                                   | 53                       | 1                                              | 9     | 1,297                    | 241 1,538     |
| Costs and Expenses:                                                  |       |                                   |                                                      |                          |                                                |       |                          |               |
| Property and casualty insurance:                                     |       |                                   |                                                      |                          |                                                |       |                          |               |
| Losses and loss adjustment expenses                                  | 579   | —                                 | —                                                    | —                        | —                                              | —     | 579                      | 31 610        |
| Commissions and other underwriting expenses                          | 254   | —                                 | —                                                    | —                        | —                                              | —     | 254                      | — 254         |
| Annuity benefits                                                     | —     | 140                               | —                                                    | —                        | —                                              | —     | 140                      | — 140         |
| Life, accident and health benefits                                   | —     | —                                 | 36                                                   | 30                       | —                                              | —     | 66                       | — 66          |
| Annuity and supplemental insurance acquisition expenses              | —     | 32                                | 5                                                    | 9                        | —                                              | —     | 46                       | — 46          |
| Interest charges on borrowed money                                   | —     | —                                 | —                                                    | —                        | —                                              | 19    | 19                       | — 19          |
| Expenses of MIEs                                                     | —     | —                                 | —                                                    | —                        | 19                                             | —     | 19                       | — 19          |
| Other expenses                                                       | 15    | 22                                | 7                                                    | 4                        | —                                              | 26    | 74                       | 25 99         |
| Total costs and expenses                                             | 848   | 194                               | 48                                                   | 43                       | 19                                             | 45    | 1,197                    | 56 1,253      |
| Earnings before income taxes                                         | 73    | 69                                | 2                                                    | 10                       | (18)                                           | (36 ) | 100                      | 185 285       |
| Provision for income taxes                                           | 23    | 22                                | 1                                                    | 4                        | —                                              | (13 ) | 37                       | 37 74         |
| Net earnings, including noncontrolling interests                     | 50    | 47                                | 1                                                    | 6                        | (18)                                           | (23 ) | 63                       | 148 211       |
| Less: Net earnings (loss) attributable to noncontrolling interests   | 2     | —                                 | —                                                    | —                        | (18)                                           | 1     | (15 )                    | — (15 )       |
| Core Net Operating Earnings                                          | 48    | 47                                | 1                                                    | 6                        | —                                              | (24 ) | 78                       |               |
| Non-core earnings attributable to shareholders (a):                  |       |                                   |                                                      |                          |                                                |       |                          |               |
| Gain on sale of Medicare supplement and critical illness, net of tax | —     | —                                 | —                                                    | 101                      | —                                              | —     | 101                      | (10) —        |
| Other realized gains, net of tax                                     | —     | —                                 | —                                                    | —                        | —                                              | 55    | 55                       | (55) —        |
| Special A&E charges, net of tax                                      | (20 ) | —                                 | —                                                    | —                        | —                                              | (1 )  | (21 )                    | 21 —          |
| AFG tax case resolution                                              | —     | —                                 | —                                                    | —                        | —                                              | 28    | 28                       | (28) —        |
| Other, net of tax                                                    | —     | —                                 | —                                                    | —                        | —                                              | (15 ) | (15 )                    | 15 —          |
| Net Earnings Attributable to Shareholders                            | \$28  | \$47                              | \$1                                                  | \$107                    | \$—                                            | \$43  | \$226                    | \$— \$226     |

- (a) See the reconciliation of core earnings to GAAP net earnings under Results of Operations — General for details on the tax and noncontrolling interest impacts of these reconciling items.

Property and Casualty Insurance Segment — Results of Operations 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. Underwriting profitability is measured by the combined ratio, which is a sum of the ratios of losses and loss adjustment expenses, and commissions and other underwriting expenses to premiums. A combined ratio under 100% indicates an underwriting profit. The combined ratio does not reflect net investment income, other income,

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## AMERICAN FINANCIAL GROUP, INC. 10-Q

## Management's Discussion and Analysis of Financial Condition and Results of Operations — Continued

other expenses or federal income taxes. AFG's property and casualty insurance operations contributed \$61 million in GAAP pretax earnings in the third quarter of 2013 compared to \$42 million in the third quarter of 2012, an increase of \$19 million (45%). Property and casualty core pretax earnings were \$115 million in the third quarter of 2013 compared to \$73 million in the third quarter of 2012, an increase of \$42 million (58%). The increase in GAAP and core pretax earnings reflects significantly higher underwriting profit across each of AFG's property and casualty insurance sub-segments. The impact of this improved profitability on GAAP pretax earnings was partially offset by higher special A&E charges in the third quarter of 2013 as compared to the 2012 quarter.

The following table details AFG's GAAP and core earnings before income taxes from its property and casualty operations for the three months ended September 30, 2013 and 2012 (dollars in millions):

|                                             | Three months ended<br>September 30, |         | % Change |    |
|---------------------------------------------|-------------------------------------|---------|----------|----|
|                                             | 2013                                | 2012    |          |    |
| Gross written premiums                      | \$1,768                             | \$1,509 | 17       | %  |
| Reinsurance premiums ceded                  | (701 )                              | (601 )  | 17       | %  |
| Net written premiums                        | 1,067                               | 908     | 18       | %  |
| Change in unearned premiums                 | (118 )                              | (60 )   | 97       | %  |
| Net earned premiums                         | 949                                 | 848     | 12       | %  |
| Loss and loss adjustment expenses (*)       | 626                                 | 579     | 8        | %  |
| Commissions and other underwriting expenses | 261                                 | 254     | 3        | %  |
| Core underwriting gain                      | 62                                  | 15      | 313      | %  |
| Net investment income                       | 65                                  | 67      | (3       | %) |
| Other income and expenses, net              | (12 )                               | (9 )    | 33       | %  |
| Core earnings before income taxes           | 115                                 | 73      | 58       | %  |
| Pretax non-core special A&E charges         | (54 )                               | (31 )   | 74       | %  |
| GAAP earnings before income taxes           | \$61                                | \$42    | 45       | %  |

(\*) Excluding non-core special A&E charges

## Combined Ratios:

| Specialty lines                          | Change |   |       |           |
|------------------------------------------|--------|---|-------|-----------|
| Loss and LAE ratio                       | 66.1   | % | 68.2  | % (2.1 %) |
| Underwriting expense ratio               | 27.4   | % | 30.0  | % (2.6 %) |
| Combined ratio                           | 93.5   | % | 98.2  | % (4.7 %) |
| Aggregate — including discontinued lines |        |   |       |           |
| Loss and LAE ratio                       | 71.7   | % | 71.9  | % (0.2 %) |
| Underwriting expense ratio               | 27.4   | % | 30.0  | % (2.6 %) |
| Combined ratio                           | 99.1   | % | 101.9 | % (2.8 %) |

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

AFG reports the underwriting performance of its Specialty insurance business in the following sub-components: (i) Property and transportation, (ii) Specialty casualty and (iii) Specialty financial.

To understand the overall profitability of particular lines, the timing of claims payments and the related impact of investment income must be considered. Certain “short-tail” lines of business (primarily property coverages) generally have quick loss payouts, which reduce the time funds are held, thereby limiting investment income earned thereon. In contrast, “long-tail” lines of business (primarily liability coverages and workers' compensation) generally have payouts that are either structured over many years or take many years to settle, thereby significantly increasing investment income earned on related premiums received.

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## Management's Discussion and Analysis of Financial Condition and Results of Operations — Continued

## Gross Written Premiums

Gross written premiums ("GWP") for AFG's property and casualty insurance segment were \$1.77 billion for the third quarter of 2013 compared to \$1.51 billion for the third quarter of 2012, an increase of \$259 million (17%). Detail of AFG's property and casualty gross written premiums is shown below (dollars in millions):

|                             | Three months ended September 30, |     | 2012      |     | % Change |   |  |
|-----------------------------|----------------------------------|-----|-----------|-----|----------|---|--|
|                             | 2013                             | %   | GWP       | %   |          |   |  |
| Property and transportation | \$1,147                          | 65  | % \$981   | 65  | % 17     | % |  |
| Specialty casualty          | 461                              | 26  | % 376     | 25  | % 23     | % |  |
| Specialty financial         | 160                              | 9   | % 152     | 10  | % 5      | % |  |
| Other specialty             | —                                | —   | % —       | —   | %        |   |  |
|                             | \$1,768                          | 100 | % \$1,509 | 100 | % 17     | % |  |

## Reinsurance Premiums Ceded

Reinsurance premiums ceded ("Ceded") for AFG's property and casualty insurance segment were 40% of gross written premiums for the third quarter of 2013 and 2012. Detail of AFG's property and casualty reinsurance premiums ceded is shown below (dollars in millions):

|                             | Three months ended September 30, |             | 2012      |             | Change in<br>% of GWP |   |  |
|-----------------------------|----------------------------------|-------------|-----------|-------------|-----------------------|---|--|
|                             | 2013                             | % of<br>GWP | Ceded     | % of<br>GWP |                       |   |  |
| Property and transportation | \$(553)                          | ) 48        | % \$(442) | ) 45        | % 3                   | % |  |
| Specialty casualty          | (136)                            | ) 30        | % (133)   | ) 35        | % (5                  | % |  |
| Specialty financial         | (36)                             | ) 23        | % (44)    | ) 29        | % (6                  | % |  |
| Other specialty             | 24                               |             | 18        |             |                       |   |  |
|                             | \$(701)                          | ) 40        | % \$(601) | ) 40        | % —                   | % |  |

## Net Written Premiums

Net written premiums ("NWP") for AFG's property and casualty insurance segment were \$1.07 billion for the third quarter of 2013 compared to \$908 million for the third quarter of 2012, an increase of \$159 million (18%). Detail of AFG's property and casualty net written premiums is shown below (dollars in millions):

|                             | Three months ended September 30, |     | 2012    |     | % Change |   |  |
|-----------------------------|----------------------------------|-----|---------|-----|----------|---|--|
|                             | 2013                             | %   | NWP     | %   |          |   |  |
| Property and transportation | \$594                            | 56  | % \$539 | 59  | % 10     | % |  |
| Specialty casualty          | 325                              | 30  | % 243   | 27  | % 34     | % |  |
| Specialty financial         | 124                              | 12  | % 108   | 12  | % 15     | % |  |
| Other specialty             | 24                               | 2   | % 18    | 2   | % 33     | % |  |
|                             | \$1,067                          | 100 | % \$908 | 100 | % 18     | % |  |

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## Management's Discussion and Analysis of Financial Condition and Results of Operations — Continued

## Net Earned Premiums

Net earned premiums ("NEP") for AFG's property and casualty insurance segment were \$949 million for the third quarter of 2013 compared to \$848 million for the third quarter of 2012, an increase of \$101 million (12%). Detail of AFG's property and casualty net earned premiums is shown below (dollars in millions):

|                             | Three months ended September 30, |     |         |     |          |   |
|-----------------------------|----------------------------------|-----|---------|-----|----------|---|
|                             | 2013                             |     | 2012    |     |          |   |
|                             | NEP                              | %   | NEP     | %   | % Change |   |
| Property and transportation | \$517                            | 55  | % \$487 | 57  | % 6      | % |
| Specialty casualty          | 289                              | 30  | % 243   | 29  | % 19     | % |
| Specialty financial         | 121                              | 13  | % 100   | 12  | % 21     | % |
| Other specialty             | 22                               | 2   | % 18    | 2   | % 22     | % |
|                             | \$949                            | 100 | % \$848 | 100 | % 12     | % |

The \$259 million increase in gross written premiums for the third quarter of 2013 compared to the third quarter of 2012 reflects double-digit premium growth in the Specialty casualty group and the timing of premium recognition in the agricultural operations. Delayed planting of spring crops resulted in late acreage reporting, which effectively shifted a portion of AFG's crop premiums from the second quarter to the third quarter when compared to 2012. Overall average renewal rates increased approximately 4% in the third quarter of 2013.

**Property and transportation** Gross written premiums increased \$166 million (17%) in the third quarter of 2013 compared to the same period in 2012 due primarily to higher crop premiums in the third quarter of 2013, as delayed planting and acreage reporting in the second quarter of 2013 shifted recognition of these premiums to the third quarter of 2013. Excluding the impact of crop insurance premiums, gross and net written premiums grew by 5% and 4%, respectively, in the third quarter of 2013 when compared to the third quarter of 2012. Average renewal rates were up approximately 5% for the third quarter of 2013. Reinsurance premiums ceded as a percentage of gross written premiums increased 3 percentage points in the third quarter of 2013 compared to the third quarter of 2012 reflecting higher cessions of multi-peril crop business.

**Specialty casualty** Gross written premiums increased \$85 million (23%) for the third quarter of 2013 compared to the third quarter of 2012 as a result of increased premiums in nearly all businesses in this group, especially in the workers' compensation and excess and surplus lines. New business opportunities, increased exposures from higher payroll on existing accounts, and sustained pricing increases have contributed to increased premiums in the workers' compensation businesses. Strong premium growth in the excess and surplus operations is the result of broadening opportunities to write business coupled with the benefit from rate increases over multiple quarters. Average renewal rates were up approximately 5% for this group in the third quarter of 2013. Reinsurance premiums ceded as a percentage of gross written premiums declined 5 percentage points for the third quarter of 2013 compared to the third quarter of 2012 reflecting a change in the mix of business and the timing of reinsurance premiums between quarters.

**Specialty financial** Gross written premiums increased \$8 million (5%) for the third quarter of 2013 compared to the third quarter of 2012 due primarily to growth in lender-placed mortgage property insurance offered by the financial institutions business. Gross written premiums for the third quarter of 2013 include \$3 million in risk fees from AFG's warranty operations. Prior to 2013, fees in the warranty operations were included in other income. Average renewal rates for this group were down 1% in the third quarter of 2013. Reinsurance premiums ceded as a percentage of gross written premiums declined 6 percentage points reflecting the impact of reinsurance reinstatement premiums paid in the third quarter of 2012 and a change in the mix of business.

Other specialty The amounts shown as reinsurance premiums ceded represent business assumed by AFG's internal reinsurance program from the operations that make up AFG's other Specialty sub-components.

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## Management's Discussion and Analysis of Financial Condition and Results of Operations — Continued

## Combined Ratio

Performance measures such as the combined ratio are often used by property and casualty insurers to help users of their financial statements better understand the company's performance. The combined ratio is the sum of the loss and loss adjustment expenses ("LAE") and underwriting expense ratios. These ratios are calculated by dividing each of the respective expenses by net earned premiums. The table below details the components of the combined ratio for AFG's property and casualty segment:

|                                          | Three months ended<br>September 30, |         | Change  |    | Three months ended<br>September 30, |         |
|------------------------------------------|-------------------------------------|---------|---------|----|-------------------------------------|---------|
|                                          | 2013                                | 2012    |         |    | 2013                                | 2012    |
| Property and transportation              |                                     |         |         |    |                                     |         |
| Loss and LAE ratio                       | 78.8                                | % 76.1  | % 2.7   | %  |                                     |         |
| Underwriting expense ratio               | 18.3                                | % 23.7  | % (5.4  | %) |                                     |         |
| Combined ratio                           | 97.1                                | % 99.8  | % (2.7  | %) |                                     |         |
| Underwriting profit                      |                                     |         |         |    | \$16                                | \$—     |
| Specialty casualty                       |                                     |         |         |    |                                     |         |
| Loss and LAE ratio                       | 60.3                                | % 63.8  | % (3.5  | %) |                                     |         |
| Underwriting expense ratio               | 33.1                                | % 32.9  | % 0.2   | %  |                                     |         |
| Combined ratio                           | 93.4                                | % 96.7  | % (3.3  | %) |                                     |         |
| Underwriting profit                      |                                     |         |         |    | \$19                                | \$8     |
| Specialty financial                      |                                     |         |         |    |                                     |         |
| Loss and LAE ratio                       | 31.2                                | % 46.7  | % (15.5 | %) |                                     |         |
| Underwriting expense ratio               | 51.1                                | % 52.1  | % (1.0  | %) |                                     |         |
| Combined ratio                           | 82.3                                | % 98.8  | % (16.5 | %) |                                     |         |
| Underwriting profit                      |                                     |         |         |    | \$22                                | \$1     |
| Total Specialty                          |                                     |         |         |    |                                     |         |
| Loss and LAE ratio                       | 66.1                                | % 68.2  | % (2.1  | %) |                                     |         |
| Underwriting expense ratio               | 27.4                                | % 30.0  | % (2.6  | %) |                                     |         |
| Combined ratio                           | 93.5                                | % 98.2  | % (4.7  | %) |                                     |         |
| Underwriting profit                      |                                     |         |         |    | \$62                                | \$16    |
| Aggregate — including discontinued lines |                                     |         |         |    |                                     |         |
| Loss and LAE ratio                       | 71.7                                | % 71.9  | % (0.2  | %) |                                     |         |
| Underwriting expense ratio               | 27.4                                | % 30.0  | % (2.6  | %) |                                     |         |
| Combined ratio                           | 99.1                                | % 101.9 | % (2.8  | %) |                                     |         |
| Underwriting profit (loss)               |                                     |         |         |    | \$8                                 | \$(16 ) |

The Specialty insurance operations generated an underwriting profit of \$62 million in the third quarter of 2013 compared to \$16 million in the third quarter of 2012, an increase of \$46 million (288%). The higher profit in the 2013 quarter reflects higher underwriting profits across each of the property and casualty insurance sub-segments. Catastrophe losses were \$1 million (0.1 points on the combined ratio), compared to \$4 million (0.6 points) in the third quarter of 2012.

**Property and transportation** This group reported an underwriting gain of \$16 million for the third quarter of 2013, compared to less than \$1 million for the third quarter of 2012. This increase is primarily attributable to improved results in the agricultural operations and lower catastrophe losses, partially offset by lower profitability in the transportation businesses. Results for the 2012 quarter include \$12 million in crop losses resulting from the effects of the drought in the Midwest. Catastrophe losses were minimal for this group during the third quarter of 2013, compared to \$2 million (0.6 points) during the third quarter of 2012.

**Specialty casualty** Underwriting profit was \$19 million for the third quarter of 2013 compared to \$8 million in the third quarter of 2012, an increase of \$11 million (138%). This increase was due primarily to higher profitability in the workers'

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## Management's Discussion and Analysis of Financial Condition and Results of Operations — Continued

compensation and excess and surplus lines businesses, as well as a reduction in adverse development in the run-off program business.

**Specialty financial** Underwriting profit was \$22 million for the third quarter of 2013 compared to \$1 million in the third quarter of 2012, an increase of \$21 million. The increased profitability was due primarily to higher underwriting profits in the financial institutions business, primarily from lender-placed mortgage property insurance, as well as improved results in the surety and trade credit operations. Results for the third quarter of 2012 include losses from a run-off book of automotive-related business.

**Aggregate** As discussed below in more detail under Net prior year reserve development, AFG recorded special charges to increase A&E reserves (net of reinsurance) by \$54 million in the third quarter of 2013 and \$31 million in the third quarter of 2012.

**Losses and Loss Adjustment Expenses**

AFG's overall loss and LAE ratio was 71.7% for the third quarter of 2013 compared to 71.9% for third quarter of 2012, a decrease of 0.2 percentage points. The components of AFG's property and casualty losses and LAE amounts and ratio are detailed below:

|                                                      | Three months ended September 30, |       |        |         |    |       |           |  |
|------------------------------------------------------|----------------------------------|-------|--------|---------|----|-------|-----------|--|
|                                                      | Amount                           |       | Ratio  |         |    |       | Change in |  |
|                                                      | 2013                             | 2012  | 2013   | 2012    |    |       | Ratio     |  |
| Property and transportation                          |                                  |       |        |         |    |       |           |  |
| Current year, excluding catastrophe losses           | \$408                            | \$371 | 79.1   | % 76.0  | %  | 3.1   | %         |  |
| Prior accident years development                     | (1                               | ) (2  | ) (0.2 | %) (0.5 | %) | 0.3   | %         |  |
| Current year catastrophe losses                      | —                                | 2     | (0.1   | %) 0.6  | %  | (0.7  | %)        |  |
| Property and transportation losses and LAE and ratio | \$407                            | \$371 | 78.8   | % 76.1  | %  | 2.7   | %         |  |
| Specialty casualty                                   |                                  |       |        |         |    |       |           |  |
| Current year, excluding catastrophe losses           | \$177                            | \$151 | 61.4   | % 62.3  | %  | (0.9  | %)        |  |
| Prior accident years development                     | (4                               | ) 3   | (1.2   | %) 1.2  | %  | (2.4  | %)        |  |
| Current year catastrophe losses                      | 1                                | 1     | 0.1    | % 0.3   | %  | (0.2  | %)        |  |
| Specialty casualty losses and LAE and ratio          | \$174                            | \$155 | 60.3   | % 63.8  | %  | (3.5  | %)        |  |
| Specialty financial                                  |                                  |       |        |         |    |       |           |  |
| Current year, excluding catastrophe losses           | \$40                             | \$50  | 33.7   | % 51.5  | %  | (17.8 | %)        |  |
| Prior accident years development                     | (4                               | ) (5  | ) (3.2 | %) (5.5 | %) | 2.3   | %         |  |
| Current year catastrophe losses                      | 1                                | 1     | 0.7    | % 0.7   | %  | —     | %         |  |
| Specialty financial losses and LAE and ratio         | \$37                             | \$46  | 31.2   | % 46.7  | %  | (15.5 | %)        |  |
| Total Specialty                                      |                                  |       |        |         |    |       |           |  |
| Current year, excluding catastrophe losses           | \$637                            | \$583 | 67.4   | % 68.7  | %  | (1.3  | %)        |  |
| Prior accident years development                     | (13                              | ) (9  | ) (1.4 | %) (1.1 | %) | (0.3  | %)        |  |
| Current year catastrophe losses                      | 2                                | 4     | 0.1    | % 0.6   | %  | (0.5  | %)        |  |
| Total Specialty losses and LAE and ratio             | \$626                            | \$578 | 66.1   | % 68.2  | %  | (2.1  | %)        |  |
| Aggregate — including discontinued lines             |                                  |       |        |         |    |       |           |  |
| Current year, excluding catastrophe losses           | \$638                            | \$583 | 67.4   | % 68.7  | %  | (1.3  | %)        |  |

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|                                    |       |       |      |   |      |   |      |    |
|------------------------------------|-------|-------|------|---|------|---|------|----|
| Prior accident years development   | 40    | 23    | 4.2  | % | 2.6  | % | 1.6  | %  |
| Current year catastrophe losses    | 2     | 4     | 0.1  | % | 0.6  | % | (0.5 | %) |
| Aggregate losses and LAE and ratio | \$680 | \$610 | 71.7 | % | 71.9 | % | (0.2 | %) |

Net prior year reserve development

AFG's Specialty property and casualty operations recorded net favorable reserve development related to prior accident years of \$13 million in the third quarter of 2013 compared to \$9 million in the third quarter of 2012, an increase of \$4 million (44%).

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**Property and transportation** Net favorable reserve development of \$1 million in the third quarter of 2013 reflects lower severity in the property and inland marine and ocean marine businesses partially offset by an increase in severity in commercial auto liability business written in the transportation businesses.

**Specialty casualty** Net favorable reserve development of \$4 million in the third quarter of 2013 reflects lower than expected claim severity in directors and officers liability insurance partially offset by higher than expected severity in run-off casualty businesses. Net adverse reserve development of \$3 million in the third quarter of 2012 reflects higher claim frequency and severity in a run-off book of U.S.-based program (motel/hotel, restaurants, taverns and recreational) business and adverse development in AFG's Lloyd's operations, partially offset by lower than expected claim severity in directors and officers liability insurance.

**Specialty financial** Net favorable reserve development of \$4 million in the third quarter of 2013 reflects lower than expected frequency and severity in the foreign credit business where economic conditions did not affect this line as adversely as previously anticipated. Net favorable reserve development of \$5 million in the third quarter of 2012 reflects lower than expected claim frequency and severity in the run-off automobile residual value insurance business.

**Other specialty** In addition to the development discussed above, total specialty net favorable reserve development reflects amortization of the deferred gain on the retroactive insurance transaction entered into in connection with the sale of a business in 1998 and reserve development associated with AFG's internal reinsurance program.

**Special Asbestos and Environmental Reserve Charges** During the third quarter of 2013, AFG completed a comprehensive external study of its asbestos and environmental exposures relating to the run-off operations of its property and casualty insurance segment and exposures related to its former railroad and manufacturing operations. AFG has periodically conducted comprehensive external studies of its asbestos and environmental reserves with the aid of specialty actuarial, engineering and consulting firms and outside counsel, generally every two years, with an in-depth internal review during the intervening years.

As a result of the study, AFG's property and casualty insurance segment recorded a \$54 million pretax special charge to increase its asbestos reserves by \$16 million (net of reinsurance) and its environmental reserves by \$38 million (net of reinsurance). The increase in the property and casualty segment's asbestos reserves was driven primarily by slightly higher than expected loss experience, higher defense costs and some increased claim severity. As the overall industry exposure to asbestos has matured, the focus of litigation has shifted to smaller companies and companies with ancillary exposures. AFG's insureds with these exposures have been the driver of the property and casualty segment's asbestos reserve increases. The increase in property and casualty environmental reserves was attributed primarily to a small number of claims where the estimated costs of remediation have increased. There were no newly identified or emerging broad industry trends that were identified in this study.

At September 30, 2013, the property and casualty insurance segment's insurance reserves include A&E reserves of \$341 million, net of reinsurance recoverables. At September 30, 2013, the property and casualty insurance segment's three-year survival ratios, excluding amounts associated with the settlements of two large asbestos claims, were 15.2 times paid losses for asbestos reserves, 6.2 times paid losses for environmental reserves and 10.4 times paid losses for total A&E reserves. These ratios compare favorably with data published by A.M. Best in October 2013, which indicate that industry survival ratios were 10.0 for asbestos, 5.8 for environmental, and 8.8 for total A&E reserves at December 31, 2012.

In addition, the study encompassed reserves for asbestos and environmental exposures of AFG's former railroad and manufacturing operations. For a discussion of the \$22 million charge recorded for those operations, see Management's Discussion and Analysis — "Holding Company, Other and Unallocated — Results of Operations."

As a result of the 2012 internal review, AFG's property and casualty insurance segment recorded a \$31 million pretax special charge to increase its asbestos reserves by \$19 million (net of reinsurance) and its environmental reserves by \$12 million (net of reinsurance). The charge in the third quarter of 2012 related primarily to an increase in environmental investigative costs and related loss adjustment expenses. See Management's Discussion and Analysis — "Uncertainties" — "Asbestos and Environmental-related ("A&E") Insurance Reserves" in AFG's 2012 Form 10-K.

Aggregate    Aggregate net prior accident years reserve development for AFG's property and casualty segment includes the special A&E charges discussed above.

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## Catastrophe losses

AFG generally seeks to reduce its exposure to catastrophes through individual risk selection, including minimizing coastal and known fault-line exposures, and the purchase of reinsurance. Based on data available at December 31, 2012, AFG's exposure to a catastrophic earthquake or windstorm that industry models indicate could occur once in every 500 years (a "500-year event") is expected to be less than 3% of AFG's shareholders' equity.

## Commissions and Other Underwriting Expenses

AFG's property and casualty commissions and other underwriting expenses ("U/W Exp") were \$261 million in the third quarter of 2013 compared to \$254 million for the third quarter of 2012, an increase of \$7 million (3%). AFG's underwriting expense ratio, calculated as commissions and other underwriting expenses divided by net premiums earned, was 27.4% for the third quarter of 2013 compared to 30.0% for the third quarter of 2012, a decrease of 2.6 percentage points. Detail of AFG's property and casualty commissions and other underwriting expenses and underwriting expense ratios is shown below (dollars in millions):

|                             | Three months ended September 30, |          |         |          | Change in |    |
|-----------------------------|----------------------------------|----------|---------|----------|-----------|----|
|                             | 2013                             |          | 2012    |          | % of NEP  |    |
|                             | U/W Exp                          | % of NEP | U/W Exp | % of NEP | % of NEP  |    |
| Property and transportation | \$94                             | 18.3     | % \$116 | 23.7     | % (5.4    | %) |
| Specialty casualty          | 96                               | 33.1     | % 80    | 32.9     | % 0.2     | %  |
| Specialty financial         | 62                               | 51.1     | % 53    | 52.1     | % (1.0    | %) |
| Other specialty             | 9                                | 35.7     | % 5     | 36.8     | % (1.1    | %) |
|                             | \$261                            | 27.4     | % \$254 | 30.0     | % (2.6    | %) |

The overall decrease of 2.6% in AFG's expense ratio for the third quarter of 2013 as compared to the third quarter of 2012, as well as the fluctuations in AFG's sub-components, reflects the timing of the determination of reimbursements for administrative and operating expenses under the Federal crop insurance program and the impact of higher premiums on the ratio, partially offset by higher profitability-based commissions paid to agents/brokers and lower profitability-based commissions received from reinsurers.

**Property and transportation** Commissions and other underwriting expenses as a percentage of net earned premiums decreased 5.4 percentage points for the third quarter of 2013 compared to the third quarter of 2012 reflecting the timing of the determination of reimbursements for administrative and operating expenses under the Federal crop insurance program and the impact of higher premiums on the ratio, partially offset by lower profitability-based commissions received from reinsurers.

**Specialty casualty** Commissions and other underwriting expenses as a percentage of net earned premiums increased 0.2 percentage points for the third quarter of 2013 compared to the third quarter of 2012.

**Specialty financial** Commissions and other underwriting expenses as a percentage of net earned premiums decreased 1.0 percentage points for the third quarter of 2013 compared to the third quarter of 2012 reflecting the impact of higher premiums on the ratio, partially offset by higher profitability-based commissions paid to agents/brokers and lower ceding commissions from reinsurers.

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## Property and Casualty Net Investment Income

Net investment income in AFG's property and casualty operations was \$65 million for the third quarter of 2013 compared to \$67 million in the third quarter of 2012, a decrease of \$2 million (3%). In recent years, yields available in the financial markets on fixed maturity securities have generally declined, placing downward pressure on AFG's investment portfolio yield. The average invested assets and overall earned yield on investments held by AFG's property and casualty operations are provided below (dollars in millions):

|                                                                 | Three months ended<br>September 30, |         | Change  | % Change |
|-----------------------------------------------------------------|-------------------------------------|---------|---------|----------|
|                                                                 | 2013                                | 2012    |         |          |
| Net investment income                                           | \$65                                | \$67    | \$(2 )  | (3 %)    |
| Average invested assets (at amortized cost)                     | \$6,835                             | \$6,621 | \$214   | 3 %      |
| Yield (net investment income as a % of average invested assets) | 3.80                                | % 4.05  | % (0.25 | %)       |

The property and casualty segment's overall yield on investments (net investment income as a percentage of average invested assets) was 3.80% for the third quarter of 2013 compared to 4.05% for the third quarter of 2012, a decline of 0.25 percentage points, reflecting the impact of lower yields available in the financial markets.

## Property and Casualty Other Income and Expense, Net

Other income and expenses, net for AFG's property and casualty operations was a net expense of \$12 million for the third quarter of 2013 compared to \$9 million for the third quarter of 2012, an increase of \$3 million (33%). The table below details the items included in other income and expenses, net for AFG's property and casualty operations (in millions):

|                                | Three months ended<br>September 30, |        |
|--------------------------------|-------------------------------------|--------|
|                                | 2013                                | 2012   |
| Other income                   |                                     |        |
| Warranty operations            | \$—                                 | \$4    |
| Other                          | 1                                   | 2      |
| Total other income             | 1                                   | 6      |
| Other expenses                 |                                     |        |
| Warranty operations            | —                                   | 5      |
| Amortization of intangibles    | 3                                   | 3      |
| Other                          | 9                                   | 7      |
| Total other expense            | 12                                  | 15     |
| Interest expense               | 1                                   | —      |
| Other income and expenses, net | \$(12 )                             | \$(9 ) |

Beginning in 2013, AFG's warranty operations are included in the Specialty financial underwriting results.

Interest expense for AFG's property and casualty operations includes interest charges on long-term debt within the property and casualty operations, primarily notes secured by real estate and other secured borrowings.

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## Annuity Segment — Results of Operations

AFG's annuity operations contributed \$78 million in pretax earnings in the third quarter of 2013 compared to \$69 million in the third quarter of 2012, an increase of \$9 million (13%). Higher pretax earnings were primarily a result of maintaining interest spreads on a growing asset base. AFG's average fixed annuity investments (at amortized cost) were 15% higher for the third quarter of 2013 as compared to the third quarter of 2012. In addition, results for the third quarter of 2012 reflect the negative impact of sharply lower interest rates on the fixed-indexed annuity business.

The following table details AFG's earnings before income taxes from its annuity operations for the three months ended September 30, 2013 and 2012 (dollars in millions).

|                                               | Three months ended<br>September 30, |       | % Change |   |
|-----------------------------------------------|-------------------------------------|-------|----------|---|
|                                               | 2013                                | 2012  |          |   |
| Revenues:                                     |                                     |       |          |   |
| Net investment income                         | \$259                               | \$249 | 4        | % |
| Other income:                                 |                                     |       |          |   |
| Guaranteed withdrawal benefit fees            | 7                                   | 4     | 75       | % |
| Policy charges and other miscellaneous income | 10                                  | 10    | —        | % |
| Total revenues                                | 276                                 | 263   | 5        | % |
| Costs and Expenses:                           |                                     |       |          |   |
| Annuity benefits (*)                          | 140                                 | 140   | —        | % |
| Acquisition expenses                          | 35                                  | 32    | 9        | % |
| Other expenses                                | 23                                  | 22    | 5        | % |
| Total costs and expenses                      | 198                                 | 194   | 2        | % |
| Earnings before income taxes                  | \$78                                | \$69  | 13       | % |

(\*) Annuity benefits consisted of the following (in millions):

|                                                           | Three months ended<br>September 30, |       | % Change |    |
|-----------------------------------------------------------|-------------------------------------|-------|----------|----|
|                                                           | 2013                                | 2012  |          |    |
| Interest credited — fixed                                 | \$113                               | \$107 | 6        | %  |
| Interest credited — fixed component of variable annuities | 2                                   | 2     | —        | %  |
| Change in expected death and annuitization reserve        | 4                                   | 5     | (20      | %) |
| Amortization of sales inducements                         | 8                                   | 8     | —        | %  |
| Change in guaranteed withdrawal benefit reserve           | 10                                  | 4     | 150      | %  |
| Change in other benefit reserves                          | 2                                   | 5     | (60      | %) |
| Derivatives related to fixed-indexed annuities:           |                                     |       |          |    |
| Embedded derivative mark-to-market                        | 33                                  | 40    | (18      | %) |
| Equity option mark-to-market                              | (32                                 | )(31  | ) 3      | %  |
| Total annuity benefits                                    | \$140                               | \$140 | —        | %  |

The profitability of a fixed annuity business is largely dependent on the ability of a company to earn income on the assets supporting the business in excess of the amounts credited to policyholder accounts plus expenses incurred (earning a "spread"). Performance measures such as net interest spread and net spread earned are often presented by annuity businesses to help users of their financial statements better understand the company's performance.



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Net Spread on Fixed Annuities (excludes variable annuity earnings)

The table below (dollars in millions) details the components of these spreads for AFG's fixed annuity operations (including fixed-indexed annuities):

|                                                                           | Three months ended |          |          |   |
|---------------------------------------------------------------------------|--------------------|----------|----------|---|
|                                                                           | September 30,      |          |          |   |
|                                                                           | 2013               | 2012     | % Change |   |
| Average fixed annuity investments (at amortized cost)                     | \$19,519           | \$16,994 | 15       | % |
| Average fixed annuity benefits accumulated                                | 19,035             | 16,759   | 14       | % |
| As % of fixed annuity benefits accumulated (except as noted):             |                    |          |          |   |
| Net investment income (as % of fixed annuity investments)                 | 5.27               | % 5.80   |          |   |
| Interest credited — fixed                                                 | (2.38              | %) (2.55 |          |   |
| Net interest spread                                                       | 2.89               | % 3.25   |          |   |
| Policy charges and other miscellaneous income                             | 0.15               | % 0.16   |          |   |
| Other annuity benefit expenses, net of guaranteed withdrawal benefit fees | (0.39              | %) (0.27 |          |   |
| Acquisition expenses                                                      | (0.72              | %) (0.72 |          |   |
| Other expenses                                                            | (0.44              | %) (0.48 |          |   |
| Change in fair value of derivatives related to fixed-indexed annuities    | 0.01               | % (0.37  |          |   |
| Net spread earned on fixed annuities                                      | 1.50               | % 1.57   |          |   |

**Annuity Net Investment Income**

Net investment income for the third quarter of 2013 was \$259 million compared to \$249 million for the third quarter of 2012, an increase of \$10 million (4%). This increase reflects primarily the growth in AFG's annuity business. The overall yield earned on investments in AFG's annuity operations, calculated as net investment income divided by average investment balances (at amortized cost), declined by 0.53 percentage points in the third quarter of 2013 compared to the third quarter of 2012. This decline in net investment yield reflects (i) the investment of new premium dollars in the recent low interest rate environment, (ii) the impact of the maturity and redemption of higher yielding investments and (iii) the impact of higher non-recurring investment income in the third quarter of 2012 as compared to the same period in 2013.

**Annuity Interest Credited — Fixed**

Interest credited — fixed for the third quarter of 2013 was \$113 million compared to \$107 million for the third quarter of 2012, an increase of \$6 million (6%). The impact of growth in the annuity business was partially offset by lower interest crediting rates on new premiums as compared to the crediting rates on policyholder funds surrendered or withdrawn. The average interest rate credited to policyholders, calculated as interest credited divided by average fixed annuity benefits accumulated, decreased 0.17 percentage points in the third quarter of 2013 compared to the third quarter of 2012. During the third quarter of 2013, interest rates credited on new premiums generally ranged from 1.00% to 2.00%.

Excluding those annuities that have guaranteed withdrawal benefits, at September 30, 2013, AFG could reduce the average crediting rate on approximately \$15 billion of traditional and fixed-indexed deferred annuities by an additional 0.43% (on a weighted average basis). Annuity policies are subject to Guaranteed Minimum Interest Rates ("GMIRs") at policy issuance. The table below shows the breakdown of annuity reserves by GMIR. The current interest crediting rates on substantially all of AFG's annuities with a GMIR of 3% or higher are at their minimum.

% of

| GMIR            | Reserves |
|-----------------|----------|
| 1 — 1.99%       | 48%      |
| 2 — 2.99%       | 12%      |
| 3 — 3.99%       | 23%      |
| 4.00% and above | 17%      |

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**Annuity Net Interest Spread**

AFG's net interest spread decreased 0.36 percentage points in the third quarter of 2013 compared to the same period in 2012 due primarily to the run-off of higher yielding investments. In addition, the 2012 quarter included higher non-recurring investment income as compared to the 2013 quarter. Due to the continued run-off of higher yielding investments, AFG expects its net interest spread to narrow in the future.

**Annuity Policy Charges and Other Miscellaneous Income**

Annuity policy charges and other miscellaneous income, which consist primarily of surrender charges, were \$10 million for both the third quarter of 2013 and the third quarter of 2012.

**Other Annuity Benefits**

Other annuity benefits, net of guaranteed withdrawal benefit fees for the third quarter of 2013 were \$17 million compared to \$18 million for the third quarter of 2012, a decrease of \$1 million (6%). In addition to interest credited to policyholders' accounts, annuity benefits expense also includes the following expenses (in millions, net of guaranteed withdrawal benefit fees):

|                                                    | Three months ended<br>September 30, |      |
|----------------------------------------------------|-------------------------------------|------|
|                                                    | 2013                                | 2012 |
| Change in expected death and annuitization reserve | \$4                                 | \$5  |
| Amortization of sales inducements                  | 8                                   | 8    |
| Change in guaranteed withdrawal benefit reserve    | 10                                  | 4    |
| Change in other benefit reserves                   | 2                                   | 5    |
| Other annuity benefits                             | 24                                  | 22   |
| Offset guaranteed withdrawal benefit fees          | (7                                  | ) (4 |
| Other annuity benefits, net                        | \$17                                | \$18 |

**Annuity Acquisition Expenses**

AFG's amortization of DPAC and commission expenses as a percentage of average fixed annuity benefits accumulated was 0.72% for both the third quarters of 2013 and 2012 and has generally ranged between 0.70% and 0.80%. Variances from the general range relate primarily to the impact of (i) material changes in interest rates or the stock market on AFG's fixed-indexed annuity business, and (ii) differences in actual experience from actuarially projected estimates and assumptions.

**Annuity Other Expenses**

Annuity other expenses for the third quarter of 2013 were \$23 million, compared to \$22 million for the third quarter of 2012, an increase of \$1 million (5%). Annuity other expenses represent primarily general and administrative expenses, as well as selling and issuance expenses that are not deferred. As a percentage of average fixed annuity benefits accumulated, these expenses declined 0.04 percentage points for the third quarter of 2013 as compared to the third quarter of 2012; this percentage is expected to continue to decrease as AFG's annuity business grows.

**Change in Fair Value of Derivatives Related to Fixed-Indexed Annuities**

AFG's fixed-indexed annuities, which represented approximately 45% of annuity benefits accumulated at September 30, 2013, provide policyholders with a crediting rate tied, in part, to the performance of an existing stock market index. AFG attempts to mitigate the risk in the index-based component of these products through the purchase of call options on the appropriate index. AFG's strategy is designed so that an increase in the liabilities, due to an increase in the market index, will generally be offset by unrealized and realized gains on the call options purchased by

AFG. Both the index-based component of the annuities and the related call options are considered derivatives that must be marked-to-market through earnings each period. The fair values of these derivatives are impacted by actual and expected stock market performance and interest rates as well as other factors. For a list of other factors impacting the fair value of the index-based component of AFG's annuity benefits accumulated, see Note D — "Fair Value Measurements." The net change in fair value of derivatives related to fixed-indexed annuities increased annuity benefits by \$1 million in the third quarter of 2013 and by \$9 million in the third quarter of 2012. The increase in 2012 reflects the negative impact of sharply lower market interest rates.

#### Annuity Net Spread Earned on Fixed Annuities

AFG's net spread earned on fixed annuities decreased 0.07 percentage points in the third quarter of 2013 compared to the same period in 2012 as the 0.36 percentage points decrease in AFG's net interest spread was offset by the impact of changes in the

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fair value of derivatives discussed above. AFG expects its net spread earned on fixed annuities to be closer to 1.30% to 1.40% in the fourth quarter of 2013 as compared to the 1.50% earned in the third quarter of 2013.

**Annuity Benefits Accumulated**

Annuity premiums received 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 and other benefits are charged to expense and decreases for surrender and other policy charges are credited to other income.

For certain products, annuity benefits accumulated also includes reserves for accrued persistency and premium bonuses (sales inducements), excess benefits expected to be paid on future deaths and annuitizations ("EDAR") and guaranteed withdrawal benefits. Annuity benefits accumulated also includes amounts advanced from the Federal Home Loan Bank of Cincinnati. The following table is a progression of AFG's annuity benefits accumulated liability for the three months ended September 30, 2013 and 2012 (in millions):

|                                                                   | Three months ended<br>September 30, |          |
|-------------------------------------------------------------------|-------------------------------------|----------|
|                                                                   | 2013                                | 2012     |
| Beginning fixed annuity reserves                                  | \$18,564                            | \$16,518 |
| Fixed annuity premiums (receipts)                                 | 1,156                               | 709      |
| Surrenders, benefits and other withdrawals                        | (381)                               | (390)    |
| Interest and other annuity benefit expenses:                      |                                     |          |
| Interest credited                                                 | 113                                 | 107      |
| Embedded derivative mark-to-market                                | 33                                  | 40       |
| Change in other benefit reserves                                  | 20                                  | 15       |
| Ending fixed annuity reserves                                     | \$19,505                            | \$16,999 |
| Reconciliation to annuity benefits accumulated per balance sheet: |                                     |          |
| Ending fixed annuity reserves (from above)                        | \$19,505                            | \$16,999 |
| Impact of unrealized investment gains                             | 84                                  | 46       |
| Fixed component of variable annuities                             | 196                                 | 200      |
| Annuity benefits accumulated per balance sheet                    | \$19,785                            | \$17,245 |

**Statutory Annuity Premiums**

AFG's annuity operations generated statutory premiums of \$1.17 billion in the third quarter of 2013 compared to \$723 million in the third quarter of 2012, an increase of \$444 million (61%). The following table summarizes AFG's annuity sales (dollars in millions):

|                                                           | Three months ended<br>September 30, |       |          |
|-----------------------------------------------------------|-------------------------------------|-------|----------|
|                                                           | 2013                                | 2012  | % Change |
| Retail single premium annuities — indexed                 | \$509                               | \$417 | 22 %     |
| Retail single premium annuities — fixed                   | 48                                  | 42    | 14 %     |
| Financial institutions single premium annuities — indexed | 352                                 | 72    | 389 %    |
| Financial institutions single premium annuities — fixed   | 198                                 | 127   | 56 %     |
| Education market — 403(b) fixed and indexed annuities     | 49                                  | 51    | (4 %)    |
| Total fixed annuity premiums                              | 1,156                               | 709   | 63 %     |
| Variable annuities                                        | 11                                  | 14    | (21 %)   |
| Total annuity premiums                                    | \$1,167                             | \$723 | 61 %     |

The 61% increase in annuity premiums as compared to the third quarter of 2012 reflects continued successful distribution channel expansion, primarily in the financial institutions market, as well as new product offerings. Management also believes that AFG has benefited from its strong ratings, and that the entire annuity industry has benefited from the rise in interest rates in 2013, particularly in the financial institutions market.

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## Annuity Earnings before Income Taxes Reconciliation

The following table reconciles the net spread earned on AFG's fixed annuities to overall annuity pretax earnings for the three months ended September 30, 2013 and 2012 (in millions):

|                                                                             | Three months ended<br>September 30, |      |
|-----------------------------------------------------------------------------|-------------------------------------|------|
|                                                                             | 2013                                | 2012 |
| Earnings on fixed annuity benefits accumulated                              | \$72                                | \$66 |
| Earnings on investments in excess of fixed annuity benefits accumulated (*) | 6                                   | 3    |
| Variable annuity earnings                                                   | —                                   | —    |
| Earnings before income taxes                                                | \$78                                | \$69 |

(\*) Net investment income (as a % of investments) of 5.27% and 5.80% for the three months ended September 30, 2013 and 2012, respectively, multiplied by the difference between average fixed annuity investments (at amortized cost) and average fixed annuity benefits accumulated in each period.

Run-off Long-Term Care and Life Segment — Results of Operations The following table details AFG's earnings before income taxes from its run-off long-term care and life operations for the three months ended September 30, 2013 and 2012 (dollars in millions):

|                                     | Three months ended<br>September 30, |       |          |    |
|-------------------------------------|-------------------------------------|-------|----------|----|
|                                     | 2013                                | 2012  | % Change |    |
| Revenues:                           |                                     |       |          |    |
| Net earned premiums:                |                                     |       |          |    |
| Long-term care                      | \$19                                | \$19  | —        | %  |
| Life operations                     | 10                                  | 11    | (9       | %) |
| Net investment income               | 20                                  | 19    | 5        | %  |
| Other income                        | 1                                   | 1     | —        | %  |
| Total revenues                      | 50                                  | 50    | —        | %  |
| Costs and Expenses:                 |                                     |       |          |    |
| Life, accident and health benefits: |                                     |       |          |    |
| Long-term care                      | 30                                  | 24    | 25       | %  |
| Life operations                     | 12                                  | 12    | —        | %  |
| Acquisition expenses                | 5                                   | 5     | —        | %  |
| Other expenses                      | 7                                   | 7     | —        | %  |
| Total costs and expenses            | 54                                  | 48    | 13       | %  |
| Earnings (loss) before income taxes | \$(4                                | ) \$2 |          |    |

The increase in long-term care benefits expense in the third quarter of 2013 as compared to the third quarter of 2012 is due primarily to an increase in new claims. Due to the nature and size of its long-term care business, AFG expects claims volatility from period to period. Management continues to monitor the long-term care business.

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Medicare Supplement and Critical Illness Segment — Results of Operations AFG's Medicare supplement and critical illness segment contributed \$165 million in GAAP pretax earnings in the third quarter of 2012, which includes a \$155 million pretax non-core realized gain on the August 2012 sale of these businesses. See Note B — “Acquisitions and Sales of Subsidiaries.” The following table details AFG's GAAP and core earnings before income taxes from its Medicare supplement and critical illness business (in millions):

|                                                                                   | Three months ended<br>September 30, |       |
|-----------------------------------------------------------------------------------|-------------------------------------|-------|
|                                                                                   | 2013                                | 2012  |
| Revenues:                                                                         |                                     |       |
| Net earned premiums                                                               | \$—                                 | \$50  |
| Net investment income                                                             | —                                   | 2     |
| Other income                                                                      | —                                   | 1     |
| Total revenues                                                                    | —                                   | 53    |
| Costs and Expenses:                                                               |                                     |       |
| Life, accident and health benefits                                                | —                                   | 30    |
| Acquisition expenses                                                              | —                                   | 9     |
| Other expenses                                                                    | —                                   | 4     |
| Total costs and expenses                                                          | —                                   | 43    |
| Core earnings before income taxes                                                 | —                                   | 10    |
| Pretax non-core realized gain on sale of Medicare supplement and critical illness | —                                   | 155   |
| GAAP earnings before income taxes                                                 | \$—                                 | \$165 |

Holding Company, Other and Unallocated — Results of Operations AFG's net GAAP pretax loss outside of its insurance operations (excluding realized gains) totaled \$61 million for both third quarters of 2013 and 2012. AFG's net core pretax loss outside of its insurance operations totaled \$39 million for the third quarter of 2013 compared to \$36 million for the third quarter of 2012, an increase of \$3 million (8%).

The following table details AFG's GAAP and core loss before income taxes from operations outside of its insurance operations for three months ended September 30, 2013 and 2012 (dollars in millions):

|                                                         | Three months ended<br>September 30, |       |          |    |
|---------------------------------------------------------|-------------------------------------|-------|----------|----|
|                                                         | 2013                                | 2012  | % Change |    |
| Revenues:                                               |                                     |       |          |    |
| Net investment income                                   | \$3                                 | \$—   | —        | %  |
| Other income                                            | 9                                   | 9     | —        | %  |
| Total revenues                                          | 12                                  | 9     | 33       | %  |
| Costs and Expenses:                                     |                                     |       |          |    |
| Interest charges on borrowed money                      | 17                                  | 19    | (11      | %) |
| Other expenses (*)                                      | 34                                  | 26    | 31       | %  |
| Total costs and expenses                                | 51                                  | 45    | 13       | %  |
| Core loss before income taxes, excluding realized gains | (39                                 | ) (36 | ) 8      | %  |
| Pretax non-core items, excluding realized gains:        |                                     |       |          |    |
| Special A&E charges                                     | (22                                 | ) (2  | ) 1,000  | %  |
| Other                                                   | —                                   | (23   | ) (100   | %) |

|                                                         |          |          |   |   |
|---------------------------------------------------------|----------|----------|---|---|
| GAAP loss before income taxes, excluding realized gains | \$ (61 ) | \$ (61 ) | — | % |
|---------------------------------------------------------|----------|----------|---|---|

(\*) Excludes pretax non-core special A&E charges of \$22 million and \$2 million for the third quarters of 2013 and 2012, respectively. Other expenses for the third quarter of 2012 also exclude \$23 million in other non-core charges (discussed below).

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## Management's Discussion and Analysis of Financial Condition and Results of Operations — Continued

## Holding Company and Other — Net Investment Income

Net investment income for the third quarter of 2013 was \$3 million compared to less than \$1 million in the third quarter of 2012. The parent company holds a small portfolio of securities that are classified as “trading” and marked-to-market through investment income. These trading securities increased in value by approximately \$2 million in the third quarter of 2013.

## Holding Company and Other — Other Income

Other income in the table above includes \$4 million and \$6 million in the third quarters of 2013 and 2012, respectively, in management fees paid to AFG by the AFG-managed CLOs (AFG's consolidated managed investment entities). These fees are eliminated in consolidation — see the other income line in the Consolidate MIEs column under Results of Operations — Segmented Statement of Earnings. Excluding amounts eliminated in consolidation, AFG recorded other income outside of its insurance operations of \$5 million in the third quarter of 2013 compared to \$3 million in the third quarter of 2012.

## Holding Company and Other — Interest Charges on Borrowed Money

AFG's holding companies and other operations outside of its insurance operations recorded interest expense of \$17 million in the third quarter of 2013 compared to \$19 million in the third quarter of 2012, a decrease of \$2 million (11%), reflecting lower average indebtedness. In June 2012, AFG issued \$230 million in new Senior Notes and used the proceeds to redeem \$198 million of higher rate debt in July 2012. In August 2012, AFG issued \$125 million in new Senior Notes and used the proceeds to redeem \$115 million of higher rate debt in September 2012. The following table details AFG's long-term debt balances as of September 30, 2013 compared to July 1, 2012 (dollars in millions):

|                                                   | September 30, 2013 | July 1, 2012 |
|---------------------------------------------------|--------------------|--------------|
| Direct obligations of AFG:                        |                    |              |
| 9-7/8% Senior Notes due June 2019                 | \$ 350             | \$350        |
| 6-3/8% Senior Notes due June 2042                 | 230                | 230          |
| 5-3/4% Senior Notes due August 2042               | 125                | —            |
| 7% Senior Notes due September 2050                | 132                | 132          |
| 7-1/8% Senior Notes                               | —                  | 115          |
| Other                                             | 3                  | 3            |
|                                                   | 840                | 830          |
| Other holding company obligations:                |                    |              |
| Obligations of AAG Holding (guaranteed by AFG):   |                    |              |
| 7-1/2% Senior Debentures                          | —                  | 112          |
| 7-1/4% Senior Debentures                          | —                  | 86           |
| Secured borrowings (guaranteed by AFG)            | —                  | 16           |
| AAG Holding Variable Rate Subordinated Debentures | —                  | 20           |
|                                                   | —                  | 234          |
| Total Holding Company and Other Debt              | \$ 840             | \$1,064      |
| Weighted Average Interest Rate                    | 7.8                | % 7.8 %      |

## Holding Company and Other — Other Expenses

As a result of the comprehensive study of A&E exposures discussed under “Special Asbestos and Environmental Reserve Charges” in the “Results of Operations — Property and Casualty Insurance” segment, AFG's holding companies

and other operations outside of its insurance operations recorded non-core special charges of \$22 million in the third quarter of 2013 and \$2 million in the third quarter of 2012 to increase liabilities related to the A&E exposures of AFG's former railroad and manufacturing operations. The 2013 charge resulted primarily from slightly higher estimated operation and maintenance costs at sites where remediation is underway, coupled with higher estimated cleanup costs at a limited number of sites. In the third quarter of 2012, these operations also recorded a \$15 million non-core charge resulting from an adverse judgment in a long-standing labor contract dispute related to AFG's former railroad operations and an \$8 million non-core loss on the retirement of debt. Excluding these non-core charges, AFG's holding companies and other operations outside of its insurance operations, recorded other expenses of \$34 million in the third quarter of 2013 compared to \$26 million in the third quarter of 2012, an increase of \$8 million (31%). The \$8 million increase reflects higher expense associated with employee benefit plans that are tied to stock market performance and slightly higher stock-based compensation expense.

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**Consolidated Realized Gains (Losses) on Securities** AFG's consolidated realized gains on securities, which are not allocated to segments, were \$56 million in the third quarter of 2013 compared to \$85 million in the third quarter of 2012, a decrease of \$29 million (34%). Realized gains (losses) on securities consisted of the following (in millions):

|                                                                            | Three months ended<br>September 30, |      |
|----------------------------------------------------------------------------|-------------------------------------|------|
|                                                                            | 2013                                | 2012 |
| Realized gains (losses) before impairments:                                |                                     |      |
| Disposals                                                                  | \$59                                | \$96 |
| Change in the fair value of derivatives                                    | 1                                   | 1    |
| Adjustments to annuity deferred policy acquisition costs and related items | 1                                   | (4)  |
|                                                                            | 61                                  | 93   |
| Impairment charges:                                                        |                                     |      |
| Securities                                                                 | (5)                                 | (10) |
| Adjustments to annuity deferred policy acquisition costs and related items | —                                   | 2    |
|                                                                            | (5)                                 | (8)  |
|                                                                            | \$56                                | \$85 |

**Consolidated Income Taxes** AFG's consolidated provision for income taxes was \$44 million for the third quarter of 2013 compared to \$74 million in the third quarter of 2012, a decrease of \$30 million (41%). See Note L — "Income Taxes" to the financial statements for an analysis of items affecting AFG's effective tax rate.

**Consolidated Noncontrolling Interests** AFG's consolidated net earnings attributable to noncontrolling interests were \$15 million for the third quarter of 2013 compared to a net loss of \$15 million for the third quarter of 2012. The following table details net earnings (loss) in consolidated subsidiaries attributable to holders other than AFG (dollars in millions):

|                             | Three months ended<br>September 30, |        |          |
|-----------------------------|-------------------------------------|--------|----------|
|                             | 2013                                | 2012   | % Change |
| National Interstate         | \$3                                 | \$4    | (25 %)   |
| Marketform                  | —                                   | (2)    | (100 %)  |
| Managed Investment Entities | 12                                  | (18)   | (167 %)  |
| Other                       | —                                   | 1      | (100 %)  |
|                             | \$15                                | \$(15) | (200 %)  |

During the third quarter of 2012, AFG acquired the remaining 28% of Marketform that it did not already own. As discussed in Notes A — "Accounting Policies," and H — "Managed Investment Entities" to the financial statements, the losses of Managed Investment Entities represent CLO losses that ultimately inure to holders of the CLO debt.

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## Management's Discussion and Analysis of Financial Condition and Results of Operations — Continued

## RESULTS OF OPERATIONS — NINE MONTHS ENDED SEPTEMBER 30, 2013 AND 2012

Segmented Statement of Earnings AFG reports its business as five segments: (i) Property and casualty insurance ("P&C"), (ii) Annuity, (iii) Run-off long-term care and life, (iv) Medicare supplement and critical illness (sold in August 2012) and (v) Other, which includes holding company costs and operations attributable to the noncontrolling interests of the managed investment entities ("MIEs").

AFG's net earnings attributable to shareholders, determined in accordance with GAAP, include certain items that may not be indicative of its ongoing core operations. The following tables for the nine months ended September 30, 2013 and 2012 identify such items by segment and reconcile net earnings attributable to shareholders to core net operating earnings, a non-GAAP financial measure that AFG believes is a useful tool for investors and analysts in analyzing ongoing operating trends (in millions):

|                                                                    | P&C     | Annuity | Run-off<br>long-term<br>care and<br>life | Consol.<br>MIEs | Other<br>Holding<br>Co.,<br>other<br>and<br>unallocated | Total   | Non-GAAP<br>reclass | Total   |
|--------------------------------------------------------------------|---------|---------|------------------------------------------|-----------------|---------------------------------------------------------|---------|---------------------|---------|
| Nine months ended September 30, 2013                               |         |         |                                          |                 |                                                         |         |                     |         |
| Revenues:                                                          |         |         |                                          |                 |                                                         |         |                     |         |
| Property and casualty insurance net earned premiums                | \$2,345 | \$—     | \$—                                      | \$—             | \$—                                                     | \$2,345 | \$—                 | \$2,345 |
| Life, accident and health net earned premiums                      | —       | —       | 87                                       | —               | —                                                       | 87      | —                   | 87      |
| Net investment income                                              | 196     | 764     | 57                                       | (27)            | 6                                                       | 996     | —                   | 996     |
| Realized gains on securities                                       | —       | —       | —                                        | —               | —                                                       | —       | 154                 | 154     |
| Income (loss) of MIEs:                                             |         |         |                                          |                 |                                                         |         |                     |         |
| Investment income                                                  | —       | —       | —                                        | 98              | —                                                       | 98      | —                   | 98      |
| Loss on change in fair value of assets/liabilities                 | —       | —       | —                                        | (21)            | —                                                       | (21)    | —                   | (21)    |
| Other income                                                       | 10      | 46      | 3                                        | (12)            | 24                                                      | 71      | —                   | 71      |
| Total revenues                                                     | 2,551   | 810     | 147                                      | 38              | 30                                                      | 3,576   | 154                 | 3,730   |
| Costs and Expenses:                                                |         |         |                                          |                 |                                                         |         |                     |         |
| Property and casualty insurance:                                   |         |         |                                          |                 |                                                         |         |                     |         |
| Losses and loss adjustment expenses                                | 1,449   | —       | —                                        | —               | —                                                       | 1,449   | 54                  | 1,503   |
| Commissions and other underwriting expenses                        | 772     | —       | —                                        | —               | —                                                       | 772     | —                   | 772     |
| Annuity benefits                                                   | —       | 394     | —                                        | —               | —                                                       | 394     | —                   | 394     |
| Life, accident and health benefits                                 | —       | —       | 120                                      | —               | —                                                       | 120     | —                   | 120     |
| Annuity and supplemental insurance acquisition expenses            | —       | 114     | 14                                       | —               | —                                                       | 128     | —                   | 128     |
| Interest charges on borrowed money                                 | 3       | —       | —                                        | —               | 51                                                      | 54      | —                   | 54      |
| Expenses of MIEs                                                   | —       | —       | —                                        | 68              | —                                                       | 68      | —                   | 68      |
| Other expenses                                                     | 34      | 66      | 20                                       | —               | 101                                                     | 221     | 27                  | 248     |
| Total costs and expenses                                           | 2,258   | 574     | 154                                      | 68              | 152                                                     | 3,206   | 81                  | 3,287   |
| Earnings before income taxes                                       | 293     | 236     | (7)                                      | (30)            | (122)                                                   | 370     | 73                  | 443     |
| Provision for income taxes                                         | 91      | 81      | (3)                                      | —               | (40)                                                    | 129     | 26                  | 155     |
| Net earnings, including noncontrolling interests                   | 202     | 155     | (4)                                      | (30)            | (82)                                                    | 241     | 47                  | 288     |
| Less: Net earnings (loss) attributable to noncontrolling interests | 2       | —       | —                                        | (30)            | 1                                                       | (27)    | 2                   | (25)    |

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|                                                     |       |       |        |     |       |       |           |
|-----------------------------------------------------|-------|-------|--------|-----|-------|-------|-----------|
| Core Net Operating Earnings                         | 200   | 155   | (4 )   | —   | (83 ) | 268   |           |
| Non-core earnings attributable to shareholders (a): |       |       |        |     |       |       |           |
| Realized gains on securities, net of tax            | —     | —     | —      | —   | 97    | 97    | (97) —    |
| Special A&E charges, net of tax                     | (35 ) | —     | —      | —   | (14 ) | (49 ) | 49 —      |
| ELNY guaranty fund assessments, net of tax          | —     | (3 )  | —      | —   | —     | (3 )  | 3 —       |
| Net Earnings Attributable to Shareholders           | \$165 | \$152 | \$(4 ) | \$— | \$—   | \$313 | \$— \$313 |

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## Management's Discussion and Analysis of Financial Condition and Results of Operations — Continued

|                                                                      | P&C     | Run-<br>long | Medicare<br>supplement<br>and critical<br>life illness | Other<br>Holding<br>Co.,<br>Consol.<br>MIEs<br>and<br>unallocated | Total | Non-<br>recla | GAAP<br>Total |
|----------------------------------------------------------------------|---------|--------------|--------------------------------------------------------|-------------------------------------------------------------------|-------|---------------|---------------|
| Nine months ended September 30, 2012                                 |         |              |                                                        |                                                                   |       |               |               |
| Revenues:                                                            |         |              |                                                        |                                                                   |       |               |               |
| Property and casualty insurance net earned premiums                  | \$2,091 | \$—          | \$—                                                    | \$—                                                               | \$—   | \$2,091       | \$— \$2,091   |
| Life, accident and health net earned premiums                        | —       | —            | 91                                                     | 199                                                               | —     | 290           | — 290         |
| Net investment income                                                | 206     | 722          | 54                                                     | 7                                                                 | (2)   | 972           | — 972         |
| Realized gains on securities                                         | —       | —            | —                                                      | —                                                                 | —     | —             | 145 145       |
| Realized gains on subsidiaries                                       | —       | —            | —                                                      | —                                                                 | —     | —             | 155 155       |
| Income (loss) of MIEs:                                               |         |              |                                                        |                                                                   |       |               |               |
| Investment income                                                    | —       | —            | —                                                      | —                                                                 | 92    | 92            | — 92          |
| Loss on change in fair value of assets/liabilities                   | —       | —            | —                                                      | —                                                                 | (63)  | (63)          | — (63 )       |
| Other income                                                         | 17      | 39           | 1                                                      | 6                                                                 | (14)  | 67            | — 67          |
| Total revenues                                                       | 2,314   | 761          | 146                                                    | 212                                                               | (6)   | 3,449         | 300 3,749     |
| Costs and Expenses:                                                  |         |              |                                                        |                                                                   |       |               |               |
| Property and casualty insurance:                                     |         |              |                                                        |                                                                   |       |               |               |
| Losses and loss adjustment expenses                                  | 1,286   | —            | —                                                      | —                                                                 | —     | 1,286         | 31 1,317      |
| Commissions and other underwriting expenses                          | 697     | —            | —                                                      | —                                                                 | —     | 697           | — 697         |
| Annuity benefits                                                     | —       | 417          | —                                                      | —                                                                 | —     | 417           | — 417         |
| Life, accident and health benefits                                   | —       | —            | 107                                                    | 131                                                               | —     | 238           | — 238         |
| Annuity and supplemental insurance acquisition expenses              | —       | 92           | 15                                                     | 31                                                                | —     | 138           | — 138         |
| Interest charges on borrowed money                                   | 3       | —            | —                                                      | —                                                                 | 54    | 57            | — 57          |
| Expenses of MIEs                                                     | —       | —            | —                                                      | —                                                                 | 58    | 58            | — 58          |
| Other expenses                                                       | 47      | 64           | 16                                                     | 22                                                                | 86    | 235           | 25 260        |
| Total costs and expenses                                             | 2,033   | 573          | 138                                                    | 184                                                               | 58    | 3,126         | 56 3,182      |
| Earnings before income taxes                                         | 281     | 188          | 8                                                      | 28                                                                | (64)  | 323           | 244 567       |
| Provision for income taxes                                           | 88      | 64           | 3                                                      | 10                                                                | (39)  | 126           | 58 184        |
| Net earnings, including noncontrolling interests                     | 193     | 124          | 5                                                      | 18                                                                | (64)  | 197           | 186 383       |
| Less: Net earnings (loss) attributable to noncontrolling interests   | 7       | —            | —                                                      | —                                                                 | (64)  | (56)          | 1 (55 )       |
| Core Net Operating Earnings                                          | 186     | 124          | 5                                                      | 18                                                                | —     | 253           | —             |
| Non-core earnings attributable to shareholders (a):                  |         |              |                                                        |                                                                   |       |               |               |
| Gain on sale of Medicare supplement and critical illness, net of tax | —       | —            | —                                                      | 101                                                               | —     | 101           | (101) —       |
| Other realized gains, net of tax                                     | —       | —            | —                                                      | —                                                                 | 92    | 92            | (92) —        |
| Special A&E charges, net of tax                                      | (20)    | —            | —                                                      | —                                                                 | (1)   | (21)          | 21 —          |
| AFG tax case resolution                                              | —       | —            | —                                                      | —                                                                 | 28    | 28            | (28) —        |
| Other, net of tax                                                    | —       | —            | —                                                      | —                                                                 | (15)  | (15)          | 15 —          |
| Net Earnings Attributable to Shareholders                            | \$166   | \$124        | \$5                                                    | \$119                                                             | \$—   | \$438         | \$— \$438     |

(a)

See the reconciliation of core earnings to GAAP net earnings under Results of Operations — General for details on the tax and noncontrolling interest impacts of these reconciling items.

Property and Casualty Insurance Segment — Results of Operations AFG's property and casualty insurance operations contributed \$239 million in GAAP pretax earnings in the first nine months of 2013 compared to \$250 million in the first nine months of 2012, a decrease of \$11 million (4%). Property and casualty core pretax earnings were \$293 million in the first nine months of 2013 compared to \$281 million in the first nine months of 2012, an increase of \$12 million (4%). Higher underwriting profits in the Specialty casualty group and Specialty financial group were partially offset by a decline in the

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## Management's Discussion and Analysis of Financial Condition and Results of Operations — Continued

underwriting profits in the Property and transportation group during the first half of the year (including higher catastrophe losses.) The decline in GAAP pretax earnings reflects the higher non-core special A&E charges in 2013 as compared to 2012.

The following table details AFG's GAAP and core earnings before income taxes from its property and casualty operations for the nine months ended September 30, 2013 and 2012 (dollars in millions):

|                                             | Nine months ended<br>September 30, |          | % Change |    |
|---------------------------------------------|------------------------------------|----------|----------|----|
|                                             | 2013                               | 2012     |          |    |
| Gross written premiums                      | \$3,734                            | \$3,356  | 11       | %  |
| Reinsurance premiums ceded                  | (1,214 )                           | (1,109 ) | 9        | %  |
| Net written premiums                        | 2,520                              | 2,247    | 12       | %  |
| Change in unearned premiums                 | (175 )                             | (156 )   | 12       | %  |
| Net earned premiums                         | 2,345                              | 2,091    | 12       | %  |
| Loss and loss adjustment expenses (*)       | 1,449                              | 1,286    | 13       | %  |
| Commissions and other underwriting expenses | 772                                | 697      | 11       | %  |
| Core underwriting gain                      | 124                                | 108      | 15       | %  |
| Net investment income                       | 196                                | 206      | (5       | %) |
| Other income and expenses, net              | (27 )                              | (33 )    | (18      | %) |
| Core earnings before income taxes           | 293                                | 281      | 4        | %  |
| Pretax non-core special A&E charges         | (54 )                              | (31 )    | 74       | %  |
| GAAP earnings before income taxes           | \$239                              | \$250    | (4       | %) |

(\*) Excluding non-core special A&E charges

## Combined Ratios:

| Specialty lines            |      |        | Change |    |
|----------------------------|------|--------|--------|----|
|                            |      |        |        |    |
| Loss and LAE ratio         | 61.5 | % 61.1 | % 0.4  | %  |
| Underwriting expense ratio | 32.9 | % 33.3 | % (0.4 | %) |
| Combined ratio             | 94.4 | % 94.4 | % —    | %  |

## Aggregate — including discontinued lines

|                            |      |        |        |    |
|----------------------------|------|--------|--------|----|
| Loss and LAE ratio         | 64.1 | % 63.0 | % 1.1  | %  |
| Underwriting expense ratio | 32.9 | % 33.3 | % (0.4 | %) |
| Combined ratio             | 97.0 | % 96.3 | % 0.7  | %  |

AFG reports the underwriting performance of its Specialty insurance business in the following sub-components: (i) Property and transportation, (ii) Specialty casualty and (iii) Specialty financial.

## Gross Written Premiums

Gross written premiums ("GWP") for AFG's property and casualty insurance segment were \$3.73 billion for the first nine months of 2013 compared to \$3.36 billion for the first nine months of 2012, an increase of \$378 million (11%).

Detail of AFG's property and casualty gross written premiums is shown below (dollars in millions):

| Nine months ended September 30, |   |      |   |          |
|---------------------------------|---|------|---|----------|
| 2013                            |   | 2012 |   |          |
| GWP                             | % | GWP  | % | % Change |

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|                             |         |     |   |         |     |   |      |    |
|-----------------------------|---------|-----|---|---------|-----|---|------|----|
| Property and transportation | \$1,945 | 52  | % | \$1,840 | 55  | % | 6    | %  |
| Specialty casualty          | 1,331   | 36  | % | 1,100   | 33  | % | 21   | %  |
| Specialty financial         | 458     | 12  | % | 415     | 12  | % | 10   | %  |
| Other specialty             | —       | —   | % | 1       | —   | % | (100 | %) |
|                             | \$3,734 | 100 | % | \$3,356 | 100 | % | 11   | %  |

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## Reinsurance Premiums Ceded

Reinsurance premiums ceded ("Ceded") for AFG's property and casualty insurance segment were 33% of gross written premiums for the first nine months of 2013 and 2012. Detail of AFG's property and casualty reinsurance premiums ceded is shown below (dollars in millions):

|                             | Nine months ended September 30,<br>2013 |             | 2012       |             | Change in |    |
|-----------------------------|-----------------------------------------|-------------|------------|-------------|-----------|----|
|                             | Ceded                                   | % of<br>GWP | Ceded      | % of<br>GWP | % of GWP  |    |
| Property and transportation | \$(747                                  | ) 38        | % \$(682   | ) 37        | % 1       | %  |
| Specialty casualty          | (428                                    | ) 32        | % (366     | ) 33        | % (1      | %) |
| Specialty financial         | (104                                    | ) 23        | % (112     | ) 27        | % (4      | %) |
| Other specialty             | 65                                      |             | 51         |             |           |    |
|                             | \$(1,214                                | ) 33        | % \$(1,109 | ) 33        | % —       | %  |

## Net Written Premiums

Net written premiums ("NWP") for AFG's property and casualty insurance segment were \$2.52 billion for the first nine months of 2013 compared to \$2.25 billion for the first nine months of 2012, an increase of \$273 million (12%). Detail of AFG's property and casualty net written premiums is shown below (dollars in millions):

|                             | Nine months ended September 30,<br>2013 |     | 2012      |     | % Change |   |
|-----------------------------|-----------------------------------------|-----|-----------|-----|----------|---|
|                             | NWP                                     | %   | NWP       | %   | %        |   |
| Property and transportation | \$1,198                                 | 47  | % \$1,158 | 52  | % 3      | % |
| Specialty casualty          | 903                                     | 36  | % 734     | 33  | % 23     | % |
| Specialty financial         | 354                                     | 14  | % 303     | 13  | % 17     | % |
| Other specialty             | 65                                      | 3   | % 52      | 2   | % 25     | % |
|                             | \$2,520                                 | 100 | % \$2,247 | 100 | % 12     | % |

## Net Earned Premiums

Net earned premiums ("NEP") for AFG's property and casualty insurance segment were \$2.35 billion for the first nine months of 2013 compared to \$2.09 billion for the first nine months of 2012, an increase of \$254 million (12%). Detail of AFG's property and casualty net earned premiums is shown below (dollars in millions):

|                             | Nine months ended September 30,<br>2013 |     | 2012      |     | % Change |   |
|-----------------------------|-----------------------------------------|-----|-----------|-----|----------|---|
|                             | NEP                                     | %   | NEP       | %   | %        |   |
| Property and transportation | \$1,111                                 | 47  | % \$1,040 | 50  | % 7      | % |
| Specialty casualty          | 825                                     | 35  | % 699     | 33  | % 18     | % |
| Specialty financial         | 350                                     | 15  | % 301     | 14  | % 16     | % |
| Other specialty             | 59                                      | 3   | % 51      | 3   | % 16     | % |
|                             | \$2,345                                 | 100 | % \$2,091 | 100 | % 12     | % |

The \$378 million increase in gross written premiums for the first nine months of 2013 compared to the first nine months of 2012 reflects strong growth across each of the property and casualty sub-segments. Overall average renewal rates increased approximately 4% in the first nine months of 2013.

**Property and transportation** Gross written premiums increased \$105 million (6%) for the first nine months of 2013 compared to the same period in 2012 due primarily to higher crop premiums and growth in the transportation businesses. Average renewal rates were up approximately 5% for the first nine months of 2013. Reinsurance premiums ceded as a percentage of gross written premiums increased 1 percentage point in the first nine months of 2013 compared to the first nine months of 2012 reflecting higher cessions of multi-peril crop business.

**Specialty casualty** Gross written premiums increased \$231 million (21%) for the first nine months of 2013 compared to the first nine months of 2012 as a result of increased premiums in nearly all businesses in this group, particularly in the workers'

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compensation and excess and surplus lines. New business opportunities, increased exposures from higher payroll on existing accounts, strong retentions and higher renewal pricing have contributed to increased premiums in the workers' compensation businesses. In addition, new business opportunities and general market hardening have generated increased premiums in several of the excess and surplus lines businesses. Average renewal rates were up approximately 6% for this group in the first nine months of 2013. Reinsurance premiums ceded as a percentage of gross written premiums declined 1 percentage point for the first nine months of 2013 compared to the first nine months of 2012 reflecting a change in the mix of business.

**Specialty financial** Gross written premiums increased \$43 million (10%) for the first nine months of 2013 compared to the first nine months of 2012 due primarily to growth in lender-placed mortgage property insurance offered by the financial institutions business. Gross written premiums for the first nine months of 2013 include \$17 million in risk fees from AFG's warranty operations. Prior to 2013, fees in the warranty operations were included in other income. Average renewal rates for this group remained relatively unchanged in the first nine months of 2013. Reinsurance premiums ceded as a percentage of gross written premiums declined 4 percentage points for the first nine months of 2013 compared to the first nine months of 2012 reflecting the impact of reinsurance reinstatement premiums paid in the third quarter of 2012 and a change in the mix of business.

**Other specialty** The amounts shown as reinsurance premiums ceded represent business assumed by AFG's internal reinsurance program from the operations that make up AFG's other Specialty sub-components.

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## Combined Ratio

The table below details the components of the combined ratio for AFG's property and casualty segment for the first nine months of 2013 compared to the first nine months of 2012:

|                                          | Nine months ended<br>September 30, |        | Change |    | Nine months ended<br>September 30, |        |
|------------------------------------------|------------------------------------|--------|--------|----|------------------------------------|--------|
|                                          | 2013                               | 2012   |        |    | 2013                               | 2012   |
| Property and transportation              |                                    |        |        |    |                                    |        |
| Loss and LAE ratio                       | 75.1                               | % 69.4 | % 5.7  | %  |                                    |        |
| Underwriting expense ratio               | 25.3                               | % 27.4 | % (2.1 | %) |                                    |        |
| Combined ratio                           | 100.4                              | % 96.8 | % 3.6  | %  |                                    |        |
| Underwriting profit (loss)               |                                    |        |        |    | \$(5                               | ) \$33 |
| Specialty casualty                       |                                    |        |        |    |                                    |        |
| Loss and LAE ratio                       | 57.1                               | % 59.5 | % (2.4 | %) |                                    |        |
| Underwriting expense ratio               | 34.4                               | % 34.0 | % 0.4  | %  |                                    |        |
| Combined ratio                           | 91.5                               | % 93.5 | % (2.0 | %) |                                    |        |
| Underwriting profit                      |                                    |        |        |    | \$70                               | \$45   |
| Specialty financial                      |                                    |        |        |    |                                    |        |
| Loss and LAE ratio                       | 33.3                               | % 38.9 | % (5.6 | %) |                                    |        |
| Underwriting expense ratio               | 52.5                               | % 51.7 | % 0.8  | %  |                                    |        |
| Combined ratio                           | 85.8                               | % 90.6 | % (4.8 | %) |                                    |        |
| Underwriting profit                      |                                    |        |        |    | \$50                               | \$28   |
| Total Specialty                          |                                    |        |        |    |                                    |        |
| Loss and LAE ratio                       | 61.5                               | % 61.1 | % 0.4  | %  |                                    |        |
| Underwriting expense ratio               | 32.9                               | % 33.3 | % (0.4 | %) |                                    |        |
| Combined ratio                           | 94.4                               | % 94.4 | % —    | %  |                                    |        |
| Underwriting profit                      |                                    |        |        |    | \$131                              | \$116  |
| Aggregate — including discontinued lines |                                    |        |        |    |                                    |        |
| Loss and LAE ratio                       | 64.1                               | % 63.0 | % 1.1  | %  |                                    |        |
| Underwriting expense ratio               | 32.9                               | % 33.3 | % (0.4 | %) |                                    |        |
| Combined ratio                           | 97.0                               | % 96.3 | % 0.7  | %  |                                    |        |
| Underwriting profit                      |                                    |        |        |    | \$70                               | \$77   |

The Specialty insurance operations generated an underwriting profit of \$131 million in the first nine months of 2013 compared to \$116 million in the first nine months of 2012, an increase of \$15 million (13%). The higher profit in the first nine months of 2013 is primarily the result of higher underwriting profits in the Specialty casualty and Specialty financial groups partially offset by lower underwriting profits and higher catastrophe losses in the Property and transportation businesses. Overall catastrophe losses were \$30 million (1.3 points on the combined ratio) during the first nine months of 2013 compared to \$13 million (0.6 points) during the first nine months of 2012.

**Property and transportation** This group reported an underwriting loss of \$5 million for the first nine months of 2013 compared to a \$33 million underwriting gain for the first nine months of 2012, a decrease in underwriting profit of \$38 million. This decline is due primarily to lower profitability in the transportation businesses and higher catastrophe

losses from the impact of the spring storms in the southeastern United States. Catastrophe losses were \$27 million (2.4 points on the combined ratio) for this group during the first nine months of 2013 compared to \$7 million (0.7 points) during the first nine months of 2012.

Specialty casualty Underwriting profit was \$70 million for the first nine months of 2013 compared to \$45 million in the first nine months of 2012, an increase of \$25 million (56%), reflecting a lower current accident year loss ratio as well as increased favorable reserve development.

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Specialty financial Underwriting profit was \$50 million for the first nine months of 2013 compared to \$28 million in the first nine months of 2012, an increase of \$22 million (79%). The improved results were due primarily to higher underwriting profits in the financial institutions business, primarily from lender-placed mortgage property insurance.

## Losses and Loss Adjustment Expenses

AFG's overall loss and LAE ratio was 64.1% for the first nine months of 2013 compared to 63.0% for the first nine months of 2012, an increase of 1.1 percentage points. The components of AFG's property and casualty losses and LAE amounts and ratio are detailed below:

|                                                      | Nine months ended September 30, |         |        |         | Change in |      |    |  |
|------------------------------------------------------|---------------------------------|---------|--------|---------|-----------|------|----|--|
|                                                      | Amount                          |         | Ratio  |         | Ratio     |      |    |  |
|                                                      | 2013                            | 2012    | 2013   | 2012    |           |      |    |  |
| Property and transportation                          |                                 |         |        |         |           |      |    |  |
| Current year, excluding catastrophe losses           | \$812                           | \$729   | 73.1   | % 70.0  | %         | 3.1  | %  |  |
| Prior accident years development                     | (4                              | ) (14   | ) (0.4 | %) (1.3 | %)        | 0.9  | %  |  |
| Current year catastrophe losses                      | 27                              | 7       | 2.4    | % 0.7   | %         | 1.7  | %  |  |
| Property and transportation losses and LAE and ratio | \$835                           | \$722   | 75.1   | % 69.4  | %         | 5.7  | %  |  |
| Specialty casualty                                   |                                 |         |        |         |           |      |    |  |
| Current year, excluding catastrophe losses           | \$511                           | \$439   | 62.0   | % 63.0  | %         | (1.0 | %) |  |
| Prior accident years development                     | (42                             | ) (25   | ) (5.0 | %) (3.7 | %)        | (1.3 | %) |  |
| Current year catastrophe losses                      | 1                               | 2       | 0.1    | % 0.2   | %         | (0.1 | %) |  |
| Specialty casualty losses and LAE and ratio          | \$470                           | \$416   | 57.1   | % 59.5  | %         | (2.4 | %) |  |
| Specialty financial                                  |                                 |         |        |         |           |      |    |  |
| Current year, excluding catastrophe losses           | \$124                           | \$130   | 35.6   | % 43.3  | %         | (7.7 | %) |  |
| Prior accident years development                     | (10                             | ) (16   | ) (2.9 | %) (5.5 | %)        | 2.6  | %  |  |
| Current year catastrophe losses                      | 2                               | 3       | 0.6    | % 1.1   | %         | (0.5 | %) |  |
| Specialty financial losses and LAE and ratio         | \$116                           | \$117   | 33.3   | % 38.9  | %         | (5.6 | %) |  |
| Total Specialty                                      |                                 |         |        |         |           |      |    |  |
| Current year, excluding catastrophe losses           | \$1,482                         | \$1,327 | 63.3   | % 63.5  | %         | (0.2 | %) |  |
| Prior accident years development                     | (70                             | ) (62   | ) (3.1 | %) (3.0 | %)        | (0.1 | %) |  |
| Current year catastrophe losses                      | 30                              | 13      | 1.3    | % 0.6   | %         | 0.7  | %  |  |
| Total Specialty losses and LAE and ratio             | \$1,442                         | \$1,278 | 61.5   | % 61.1  | %         | 0.4  | %  |  |
| Aggregate — including discontinued lines             |                                 |         |        |         |           |      |    |  |
| Current year, excluding catastrophe losses           | \$1,483                         | \$1,327 | 63.3   | % 63.5  | %         | (0.2 | %) |  |
| Prior accident years development                     | (10                             | ) (23   | ) (0.5 | %) (1.1 | %)        | 0.6  | %  |  |
| Current year catastrophe losses                      | 30                              | 13      | 1.3    | % 0.6   | %         | 0.7  | %  |  |
| Aggregate losses and LAE and ratio                   | \$1,503                         | \$1,317 | 64.1   | % 63.0  | %         | 1.1  | %  |  |

## Net prior year reserve development

AFG's Specialty property and casualty operations recorded net favorable reserve development related to prior accident years of \$70 million in the first nine months of 2013 compared to \$62 million in the first nine months of 2012, an increase of \$8 million (13%).

Property and transportation Net favorable reserve development of \$4 million in the first nine months of 2013 reflects lower than expected claims handling expense in the crop business and lower claim severity in the property inland marine and ocean marine businesses, substantially offset by adverse development from increased severity in the commercial auto liability business written by the transportation businesses. Net favorable reserve development of \$14 million in the first nine months of 2012 reflects lower than expected loss frequency in crop products, partially offset by higher than expected claim severity in the property and inland marine business.

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**Specialty casualty** Net favorable reserve development of \$42 million in the first nine months of 2013 reflects lower than expected claim severity in directors and officers liability insurance and lower than expected claim severity and frequency in excess liability business. Net favorable reserve development of \$25 million in the first nine months of 2012 reflects lower than expected claim severity and frequency in homebuilders' general liability products and lower than expected claim severity in directors and officers liability insurance substantially offset by higher claim frequency and severity in a run-off book of U.S.-based program (motel/hotel, restaurants, taverns and recreational) business.

**Specialty financial** Net favorable reserve development of \$10 million in the first nine months of 2013 is due to lower than expected frequency and severity in the foreign credit and financial institution services businesses as economic conditions did not affect these lines as adversely as had been anticipated. Net favorable reserve development of \$16 million in the first nine months of 2012 reflects lower than expected claim severity in fidelity and crime products, lower than expected frequency and severity in the financial institution service businesses and lower than expected claim frequency and severity in the run-off automobile residual value insurance business.

**Other specialty** In addition to the development discussed above, total specialty net favorable reserve development reflects amortization of the deferred gain on the retroactive insurance transaction entered into in connection with the sale of a business in 1998 and reserve development associated with AFG's internal reinsurance program.

**Special Asbestos and Environmental Reserve Charges** See "Net prior year reserve development" under "Property and Casualty Insurance — Results of Operations" for the quarters ended September 30, 2013 and 2012 for a discussion of the \$54 million and \$31 million special A&E charges recorded in the third quarters of 2013 and 2012, respectively.

**Aggregate** Aggregate net prior accident years reserve development for AFG's property and casualty segment includes the special A&E charges mentioned above.

**Catastrophe losses**

AFG generally seeks to reduce its exposure to catastrophes through individual risk selection, including minimizing coastal and known fault-line exposures, and the purchase of reinsurance. The \$27 million in catastrophe losses in the property and transportation group in the first nine months of 2013 resulted primarily from spring storms in the southeastern United States.

**Commissions and Other Underwriting Expenses**

AFG's property and casualty commissions and other underwriting expenses ("U/W Exp") were \$772 million in the first nine months of 2013 compared to \$697 million for the first nine months of 2012, an increase of \$75 million (11%). AFG's underwriting expense ratio was 32.9% for the first nine months of 2013 compared to 33.3% for the first nine months of 2012, a decrease of 0.4 percentage points. Detail of AFG's property and casualty commissions and other underwriting expenses and underwriting expense ratios is shown below (dollars in millions):

|                             | Nine months ended September 30, |          |         |          |           |    |
|-----------------------------|---------------------------------|----------|---------|----------|-----------|----|
|                             | 2013                            |          | 2012    |          | Change in |    |
|                             | U/W Exp                         | % of NEP | U/W Exp | % of NEP | % of NEP  |    |
| Property and transportation | \$281                           | 25.3     | % \$285 | 27.4     | % (2.1    | %) |
| Specialty casualty          | 285                             | 34.4     | % 238   | 34.0     | % 0.4     | %  |
| Specialty financial         | 184                             | 52.5     | % 156   | 51.7     | % 0.8     | %  |
| Other specialty             | 22                              | 37.3     | % 18    | 37.2     | % 0.1     | %  |
|                             | \$772                           | 32.9     | % \$697 | 33.3     | % (0.4    | %) |

The overall decrease of 0.4% in AFG's expense ratio for the first nine months of 2013 as compared to the first nine months of 2012, as well as the fluctuations in AFG's sub-components, reflects the impact of higher premiums on the ratio partially offset by changes in the mix of AFG's business and the impact of certain reinsurance ceding commissions received that are partially based on the profitability of the business ceded.

Property and transportation Commissions and other underwriting expenses as a percentage of net earned premiums decreased 2.1 percentage points for the first nine months of 2013 compared to the first nine months of 2012 reflecting the timing of the determination of reimbursements for administrative and operating expenses under the Federal crop insurance program and the impact of higher premiums on the ratio partially offset by lower profitability-based commissions received from reinsurers.

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**Specialty casualty** Commissions and other underwriting expenses as a percentage of net earned premiums increased 0.4 percentage points for the first nine months of 2013 compared to the first nine months of 2012 reflecting higher profitability-based commissions related to international business, partially offset by the impact of higher premiums on the ratio.

**Specialty financial** Commissions and other underwriting expenses as a percentage of net earned premiums increased 0.8 percentage points for the first nine months of 2013 compared to the first nine months of 2012 reflecting higher profitability-based commissions and lower ceding commissions from reinsurers, partially offset by the impact of higher premiums on the ratio.

**Property and Casualty Net Investment Income**

Net investment income in AFG's property and casualty operations was \$196 million for the first nine months of 2013 compared to \$206 million in the first nine months of 2012, a decrease of \$10 million (5%). In recent years, yields available in the financial markets on fixed maturity securities have generally declined, placing downward pressure on AFG's investment portfolio yield. The average invested assets and overall earned yield on investments held by AFG's property and casualty operations are provided below (dollars in millions):

|                                                                 | Nine months ended<br>September 30, |         | Change   | % Change |
|-----------------------------------------------------------------|------------------------------------|---------|----------|----------|
|                                                                 | 2013                               | 2012    |          |          |
| Net investment income                                           | \$196                              | \$206   | \$(10 )  | (5 %)    |
| Average invested assets (at amortized cost)                     | \$6,876                            | \$6,623 | \$253    | 4 %      |
| Yield (net investment income as a % of average invested assets) | 3.80 %                             | 4.15 %  | (0.35 %) |          |

The property and casualty segment's overall yield on investments (net investment income as a percentage of average invested assets) was 3.80% for the first nine months of 2013 compared to 4.15% for the first nine months of 2012, a decline of 0.35 percentage points. In addition to the impact of lower yields available in the financial markets, the \$253 million increase in average invested assets reflects primarily higher average cash and cash equivalent balances.

**Property and Casualty Other Income and Expense, Net**

Other income and expenses, net for AFG's property and casualty operations was a net expense of \$27 million for the first nine months of 2013 compared to \$33 million for the first nine months of 2012, a decrease of \$6 million (18%). The table below details the items included in other income and expenses, net for AFG's property and casualty operations (in millions):

|                                     | Nine months ended<br>September 30, |      |
|-------------------------------------|------------------------------------|------|
|                                     | 2013                               | 2012 |
| Other income                        |                                    |      |
| Warranty operations                 | \$—                                | \$12 |
| Income from the sale of real estate | 4                                  | —    |
| Other                               | 6                                  | 5    |
| Total other income                  | 10                                 | 17   |
| Other expenses                      |                                    |      |
| Warranty operations                 | —                                  | 14   |
| Amortization of intangibles         | 10                                 | 10   |

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|                                |       |         |
|--------------------------------|-------|---------|
| Other                          | 24    | 23      |
| Total other expense            | 34    | 47      |
| Interest expense               | 3     | 3       |
| Other income and expenses, net | \$(27 | ) \$(33 |

Beginning in 2013, AFG's warranty operations are included in the Specialty financial underwriting results.

Interest expense for AFG's property and casualty operations includes interest charges on long-term debt within the property and casualty operations, primarily notes secured by real estate and other secured borrowings.

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## Annuity Segment — Results of Operations

AFG's annuity operations contributed \$231 million in GAAP pretax earnings in the first nine months of 2013 compared to \$188 million in the first nine months of 2012, an increase of \$43 million (23%). AFG's annuity operations contributed \$236 million in core pretax earnings in the first nine months of 2013 compared to \$188 million in the first nine months of 2012, an increase of \$48 million (26%). The increase in both GAAP and core pretax earnings was a result of growth in the annuity business and the favorable impact that rising interest rates and strong stock market performance in the first nine months of 2013 had on AFG's fixed-indexed annuity business. Results for the first nine months of 2012 reflect the negative impact of sharply lower interest rates partially offset by the impact of strong stock market performance on the fixed-indexed annuity business.

In the second quarter of 2013, AFG recorded a pretax charge of \$5 million in its annuity operations to cover expected assessments from state guaranty funds related to the insolvency and liquidation of Executive Life Insurance Company of New York ("ELNY"), an unaffiliated life insurance company. ELNY was placed into rehabilitation by the New York Insurance Department in 1991. In April 2012, ELNY was declared insolvent and ordered into liquidation. AFG's life insurance subsidiaries are required under the solvency or guaranty laws of most states in which they do business to pay assessments up to certain prescribed limits to fund policyholder losses or liabilities of insolvent insurance companies such as ELNY and started receiving guaranty fund assessments related to ELNY from various states in the second quarter of 2013. AFG does not expect to record significant additional charges for ELNY guaranty fund assessments in future quarters.

The following table details AFG's GAAP and core earnings before income taxes from its annuity operations for the nine months ended September 30, 2013 and 2012 (dollars in millions).

|                                                                | Nine months ended<br>September 30, |       | % Change |    |
|----------------------------------------------------------------|------------------------------------|-------|----------|----|
|                                                                | 2013                               | 2012  |          |    |
| Revenues:                                                      |                                    |       |          |    |
| Net investment income                                          | \$764                              | \$722 | 6        | %  |
| Other income:                                                  |                                    |       |          |    |
| Guaranteed withdrawal benefit fees                             | 18                                 | 9     | 100      | %  |
| Policy charges and other miscellaneous income                  | 28                                 | 30    | (7       | %) |
| Total revenues                                                 | 810                                | 761   | 6        | %  |
| Costs and Expenses:                                            |                                    |       |          |    |
| Annuity benefits (a)                                           | 394                                | 417   | (6       | %) |
| Acquisition expenses                                           | 114                                | 92    | 24       | %  |
| Other expenses (b)                                             | 66                                 | 64    | 3        | %  |
| Total costs and expenses                                       | 574                                | 573   | —        | %  |
| Core earnings before income taxes                              | 236                                | 188   | 26       | %  |
| Pretax non-core ELNY guaranty fund assessments                 | (5                                 | ) —   | —        | %  |
| GAAP earnings before income taxes                              | \$231                              | \$188 | 23       | %  |
| (a) Annuity benefits consisted of the following (in millions): |                                    |       |          |    |
|                                                                | Nine months ended<br>September 30, |       | % Change |    |
|                                                                | 2013                               | 2012  |          |    |
| Interest credited — fixed                                      | \$333                              | \$329 | 1        | %  |
| Interest credited — fixed component of variable annuities      | 5                                  | 5     | —        | %  |

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|                                                                         |       |       |      |    |
|-------------------------------------------------------------------------|-------|-------|------|----|
| Change in expected death and annuitization reserve                      | 14    | 14    | —    | %  |
| Amortization of sales inducements                                       | 23    | 23    | —    | %  |
| Change in guaranteed withdrawal benefit reserve                         | 28    | 9     | 211  | %  |
| Change in other benefit reserves                                        | 6     | 7     | (14  | %) |
| Derivatives related to fixed-indexed annuities:                         |       |       |      |    |
| Embedded derivative mark-to-market                                      | 110   | 97    | 13   | %  |
| Equity option mark-to-market                                            | (125  | ) (67 | ) 87 | %  |
| Total annuity benefits                                                  | \$394 | \$417 | (6   | %) |
| (b) Other expenses exclude the non-core ELNY guaranty fund assessments. |       |       |      |    |

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## Net Spread on Fixed Annuities (excludes variable annuity earnings)

The table below (dollars in millions) details the components of these spreads for AFG's fixed annuity operations (including fixed-indexed annuities):

|                                                                           | Nine months ended September 30, |          |          |   |
|---------------------------------------------------------------------------|---------------------------------|----------|----------|---|
|                                                                           | 2013                            | 2012     | % Change |   |
| Average fixed annuity investments (at amortized cost)                     | \$18,693                        | \$16,371 | 14       | % |
| Average fixed annuity benefits accumulated                                | 18,231                          | 16,147   | 13       | % |
| As % of fixed annuity benefits accumulated (except as noted):             |                                 |          |          |   |
| Net investment income (as % of fixed annuity investments)                 | 5.40                            | % 5.82   | %        |   |
| Interest credited — fixed                                                 | (2.43                           | %) (2.72 | %)       |   |
| Net interest spread                                                       | 2.97                            | % 3.10   | %        |   |
| Policy charges and other miscellaneous income                             | 0.14                            | % 0.17   | %        |   |
| Other annuity benefit expenses, net of guaranteed withdrawal benefit fees | (0.39                           | %) (0.32 | %)       |   |
| Acquisition expenses                                                      | (0.80                           | %) (0.72 | %)       |   |
| Other expenses (*)                                                        | (0.45                           | %) (0.49 | %)       |   |
| Change in fair value of derivatives related to fixed-indexed annuities    | 0.11                            | % (0.29  | %)       |   |
| Net spread earned on fixed annuities                                      | 1.58                            | % 1.45   | %        |   |

(\*) Excludes the \$5 million second quarter 2013 non-core charge for the ELNY guaranty fund assessments. Including this charge, the net spread earned on fixed annuities was 1.54% for the nine months ended September 30, 2013.

## Annuity Net Investment Income

Net investment income for the first nine months of 2013 was \$764 million compared to \$722 million for the first nine months of 2012, an increase of \$42 million (6%). This increase reflects primarily the growth in AFG's annuity business. The overall yield earned on investments in AFG's annuity operations, calculated as net investment income divided by average investment balances (at amortized cost), declined by 0.42 percentage points for the first nine months of 2013 compared to the same period in 2012. This decline in net investment yield reflects (i) the investment of new premium dollars in the recent low interest rate environment and (ii) the impact of the maturity and redemption of higher yielding investments.

## Annuity Interest Credited — Fixed

Interest credited — fixed for the first nine months of 2013 was \$333 million compared to \$329 million for the first nine months of 2012, an increase of \$4 million (1%). The impact of growth in the annuity business was partially offset by lower interest crediting rates on new premiums as compared to the crediting rates on policyholder funds surrendered or withdrawn as well as the impact of crediting rate reductions on existing policyholder funds that were implemented in the second half of 2012. The average interest rate credited to policyholders, calculated as interest credited divided by average fixed annuity benefits accumulated, decreased 0.29 percentage points in the first nine months of 2013 compared to the same period of 2012. During the first nine months of 2013, interest rates credited on new premiums generally ranged from 1.00% to 2.00%.

## Annuity Net Interest Spread

AFG's net interest spread decreased 0.13 percentage points in the first nine months of 2013 compared to the same period in 2012 due primarily to the run-off of higher yielding investments, partially offset by lower crediting rates.

**Annuity Policy Charges and Other Miscellaneous Income**

Annuity policy charges and other miscellaneous income for the first nine months of 2013 were \$28 million compared to \$30 million for the first nine months of 2012, a decrease of \$2 million (7%). Policy charges and other miscellaneous income for AFG's annuity operations, which consist primarily of surrender charges, as a percentage of average fixed annuity benefits accumulated declined 0.03 percentage points primarily reflecting lower surrender charge rates.

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## Other Annuity Benefits

Other annuity benefits, net of guaranteed withdrawal benefit fees for the first nine months of 2013 were \$53 million compared to \$44 million for the first nine months of 2012, an increase of \$9 million (20%). In addition to interest credited to policyholders' accounts, annuity benefits expense also includes the following expenses (in millions, net of guaranteed withdrawal benefit fees):

|                                                    | Nine months ended<br>September 30, |      |
|----------------------------------------------------|------------------------------------|------|
|                                                    | 2013                               | 2012 |
| Change in expected death and annuitization reserve | \$14                               | \$14 |
| Amortization of sales inducements                  | 23                                 | 23   |
| Change in guaranteed withdrawal benefit reserve    | 28                                 | 9    |
| Change in other benefit reserves                   | 6                                  | 7    |
| Other annuity benefits                             | 71                                 | 53   |
| Offset guaranteed withdrawal benefit fees          | (18                                | ) (9 |
| Other annuity benefits, net                        | \$53                               | \$44 |

The \$9 million increase in other annuity benefits, net of guaranteed withdrawal benefit fees for the first nine months of 2013 compared to the first nine months of 2012 reflects primarily increased sales of products with guaranteed withdrawal benefit features.

## Annuity Acquisition Expenses

AFG's amortization of DPAC and commission expenses as a percentage of average fixed annuity benefits accumulated was 0.80% for the first nine months of 2013 compared to 0.72% for the first nine months of 2012 and has generally ranged between 0.70% and 0.80%. Variances in these percentages generally relate to the impact of (i) material changes in interest rates or the stock market on AFG's fixed-indexed annuity business, and (ii) differences in actual experience from actuarially projected estimates and assumptions. For example, the favorable impact of the increase in market interest rates during 2013 on the fair value of derivatives related to fixed-indexed annuities (discussed below) resulted in a partially offsetting acceleration in the amortization of DPAC.

## Annuity Other Expenses

Annuity other expenses for the first nine months of 2013 were \$66 million excluding the non-core ELNY guaranty fund assessments charge, compared to \$64 million for the first nine months of 2012, an increase of \$2 million (3%). Annuity other expenses represent primarily general and administrative expenses, as well as selling and issuance expenses that are not deferred. As a percentage of average fixed annuity benefits accumulated, these expenses declined 0.04 percentage points for the first nine months of 2013 as compared to the first nine months of 2012.

## Change in Fair Value of Derivatives Related to Fixed-Indexed Annuities

AFG's fixed-indexed annuities, which represented approximately 45% of annuity benefits accumulated at September 30, 2013, provide policyholders with a crediting rate tied, in part, to the performance of an existing stock market index. AFG attempts to mitigate the risk in the index-based component of these products through the purchase of call options on the appropriate index. AFG's strategy is designed so that an increase in the liabilities, due to an increase in the market index, will generally be offset by unrealized and realized gains on the call options purchased by AFG. Both the index-based component of the annuities and the related call options are considered derivatives that must be marked-to-market through earnings each period. The fair values of these derivatives are impacted by actual and expected stock market performance and interest rates as well as other factors. For a list of other factors impacting the fair value of the index-based component of AFG's annuity benefits accumulated, see Note D — "Fair Value

Measurements.” The net change in fair value of derivatives related to fixed-indexed annuities reduced annuity benefits by \$15 million in the first nine months of 2013 as the impact of strong stock market performance on the embedded derivative was more than offset by the positive impact of higher market interest rates. Conversely, the net change in fair value of the derivatives related to fixed-indexed annuities increased annuity benefits expense by \$30 million in the first nine months of 2012 reflecting the negative impact of sharply lower market interest rates on the embedded derivative.

#### Annuity Net Spread Earned on Fixed Annuities

AFG’s net spread earned on fixed annuities increased 0.13 percentage points in the first nine months of 2013 compared to the same period in 2012 as the 0.13 percentage points decrease in AFG’s net interest spread was more than offset by the impact of changes in the fair value of derivatives discussed above.

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## AMERICAN FINANCIAL GROUP, INC. 10-Q

## Management's Discussion and Analysis of Financial Condition and Results of Operations — Continued

## Annuity Benefits Accumulated

Annuity premiums received 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 and other benefits are charged to expense and decreases for surrender and other policy charges are credited to other income.

For certain products, annuity benefits accumulated also includes reserves for accrued persistency and premium bonuses (sales inducements), excess benefits expected to be paid on future deaths and annuitizations ("EDAR") and guaranteed withdrawal benefits. Annuity benefits accumulated also includes amounts advanced from the Federal Home Loan Bank of Cincinnati. The following table is a progression of AFG's annuity benefits accumulated liability for the nine months ended September 30, 2013 and 2012 (in millions):

|                                                                   | Nine months ended<br>September 30, |          |
|-------------------------------------------------------------------|------------------------------------|----------|
|                                                                   | 2013                               | 2012     |
| Beginning fixed annuity reserves                                  | \$17,274                           | \$15,188 |
| Fixed annuity premiums (receipts)                                 | 2,613                              | 2,385    |
| Federal Home Loan Bank advances                                   | 200                                | —        |
| Surrenders, benefits and other withdrawals                        | (1,085)                            | (1,042)  |
| Interest and other annuity benefit expenses:                      |                                    |          |
| Interest credited                                                 | 333                                | 329      |
| Embedded derivative mark-to-market                                | 110                                | 97       |
| Change in other benefit reserves                                  | 60                                 | 42       |
| Ending fixed annuity reserves                                     | \$19,505                           | \$16,999 |
| Reconciliation to annuity benefits accumulated per balance sheet: |                                    |          |
| Ending fixed annuity reserves (from above)                        | \$19,505                           | \$16,999 |
| Impact of unrealized investment gains                             | 84                                 | 46       |
| Fixed component of variable annuities                             | 196                                | 200      |
| Annuity benefits accumulated per balance sheet                    | \$19,785                           | \$17,245 |

## Statutory Annuity Premiums

AFG's annuity operations generated statutory premiums of \$2.65 billion in the first nine months of 2013 compared to \$2.43 billion in the first nine months of 2012, an increase of \$221 million (9%). The following table summarizes AFG's annuity sales (dollars in millions):

|                                                           | Nine months ended<br>September 30, |         |          |
|-----------------------------------------------------------|------------------------------------|---------|----------|
|                                                           | 2013                               | 2012    | % Change |
| Retail single premium annuities — indexed                 | \$1,314                            | \$1,357 | (3 %)    |
| Retail single premium annuities — fixed                   | 112                                | 118     | (5 %)    |
| Financial institutions single premium annuities — indexed | 604                                | 232     | 160 %    |
| Financial institutions single premium annuities — fixed   | 427                                | 501     | (15 %)   |
| Education market — 403(b) fixed and indexed annuities     | 156                                | 177     | (12 %)   |
| Total fixed annuity premiums                              | 2,613                              | 2,385   | 10 %     |
| Variable annuities                                        | 39                                 | 46      | (15 %)   |
| Total annuity premiums                                    | \$2,652                            | \$2,431 | 9 %      |

The 9% increase in annuity premiums in the first nine months of 2013 compared to the same period in 2012 reflects continued successful distribution channel expansion, primarily in the financial institutions market, as well as new product offerings. Management also believes that AFG has benefitted from its strong ratings, and that the entire annuity industry has benefitted from the rise in interest rates in 2013, particularly in the financial institutions market.

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## AMERICAN FINANCIAL GROUP, INC. 10-Q

## Management's Discussion and Analysis of Financial Condition and Results of Operations — Continued

## Annuity Earnings before Income Taxes Reconciliation

The following table reconciles the GAAP and core net spread earned on AFG's fixed annuities to overall annuity pretax earnings for the nine months ended 2013 and 2012 (in millions):

|                                                                             | Nine months ended<br>September 30, |       |
|-----------------------------------------------------------------------------|------------------------------------|-------|
|                                                                             | 2013                               | 2012  |
| Earnings on fixed annuity benefits accumulated (a)                          | \$216                              | \$179 |
| Earnings on investments in excess of fixed annuity benefits accumulated (b) | 18                                 | 9     |
| Variable annuity earnings                                                   | 2                                  | —     |
| Core earnings before income taxes                                           | 236                                | 188   |
| Pretax non-core ELNY guaranty fund assessments                              | (5                                 | ) —   |
| GAAP earnings before income taxes                                           | \$231                              | \$188 |

(a) Excludes the pretax non-core ELNY guarantee fund assessments of \$5 million recorded in the second quarter of 2013.

(b) Net investment income (as a % of investments) of 5.40% and 5.82% for the nine months ended September 30, 2013 and 2012, respectively, multiplied by the difference between average fixed annuity investments (at amortized cost) and average fixed annuity benefits accumulated in each period.

Run-off Long-Term Care and Life Segment — Results of Operations The following table details AFG's earnings before income taxes from its run-off long-term care and life operations for the nine months ended September 30, 2013 and 2012 (dollars in millions):

|                                     | Nine months ended<br>September 30, |       |          |    |
|-------------------------------------|------------------------------------|-------|----------|----|
|                                     | 2013                               | 2012  | % Change |    |
| Revenues:                           |                                    |       |          |    |
| Net earned premiums:                |                                    |       |          |    |
| Long-term care                      | \$58                               | \$59  | (2       | %) |
| Life operations                     | 29                                 | 32    | (9       | %) |
| Net investment income               | 57                                 | 54    | 6        | %) |
| Other income                        | 3                                  | 1     | 200      | %) |
| Total revenues                      | 147                                | 146   | 1        | %) |
| Costs and Expenses:                 |                                    |       |          |    |
| Life, accident and health benefits: |                                    |       |          |    |
| Long-term care                      | 85                                 | 66    | 29       | %) |
| Life operations                     | 35                                 | 41    | (15      | %) |
| Acquisition expenses                | 14                                 | 15    | (7       | %) |
| Other expenses                      | 20                                 | 16    | 25       | %) |
| Total costs and expenses            | 154                                | 138   | 12       | %) |
| Earnings (loss) before income taxes | \$(7                               | ) \$8 |          |    |

The increase in long-term care benefits expense in the first nine months of 2013 as compared to the 2012 period is due primarily to an increase in new claims. Due to the nature and size of its long-term care business, AFG expects claims volatility from period to period. Management continues to monitor the long-term care business. The decrease in life benefits expense in the first nine months of 2013 as compared to the 2012 period is due primarily to improved claims

experience in the first half of 2013.

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## AMERICAN FINANCIAL GROUP, INC. 10-Q

## Management's Discussion and Analysis of Financial Condition and Results of Operations — Continued

Medicare Supplement and Critical Illness Segment — Results of Operations AFG's Medicare supplement and critical illness segment contributed \$183 million in GAAP pretax earnings in the first nine months of 2012, which includes a \$155 million pretax non-core realized gain on the August 2012 sale of these businesses. See Note B — “Acquisitions and Sales of Subsidiaries.” The following table details AFG's GAAP and core earnings before income taxes from its Medicare supplement and critical illness business (in millions):

|                                                                                   | Nine months ended<br>September 30, |       |
|-----------------------------------------------------------------------------------|------------------------------------|-------|
|                                                                                   | 2013                               | 2012  |
| Revenues:                                                                         |                                    |       |
| Net earned premiums                                                               | \$—                                | \$199 |
| Net investment income                                                             | —                                  | 7     |
| Other income                                                                      | —                                  | 6     |
| Total revenues                                                                    | —                                  | 212   |
| Costs and Expenses:                                                               |                                    |       |
| Life, accident and health benefits                                                | —                                  | 131   |
| Acquisition expenses                                                              | —                                  | 31    |
| Other expenses                                                                    | —                                  | 22    |
| Total costs and expenses                                                          | —                                  | 184   |
| Core earnings before income taxes                                                 | —                                  | 28    |
| Pretax non-core realized gain on sale of Medicare supplement and critical illness | —                                  | 155   |
| GAAP earnings before income taxes                                                 | \$—                                | \$183 |

Holding Company, Other and Unallocated — Results of Operations AFG's net GAAP pretax loss outside of its insurance operations (excluding realized gains) totaled \$144 million for the first nine months of 2013 compared to \$143 million in the first nine months of 2012, an increase of \$1 million (1%). AFG's net core pretax loss outside of its insurance operations (excluding realized gains) totaled \$122 million for the first nine months of 2013 compared to \$118 million for the first nine months of 2012, an increase of \$4 million (3%).

The following table details AFG's GAAP and core loss before income taxes from operations outside of its insurance operations for the nine months ended September 30, 2013 and 2012 (dollars in millions):

|                                                         | Nine months ended<br>September 30, |        |          |    |
|---------------------------------------------------------|------------------------------------|--------|----------|----|
|                                                         | 2013                               | 2012   | % Change |    |
| Revenues:                                               |                                    |        |          |    |
| Net investment income                                   | \$6                                | \$4    | 50       | %  |
| Other income                                            | 24                                 | 18     | 33       | %  |
| Total revenues                                          | 30                                 | 22     | 36       | %  |
| Costs and Expenses:                                     |                                    |        |          |    |
| Interest charges on borrowed money                      | 51                                 | 54     | (6       | %) |
| Other expenses (*)                                      | 101                                | 86     | 17       | %  |
| Total costs and expenses                                | 152                                | 140    | 9        | %  |
| Core loss before income taxes, excluding realized gains | (122                               | ) (118 | ) 3      | %  |
| Pretax non-core items, excluding realized gains:        |                                    |        |          |    |
| Special A&E charge                                      | (22                                | ) (2   | ) 1,000  | %  |

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|                                                             |        |     |        |      |    |   |
|-------------------------------------------------------------|--------|-----|--------|------|----|---|
| Other                                                       | —      | (23 | )      | (100 | %) |   |
| GAAP earnings before income taxes, excluding realized gains | \$(144 | )   | \$(143 | )    | 1  | % |

(\*) Excludes pretax non-core special A&E charges of \$22 million and \$2 million for the first nine months of 2013 and 2012, respectively. Other expenses for the first nine months of 2012 also exclude \$23 million in other non-core charges. See “Holding Company, Other and Unallocated — Results of Operations” for the quarters ended September 30, 2013 and 2012 for a discussion of these non-core charges.

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## AMERICAN FINANCIAL GROUP, INC. 10-Q

## Management's Discussion and Analysis of Financial Condition and Results of Operations — Continued

## Holding Company and Other — Net Investment Income

AFG recorded investment income on investments held outside of its insurance operations of \$6 million in the first nine months of 2013 and \$4 million in the first nine months of 2012.

## Holding Company and Other — Other Income

Other income in the table above includes \$12 million in the first nine months of 2013 and \$14 million in the first nine months of 2012 of management fees paid to AFG by the AFG-managed CLOs (AFG's consolidated managed investment entities). These fees are eliminated in consolidation — see the other income line in the Consolidate MIEs column under Results of Operations — Segmented Statement of Earnings. Excluding amounts eliminated in consolidation, AFG recorded other income outside of its insurance operations of \$12 million in the first nine months of 2013 compared to \$4 million in the first nine months of 2012. Results for the first nine months of 2012 include a charge of \$4 million to write-down a fixed asset that is being sold.

## Holding Company and Other — Interest Charges on Borrowed Money

AFG's holding companies and other operations outside of its insurance operations recorded interest expense of \$51 million in the first nine months of 2013 compared to \$54 million in the first nine months of 2012, a decrease of \$3 million (6%). In 2012, AFG issued new Senior Notes and used the proceeds to redeem higher rate debt.

## Holding Company and Other — Other Expenses

See “Holding Company and Other — Other Expenses” under “Holding Company, Other and Unallocated — Results of Operations” for the quarters ended September 30, 2013 and 2012 for a discussion of the \$22 million and \$25 million in non-core charges recorded in the third quarter of 2013 and 2012, respectively. Excluding these non-core charges, AFG's holding companies and other operations outside of its insurance operations recorded other expenses of \$101 million in the first nine months of 2013 compared to \$86 million in the first nine months of 2012, an increase of \$15 million (17%). The \$15 million increase reflects the impact of higher holding company expenses, primarily related to certain share-based incentive plans.

**Consolidated Realized Gains (Losses) on Securities** AFG's consolidated realized gains on securities, which are not allocated to segments, were \$154 million in the first nine months of 2013 compared to \$145 million in the first nine months of 2012, an increase of \$9 million (6%). Realized gains (losses) on securities consisted of the following (in millions):

|                                                                            | Nine months ended<br>September 30, |       |
|----------------------------------------------------------------------------|------------------------------------|-------|
|                                                                            | 2013                               | 2012  |
| Realized gains (losses) before impairments:                                |                                    |       |
| Disposals                                                                  | \$158                              | \$169 |
| Change in the fair value of derivatives                                    | 2                                  | 1     |
| Adjustments to annuity deferred policy acquisition costs and related items | —                                  | (6)   |
|                                                                            | 160                                | 164   |
| Impairment charges:                                                        |                                    |       |
| Securities                                                                 | (6)                                | (24)  |
| Adjustments to annuity deferred policy acquisition costs and related items | —                                  | 5     |
|                                                                            | (6)                                | (19)  |
|                                                                            | \$154                              | \$145 |

Realized gains on disposals include gains on sales of shares of Verisk Analytics, Inc. of \$49 million in the first nine months of 2013 and \$66 million in the first nine months of 2012.

**Consolidated Income Taxes** AFG's consolidated provision for income taxes was \$155 million for the first nine months of 2013 compared to \$184 million in the first nine months of 2012, a decrease of \$29 million (16%). See Note L — “Income Taxes” to the financial statements for an analysis of items affecting AFG’s effective tax rate.

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## AMERICAN FINANCIAL GROUP, INC. 10-Q

## Management's Discussion and Analysis of Financial Condition and Results of Operations — Continued

**Consolidated Noncontrolling Interests** AFG's consolidated net loss attributable to noncontrolling interests was \$25 million for the first nine months of 2013 compared to \$55 million for the first nine months of 2012, a decrease of \$30 million. The following table details net earnings (loss) in consolidated subsidiaries attributable to holders other than AFG (dollars in millions):

|                             | Nine months ended<br>September 30, |         | % Change |    |
|-----------------------------|------------------------------------|---------|----------|----|
|                             | 2013                               | 2012    |          |    |
| National Interstate         | \$4                                | \$12    | (67      | %) |
| Marketform                  | —                                  | (4      | ) (100   | %) |
| Managed Investment Entities | (30                                | ) (64   | ) (53    | %) |
| Other                       | 1                                  | 1       | —        | %  |
|                             | \$(25                              | ) \$(55 | ) (55    | %) |

During the third quarter of 2012, AFG acquired the remaining 28% of Marketform that it did not already own. As discussed in Notes A — “Accounting Policies,” and H — “Managed Investment Entities” to the financial statements, the losses of Managed Investment Entities represent CLO losses that ultimately inure to holders of the CLO debt.

**NEW ACCOUNTING STANDARDS**

See Note A — “Accounting Policies — Accounting Standards Adopted in 2013” for a discussion of new accounting standards adopted by AFG in 2013.

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## AMERICAN FINANCIAL GROUP, INC. 10-Q

## ITEM 3

## Quantitative and Qualitative Disclosure of Market Risk

As of September 30, 2013, there were no material changes to the information provided in Item 7A — “Quantitative and Qualitative Disclosures about Market Risk” of AFG’s 2012 Form 10-K.

## ITEM 4

## Controls and Procedures

AFG’s management, with participation of its Co-Chief Executive Officers and its Chief 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 CFO concluded that the controls and procedures are effective. There have been no changes in AFG’s internal control over financial reporting during the third fiscal quarter of 2013 that materially affected, or are reasonably likely to materially affect, AFG’s internal control over financial reporting.

In the ordinary course of business, AFG and its subsidiaries routinely enhance their information systems by either upgrading current systems or implementing new systems. There has been no change in AFG’s business processes and procedures during the third fiscal quarter of 2013 that has materially affected, or is reasonably likely to materially affect, AFG’s internal control over financial reporting.

## PART II

## OTHER INFORMATION

## ITEM 2

## Unregistered Sales of Equity Securities and Use of Proceeds

Issuer Purchases of Equity Securities AFG repurchased shares of its Common Stock during the first nine months of 2013 as follows:

|                | Total<br>Number<br>of Shares<br>Purchased | Average<br>Price Paid<br>Per Share | Total Number<br>of Shares<br>Purchased as<br>Part of Publicly<br>Announced Plans<br>or Programs | Maximum Number<br>of Shares<br>that May<br>Yet be Purchased<br>Under the Plans<br>or Programs (a) |
|----------------|-------------------------------------------|------------------------------------|-------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------|
| First Quarter  | 61,586                                    | \$43.71                            | 61,586                                                                                          | 7,501,271                                                                                         |
| Second Quarter | 1,386,570                                 | \$48.37                            | 1,386,570                                                                                       | 6,114,701                                                                                         |
| July           | —                                         | \$—                                | —                                                                                               | 6,114,701                                                                                         |
| August         | —                                         | \$—                                | —                                                                                               | 6,114,701                                                                                         |
| September      | —                                         | \$—                                | —                                                                                               | 6,114,701                                                                                         |

Represents the remaining shares that may be repurchased under the Plans authorized by AFG’s Board of Directors (a) in August 2012 and February 2013. AFG’s Board of Directors authorized the repurchase of five million additional shares in February 2013.

In addition, AFG acquired 890 shares of its Common Stock (at \$41.42 per share) in January 2013, 28,463 shares (at an average of \$43.52 per share) in February 2013, and 15,826 shares (at \$51.82 per share) in August 2013 in connection with its stock incentive plans.

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ITEM 6

Exhibits

| Number | Exhibit Description                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                     |
|--------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 12     | Computation of ratios of earnings to fixed charges.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                     |
| 31(a)  | Certification of Co-Chief Executive Officer pursuant to section 302(a) of the Sarbanes-Oxley Act of 2002.                                                                                                                                                                                                                                                                                                                                                                                                                                               |
| 31(b)  | Certification of Co-Chief Executive Officer pursuant to section 302(a) of the Sarbanes-Oxley Act of 2002.                                                                                                                                                                                                                                                                                                                                                                                                                                               |
| 31(c)  | Certification of Chief Financial Officer pursuant to section 302(a) of the Sarbanes-Oxley Act of 2002.                                                                                                                                                                                                                                                                                                                                                                                                                                                  |
| 32     | Certification of Co-Chief Executive Officers and Chief Financial Officer pursuant to section 906 of the Sarbanes-Oxley Act of 2002.                                                                                                                                                                                                                                                                                                                                                                                                                     |
| 101    | The following financial information from American Financial Group's Form 10-Q for the quarter ended September 30, 2013 formatted in XBRL (Extensible Business Reporting Language): <ul style="list-style-type: none"> <li>(i) Consolidated Balance Sheet</li> <li>(ii) Consolidated Statement of Earnings</li> <li>(iii) Consolidated Statement of Comprehensive Income</li> <li>(iv) Consolidated Statement of Changes in Equity</li> <li>(v) Consolidated Statement of Cash Flows</li> <li>(vi) Notes to Consolidated Financial Statements</li> </ul> |

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, 2013

BY: /s/ Joseph E. (Jeff) Consolino  
Joseph E. (Jeff) Consolino  
Executive Vice President and  
Chief Financial Officer