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**SECURITIES AND EXCHANGE COMMISSION**  
**Washington, D.C. 20549**

**FORM 10-K**

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

**For the Fiscal Year Ended**  
**December 31, 2002**

**Commission File**  
**No. 1-7361**

**AMERICAN FINANCIAL CORPORATION**

**Incorporated under**  
**the Laws of Ohio**

**IRS Employer I.D.**  
**No. 31-0624874**

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

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

Title of Each Class  
Series J Voting Cumulative Preferred Stock

Name of Each Exchange  
on which Registered  
Archipelago Exchange

**Securities Registered Pursuant to Section 12(g) of the Act:** None

**Other securities for which reports are submitted pursuant to Section 15(d) of the Act:** None

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and need not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. [X]

Indicate by check mark whether the registrant is an accelerated filer. Yes \_\_\_ No X

The aggregate market value of the Registrant's Preferred Stock as of the Registrant's most recently completed second fiscal quarter (June 30, 2002) was approximately \$57.7 million (based upon nonaffiliate holdings of 2,886,161 shares and a market price of \$20.00 per share).

As of March 1, 2003, there were 10,593,000 shares of the Registrant's Common Stock outstanding, all of which were owned by American Financial Group, Inc. At that date there were 2,886,161 shares of Series J Voting Preferred Stock outstanding (all of which were owned by non-affiliates).

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**Documents Incorporated by Reference:** None

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# AMERICAN FINANCIAL CORPORATION

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(a) The response to this Item is "none".

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## AMERICAN FINANCIAL CORPORATION

### FORWARD-LOOKING STATEMENTS

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

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

- changes in economic conditions, including interest rates, performance of securities markets, and the availability of capital;*
- regulatory actions;*
- changes in legal environment;*
- tax law changes;*
- levels of natural catastrophes, terrorist events, incidents of war and other major losses;*
- the ultimate amount of liabilities associated with certain asbestos and environmental-related claims;*
- the unpredictability of possible future litigation if certain settlements do not become effective;*
- adequacy of insurance reserves;*
- trends in mortality and morbidity;*
- availability of reinsurance and ability of reinsurers to pay their obligations;*
- competitive pressures, including the ability to obtain rate increases; and*
- changes in debt and claims paying ratings.*

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

## PART I

### ITEM 1

#### Business

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

#### Introduction

American Financial Corporation ("AFC") is a holding company which, through subsidiaries, is engaged primarily in property and casualty insurance, focusing on specialized commercial products for businesses, and in the sale of retirement annuities, life, and supplemental health insurance products. AFC was incorporated as an Ohio corporation in 1955. Its insurance subsidiaries have been operating as far back as the 1800's. Its address is One East Fourth Street, Cincinnati, Ohio 45202; its phone number is (513) 579-2121. At December 31, 2002, all of the outstanding Common Stock of AFC was owned by American Financial Group, Inc. ("AFG").

Over the years, AFC has owned, operated, and invested in businesses in a variety of industries and geographic areas, culminating in today's group of insurance companies. Generally, AFC's interests have been in the following areas: insurance, savings and loan, leasing, banking, real estate, communications/ entertainment and food distribution. A small number of opportunistic investments have been made in troubled and other undervalued assets.

#### **Recent Transactions**

Infinity Property and Casualty Corporation ("Infinity") was incorporated in September 2002 as a wholly-owned subsidiary of AFC. On December 31, 2002, AFC transferred to Infinity the following subsidiaries: Atlanta Casualty Company, Infinity Insurance Company, Leader Insurance Company and Windsor Insurance Company. In exchange, AFC received all of the issued and outstanding shares of Infinity common stock and a \$55 million 10-year promissory note. In addition, effective January 1, 2003, Great American Insurance Company ("GAI"), an AFC subsidiary, transferred to Infinity its personal insurance business written through independent agents. In 2002, 2001 and 2000, these businesses represented 28%, 35% and 46%, respectively, of AFC's property and casualty group's net written premiums. In a February 2003 public offering, AFC sold 61% (12.5 million shares) of Infinity for net proceeds of approximately \$186 million, realizing a pretax loss of approximately \$40 million. In January 2003, GAI entered into an agreement to sell its direct-to-consumer auto business.

In March 2001, GAI sold its Japanese property and casualty division to Mitsui Marine & Fire Insurance Company of America for \$22 million in cash. At the same time, a reinsurance agreement under which GAI ceded a portion of its pool of insurance to Mitsui was terminated. The Japanese division generated net written premiums of approximately \$60 million per year to GAI while GAI ceded approximately \$45 million per year to Mitsui.

In connection with the sale of the Japanese division, GAI continues to write certain business for, and fully reinsures it to, Mitsui. When GAI sold its commercial lines division in 1998, it had a similar arrangement which lasted through early 2001. Such business does not appear in the net written premiums or net earned premiums information herein.

In September 2000, AFC sold Stonewall Insurance Company for approximately \$31 million. Stonewall was a non-operating property and casualty subsidiary engaged primarily in the run-off of approximately \$170 million in asbestos and environmental liabilities associated with policies written through 1991.

*The businesses discussed above are included in the tables and financial statements herein through their respective disposal dates.*

## Property and Casualty Insurance Operations

AFC's property and casualty group has been engaged primarily in specialty and private passenger automobile insurance businesses which have been managed as two major business groups: Specialty and Personal. Each group has reported to an individual senior executive and is comprised of multiple business units which operate autonomously but with certain strong central controls and full accountability. Decentralized control allows each unit the autonomy necessary to respond to local and specialty market conditions while capitalizing on the efficiencies of centralized investment and administrative support functions. Approximately 40% of the 7,100 people employed by AFC's property and casualty insurance operations at December 31, 2002 work for the businesses transferred to Infinity.

The property and casualty group operates in a highly competitive industry that is affected by many factors which can cause significant fluctuations in its results of operations. The industry has historically been subject to pricing cycles characterized by periods of intense competition and lower premium rates (a "downcycle") followed by periods of reduced competition, reduced underwriting capacity due to lower policyholders' surplus and higher premium rates (an "upcycle"). After being in an extended downcycle for over a decade, the property and casualty insurance industry is experiencing significant market firming and price increases in certain specialty markets and in the private passenger automobile market.

The primary objective of AFC's property and casualty insurance operations is to achieve solid underwriting profitability while providing excellent service to its policyholders. Underwriting profitability is measured by the combined ratio which is a sum of the ratios of underwriting losses, loss adjustment expenses ("LAE"), underwriting expenses and policyholder dividends to premiums. When the combined ratio is under 100%, underwriting results are generally considered profitable; when the ratio is over 100%, underwriting results are generally considered unprofitable. The combined ratio does not reflect investment income, other income or federal income taxes.

While many costs included in underwriting may be readily determined (commissions, administrative expenses, many of the losses on claims reported), the process of determining overall underwriting results is also highly dependent upon the use of estimates in the case of losses incurred or expected but not yet reported or developed. Actuarial procedures and projections are used to obtain "best estimates" which are then included in the overall results. While the process is imprecise and develops amounts which are subject to change over time, AFC's projections, excluding asbestos and environmental ("A&E") claims, have been close to the developed ultimate results, as can be seen in the "reserve development triangles" on page 13.

AFC's property and casualty group, like many others in the industry, has A&E claims arising in most cases from general liability policies written in years before 1987. The establishment of reserves for such A&E claims presents unique and difficult challenges and is subject to uncertainties significantly greater than those presented by other types of claims.

In February 2003, GAI entered into an agreement for the settlement of asbestos-related coverage litigation from insurance policies issued in the 1970's and 1980's. Management believes that the \$123.5 million settlement (GAI has the option to pay in cash or over time with 5.25% interest) with parties related to and known as A.P. Green Industries, Inc. will enhance financial certainty and provide resolution to litigation that represents AFC's largest known asbestos-related claim and the only such claim that management believes to be material. For a discussion of uncertainties related to A&E claims, see *Management's Discussion and Analysis - "Asbestos and Environmental-related Reserves."*

Management's focus on underwriting performance has resulted in a statutory combined ratio averaging 107.2% for the period 1998 to 2002 (or 104.4% excluding special charges in 2002, 2001 and 1998 related to asbestos and other environmental matters), as compared to 109.1% for the property and casualty industry over the same period (Source: "Best's Review/Preview - Property/Casualty" - January 2003 Edition). AFC believes that its product line diversification and underwriting discipline have

contributed to the Company's ability to consistently outperform the industry's underwriting results. Management's philosophy is to refrain from writing business that is not expected to produce an underwriting profit even if it is necessary to limit premium growth to do so.

Generally, while financial data is reported on a statutory basis for insurance regulatory purposes, it is reported in accordance with generally accepted accounting principles ("GAAP") for shareholder and other investment purposes. In general, statutory accounting results in lower capital and surplus and lower net earnings than result from application of GAAP. Major differences include charging policy acquisition costs to expense as incurred rather than spreading the costs over the periods covered by the policies; reporting investment-grade bonds and redeemable preferred stocks at amortized cost; netting of reinsurance recoverables and prepaid reinsurance premiums against the corresponding liability; requiring additional loss reserves; and charging to surplus certain assets, such as furniture and fixtures and agents' balances over 90 days old.

*Unless indicated otherwise, the financial information presented for the property and casualty insurance operations herein is presented based on GAAP.*

The following table shows (in millions) certain information of AFC's property and casualty insurance operations.

	<u>2002</u>	<u>2001</u>	<u>2000</u>
<u>Statutory Basis</u>			
Premiums Earned	\$ 2,372	\$ 2,566	\$2,484
Admitted Assets	7,233	6,736	6,472
Unearned Premiums	1,168	1,158	1,154
Loss and LAE Reserves (net)	3,607	3,539	3,445
Capital and Surplus	1,742	1,669	1,763
<u>GAAP Basis</u>			
Premiums Earned	\$ 2,403	\$ 2,594	\$2,495
Total Assets	10,927	10,007	9,458
Unearned Premiums	1,848	1,641	1,414
Loss and LAE Reserves (gross) (*)	5,204	4,778	4,516
Shareholder's Equity	3,241	3,288	3,360

(\*) GAAP loss and LAE reserves net of reinsurance recoverable were \$3.4 billion at December 31, 2002, \$3.3 billion at December 31, 2001, and \$3.2 billion at December 31, 2000.

The following table shows the segment, independent ratings, and size (in millions) of AFC's major property and casualty insurance subsidiaries. AFC continues to focus on growth opportunities in what it believes to be more profitable specialty businesses.

Company	(Ratings - AM Best/S&P)		Net Written Premiums	
			Personal	Specialty
Great American Pool(a):	A	A		
Written through independent agents			\$ 80 (b)	\$ 929
Written directly with customers			108 (c)	-
Mid-Continent	A	A	19	215
Republic Indemnity	A-	A	2	219
National Interstate	A-	-	-	92
American Empire Surplus Lines	A	A	-	116
Infinity Property and Casualty:				
Infinity	A	A	233 (b)	-
Windsor	A	A	145 (b)	-
Atlanta Casualty	A	A	142 (b)	-
Leader	A	A	93 (b)	-
Other			14	6
			<u>\$836</u>	<u>\$1,577</u>

- (a) The Great American Pool represents approximately 15 subsidiaries.
- (b) Business transferred to Infinity Property and Casualty Corporation except for \$6 million in assigned risk business retained by GAI. In February 2003, AFC sold 61% of Infinity in a public offering.
- (c) The direct-to-consumer business which GAI agreed to sell in 2003 produced \$79 million of the 2002 premiums.

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

	<u>2002</u>	<u>2001</u>	<u>2000</u>
Gross written premiums (a)	\$3,935	\$3,520	\$3,231
Ceded reinsurance (a)	<u>(1,521)</u>	<u>(938)</u>	<u>(593)</u>
Net written premiums	<u>\$2,414</u>	<u>\$2,582</u> (b)	<u>\$2,638</u>
Net earned premiums	\$2,403	\$2,594	\$2,495
Loss and LAE	1,785	1,980	1,962
Asbestos litigation settlement	30	-	-
Special A&E charge	-	100	-
Underwriting expenses	606	737	732
Policyholder dividends	8	5	3
Underwriting loss	<u>(\$ 26)</u>	<u>(\$ 228)</u>	<u>(\$ 202)</u>
GAAP ratios:			
Loss and LAE ratio	75.5%	80.2%	78.6%
Underwriting expense ratio	25.3	28.4	29.3
Policyholder dividend ratio	.3	.2	.1
Combined ratio (c)	<u>101.1%</u>	<u>108.8%</u>	<u>108.0%</u>
Statutory ratios:			
Loss and LAE ratio	76.4%	81.1%	80.1%
Underwriting expense ratio	25.0	28.3	28.4
Policyholder dividend ratio	.2	.3	.3
Combined ratio (c)	<u>101.6%</u>	<u>109.7%</u>	<u>108.8%</u>
Industry statutory combined ratio (d)	105.7%	116.0%	110.1%

- (a) Excludes the following premiums that were written on behalf of, and fully reinsured to, the purchasers of the Commercial lines and Japanese divisions: 2002 - \$173 million; 2001 - \$143 million; and 2000 - \$213 million.
- (b) Before a reduction of \$29.7 million for unearned premium transfer related to the sale of the Japanese division.
- (c) The 2002 combined ratios include 1.2 percentage points (GAAP) and 1.3 points (statutory) related to the A.P. Green asbestos litigation settlement. The 2001 combined ratios include 3.9 percentage points for the third quarter strengthening of insurance reserves relating to A&E matters and 1 percentage point attributable to the attack on the World Trade Center. The 2000 combined ratios include 1.4 percentage points for reserve strengthening in AFC's California workers' compensation business.
- (d) Ratios are derived from "Best's Review/Preview - Property/Casualty" (January 2003 Edition).

As with other property and casualty insurers, AFC's operating results can be adversely affected by unpredictable catastrophe losses. Certain natural disasters (hurricanes, tornadoes, floods, forest fires, etc.) and other incidents of major loss (explosions, civil disorder, fires, etc.) are classified as catastrophes by industry associations. Losses from these incidents are usually tracked separately from other business of insurers because of their sizable effects on overall operations. AFC generally seeks to reduce its exposure to such events through individual risk selection and the purchase of reinsurance. Total net losses to AFC's insurance operations from catastrophes were \$7 million in 2002; \$42 million in 2001 and \$8 million in 2000. These amounts are included in the tables herein. AFC's catastrophe losses in 2001 included \$25 million related to the terrorist attack on the World Trade Center.

The Terrorism Risk Insurance Act of 2002 ("TRIA") is to be in effect until the end of 2005 and establishes a temporary Terrorism Risk Insurance Program which requires commercial insurers to offer virtually all policyholders coverage for certain "acts of terrorism" as defined by TRIA. This federal legislation provides that coverage may not materially differ from the terms, amounts, and other coverage limitations applicable to losses arising from occurrences other than terrorism. The federal government provides some stop loss insurance to insurers after an act has



been certified by the government as an act of terrorism and after an insurer has paid losses in excess of a deductible. The deductible progresses from 7% to 15% of direct earned premium in each of the three program years. TRIA supersedes state insurance law to the extent that such law is inconsistent with its terms.

For 2003, AFC would have to sustain losses in excess of \$128 million to be eligible for the reinsurance under TRIA. AFC believes that it is unlikely that its losses in the event of a terrorist act would be so significant as to exceed the deductible necessary to participate in the federal reinsurance. AFC generally seeks to limit its exposure to catastrophe losses including those arising from terrorist acts. AFC is complying with the obligations of TRIA to offer coverage but continues to review its business with consideration of the price it charges for such coverage, as well as through management of individual risk selection.

## Specialty

**General** The Specialty group emphasizes the writing of specialized insurance coverage where AFC personnel are experts in particular lines of business or customer groups. The following are examples of such specialty businesses:

<i>Inland and Ocean Marine</i>	Provides coverage primarily for marine cargo, boat dealers, marina operators/dealers, excursion vessels, builder's risk, contractor's equipment, excess property and motor truck cargo.
<i>Workers' Compensation</i>	Writes coverage for prescribed benefits payable to employees (principally in California) who are injured on the job.
<i>Agricultural-related</i>	Provides federally reinsured multi-peril crop (allied lines) insurance covering most perils as well as crop hail, equine mortality and other coverages for full-time operating farms/ranches and agribusiness operations on a nationwide basis.
<i>Executive and Professional Liability</i>	Markets coverage for attorneys, architects and engineers, and for directors and officers of businesses and not-for-profit organizations.
<i>Fidelity and Surety Bonds</i>	Provides surety coverage for various types of contractors and public and private corporations and fidelity and crime coverage for government, mercantile and financial institutions.
<i>Collateral Protection</i>	Provides coverage for insurance risk management programs for lending and leasing institutions.
<i>Umbrella and Excess Liability</i>	Provides higher layer liability coverage in excess of primary layers.
<i>Excess and Surplus</i>	Specially designed insurance products offered to those that can't find coverage in standard markets.
<i>Commercial Automobile</i>	Markets customized insurance programs for public transportation operations (such as busses and limousines), and a specialized physical damage product for the trucking industry.

Specialization is the key element to the underwriting success of these business units. Each unit has independent management with significant operating autonomy to oversee the important operational functions of its business such as underwriting, pricing, marketing, policy processing and claims service. These specialty businesses are opportunistic and their premium volume will vary based on prevailing market conditions. AFC continually evaluates expansion in existing markets and opportunities in new specialty markets that meet its profitability objectives.

The U.S. geographic distribution of the Specialty group's statutory direct written premiums in 2002 (excluding business written on behalf of, and fully reinsured to, the purchaser of the Japanese division) compared to 1998 is shown below.

	<u>2002</u>	<u>1998</u>		<u>2002</u>	<u>1998</u>
California	21.4%	22.1%	Pennsylvania	2.7%	2.6%
Texas	9.9	7.1	New Jersey	2.6	3.8
New York	5.7	6.6	Michigan	2.1	2.4
Florida	5.5	4.1	Missouri	2.0	*
Illinois	4.3	3.7	Massachusetts	*	4.8
Georgia	3.0	2.2	North Carolina	*	3.0
Ohio	2.9	2.3	Connecticut	*	2.2
Oklahoma	2.8	3.0	Other	35.1	30.1
				<u>100.0%</u>	<u>100.0%</u>

(\*) less than 2%

The following table sets forth a distribution of statutory net written premiums for AFC's Specialty group by NAIC annual statement line for 2002 compared to 1998.

	<u>2002</u>	<u>1998</u>
Other liability	30.1%	19.7%
Workers' compensation	16.2	23.5
Auto liability	8.7	9.0
Commercial multi-peril	8.6	10.7
Inland marine	7.2	10.1
Fidelity and surety	5.8	4.5
Collateral protection	5.3	*
Auto physical damage	4.8	4.5
Ocean marine	3.7	3.2
Product Liability	2.7	*
Allied lines	2.5	4.7
Aircraft	*	4.0
Other	4.4	6.1
	<u>100.0%</u>	<u>100.0%</u>

(\*) less than 2%

The following table shows the performance of AFC's Specialty group insurance operations (dollars in millions):

	<u>2002</u>	<u>2001</u>	<u>2000</u>
Gross written premiums (a)	\$2,713	\$2,236	\$1,889
Ceded reinsurance (a)	<u>(1,136)</u>	<u>(694)</u>	<u>(565)</u>
Net written premiums	<u>\$1,577</u>	<u>\$1,542</u> (b)	<u>\$1,324</u>
Net earned premiums	\$1,497	\$1,409	\$1,223
Loss and LAE	1,009	997	902
Underwriting expenses	455	430	413
Policyholder dividends	8	5	3
Underwriting profit (loss)	<u>\$ 25</u>	<u>(\$ 23)</u>	<u>(\$ 95)</u>
GAAP ratios:			
Loss and LAE ratio	67.5%	70.7%	73.8%
Underwriting expense ratio	30.4	30.6	33.8
Policyholder dividend ratio	.5	.4	.3
Combined ratio (c)	<u>98.4%</u>	<u>101.7%</u>	<u>107.9%</u>
Statutory ratios:			
Loss and LAE ratio	68.7%	73.6%	76.5%
Underwriting expense ratio	31.1	30.5	31.4
Policyholder dividend ratio	.3	.5	.5
Combined ratio (c)	<u>100.1%</u>	<u>104.6%</u>	<u>108.4%</u>
Industry statutory combined ratio (d)	103.4%	117.1%	108.2%

- (a) Excludes the following premiums that were written on behalf of, and fully reinsured to, the purchasers of the Commercial lines and Japanese divisions: 2002 - \$173 million; 2001 - \$143 million; and 2000 - \$213 million.
- (b) Before a reduction of \$29.7 million for unearned premium transfer related to the sale of the Japanese division.
- (c) The 2001 combined ratios include 1.8 percentage points attributable to the attack on the World Trade Center. The 2000 combined ratios include 2.9 percentage points for reserve strengthening in AFC's California workers' compensation business. Because the combined ratio is calculated based on premiums, the impact of these two items is greater for the Specialty segment alone than it is for the overall company.
- (d) Represents the commercial industry statutory combined ratio derived from "Best's Review/Preview - Property/Casualty" (January 2003 Edition).

**Marketing** The Specialty group operations direct their sales efforts primarily through independent property and casualty insurance agents and brokers, although portions are written through employee agents. These businesses write insurance through several thousand agents and brokers and have approximately 440,000 policies in force.

**Competition** These businesses compete with other individual insurers, state funds and insurance groups of varying sizes, some of which are mutual insurance companies possessing competitive advantages in that all their profits inure to their policyholders. They also compete with self-insurance plans, captive programs and risk retention groups. Because of the specialty nature of these coverages, competition is based primarily on service to policyholders and agents, specific characteristics of products offered and reputation for claims handling. Price, commissions and profit sharing terms are also important factors. Management believes that sophisticated data analysis for refinement of risk profiles, extensive specialized knowledge and loss prevention service have helped AFC's Specialty group compete successfully.

## Personal

**General** The Personal group wrote primarily private passenger automobile liability and physical damage insurance, and to a lesser extent, homeowners' insurance. In February 2003, AFC sold 61% of Infinity Property and Casualty Corporation in a public offering. The businesses sold in the Infinity transaction represented 82% of the Personal group's 2002 net written premiums. In January 2003, GAI entered into an agreement to sell its direct-to-consumer auto business. As a result of these transactions, AFC's future interest in personal lines insurance will be limited to two subsidiaries that generated less than \$35 million in net written premiums in 2002, certain direct-to-consumer business in run-off that had approximately \$28 million in net written premiums in 2002 and its 39% continuing interest in Infinity.

Historically, the majority of the Personal group's auto premiums was from sales in the nonstandard market covering drivers unable to obtain insurance through standard market carriers due to factors such as age, record of prior accidents, driving violations, particular occupation or type of vehicle. The Personal group's approach to its auto business was to develop tailored rates for its personal automobile customers based on a variety of factors, including the driving record of the insureds, the number of and type of vehicles covered, credit history, and other factors. Management believes this approach enabled the Personal group to rate each risk appropriately and provided a means to serve a broad spectrum of customers.

The Personal group's approach to homeowners business was to limit exposure in locations which have significant catastrophic potential (such as windstorms, earthquakes and hurricanes). Since 1997, the Personal group ceded the majority of its homeowners' business through reinsurance agreements; in 2002, it ceded 80% of this business.

The Personal group held licenses to write policies in all states and the District of Columbia. The U.S. geographic distribution of the Personal group's statutory direct written premiums in 2002 compared to 1998, was as follows:

	<u>2002</u>	<u>1998</u>		<u>2002</u>	<u>1998</u>
California	28.7%	14.8%	New Jersey	2.8%	3.3%
New York	10.0	6.2	Oklahoma	2.2	*
Florida	10.0	9.4	South Carolina	2.0	*
Connecticut	8.3	10.0	North Carolina	*	2.8
Pennsylvania	7.2	5.5	Arizona	*	2.6
Georgia	6.0	10.1	Missouri	*	2.0
Texas	4.0	5.0	Other	18.8	28.3
				<u>100.0%</u>	<u>100.0%</u>

(\*) less than 2%

The Personal group's underwriting strategy was to sell its products through independent agents in the states that management believed offer the greatest opportunity for profitable growth based on market size and legal and regulatory environments. Management was focused on obtaining adequate rates to achieve underwriting profitability and was willing to forego volume to meet its profit objectives. Since April 1, 2001, the Personal group ceded 90% of the automobile physical damage business written by certain subsidiaries under reinsurance agreements.

The following table shows the performance of AFC's Personal group insurance operations (dollars in millions):

	<u>2002</u>	<u>2001</u>	<u>2000</u>
Gross written premiums	\$1,221	\$1,284	\$1,339
Ceded reinsurance	(385)	(244)	(28)
Net written premiums	<u>\$ 836</u>	<u>\$1,040</u>	<u>\$1,311</u>
Net earned premiums	\$ 905	\$1,183	\$1,270
Loss and LAE	753	970	1,061
Underwriting expenses (a)	151	306	317
Underwriting profit (loss)	<u>\$ 1</u>	<u>(\$ 93)</u>	<u>(\$ 108)</u>
GAAP ratios:			
Loss and LAE ratio	83.1%	82.1%	83.6%
Underwriting expense ratio (a)	16.7	25.8	25.0
Combined ratio	<u>99.8%</u>	<u>107.9%</u>	<u>108.6%</u>
Statutory ratios:			
Loss and LAE ratio	83.4%	82.3%	83.9%
Underwriting expense ratio (a)	13.3	25.0	25.2
Combined ratio	<u>96.7%</u>	<u>107.3%</u>	<u>109.1%</u>
Industry statutory combined ratio (b)	105.6%	111.6%	110.3%

(a) The Personal group recorded commissions of \$159 million in 2002 and \$47 million in 2001 on business ceded to reinsurers. Commissions on ceded business are recorded as a reduction of underwriting expenses.

(b) Represents the personal lines industry statutory combined ratio derived from "Best's Review/Preview - Property/Casualty" (January 2003 Edition).

The Personal group had approximately 790,000 auto policies in force at December 31, 2002, over 75% of which had policy limits of \$50,000 or less per occurrence.

## Reinsurance

Consistent with standard practice of most insurance companies, AFC reinsures a portion of its business with other insurance companies and assumes a relatively small amount of business from other insurers. Ceding reinsurance permits diversification of risks and limits the maximum loss arising from large or unusually hazardous risks or catastrophic events. The availability and cost of reinsurance are subject to prevailing market conditions which may affect the volume and profitability of business that is written. AFC is subject to credit risk with respect to its reinsurers, as the ceding of risk to reinsurers generally does not relieve AFC of its liability to its insureds until claims are fully settled.

AFC regularly monitors the financial strength of its reinsurers. This process periodically results in the transfer of risks to more financially secure reinsurers. Substantially all reinsurance is ceded to reinsurers having more than \$100 million in capital and A.M. Best ratings of "A-" or better. AFC further minimizes the credit risk of certain ceding arrangements, including the 90% automobile physical damage quota share, by entering into the contracts on a "funds withheld" basis. Under "funds withheld" arrangements, AFC retains ceded premiums, in exchange for a fee, to fund ceded losses as they become due from the reinsurer. As an alternative method to reduce credit risk, AFC has, on occasion, required reinsurers to secure financial guarantees or establish lines of credit to support recoverables under reinsurance agreements. Excluding Mitsui and Ohio Casualty (discussed below), approximately half of AFC's total reinsurance recoverable (net of funds withheld) at December 31, 2002, was with the following companies: American Re-Insurance Company, Swiss Reinsurance America Corporation, General Reinsurance Corporation, X.L. Reinsurance America, Inc., Converium Reinsurance North America, Inc., Employers Reinsurance Corporation, Inter-Ocean Reinsurance (Ireland) Ltd., Continental Casualty Company, Everest Reinsurance Company, Transatlantic Reinsurance Company, Hartford Fire Insurance Company, Berkley Insurance Company and Folksamerica Reinsurance Company. At December 31, 2002, less than 1% of AFC's reinsurance recoverable balance was with companies affiliated with reinsurer Gerling Global Re., a European reinsurer which has been the subject of recent news articles.

Reinsurance is provided on one of two bases, facultative or treaty. Facultative reinsurance is generally provided on a risk by risk basis. Individual risks are ceded and assumed based on an offer and acceptance of risk by each party to the transaction. Treaty reinsurance provides for risks meeting prescribed criteria to be automatically ceded and assumed according to contract provisions. The following table presents (by type of coverage) the amount of each loss above the specified retention maximum generally covered by treaty reinsurance programs (in millions):

<u>Coverage</u>	<u>Retention Maximum</u>	<u>Reinsurance Coverage (a)</u>
California Workers' Compensation	\$ 1.0	\$99.0
Other Workers' Compensation	2.0	48.0
Commercial Umbrella	3.6	46.4
Other Casualty	5.0	25.0
Property - General	2.0	28.0 (b)
Property - Catastrophe	10.0	65.0

- (a) Reinsurance covers substantial portions of losses in excess of retention. However, in general, losses resulting from terrorism are not covered.
- (b) Since 1997, AFC has ceded at least 80% of its homeowners insurance coverage through reinsurance agreements. Since April 1, 2001, AFC has ceded 90% of the automobile physical damage business written by certain subsidiaries. In July 2002, AFC added certain specialty businesses to the 90% reinsurance agreement.

AFC also purchases facultative reinsurance providing coverage on a risk by risk basis, both pro rata and excess of loss, depending on the risk and available reinsurance markets.

Included in the balance sheet caption "recoverables from reinsurers and prepaid reinsurance premiums" were approximately \$226 million on paid losses and LAE and \$1.8 billion on unpaid losses and LAE at December 31, 2002. The collectibility of a reinsurance balance is based upon the financial condition of a reinsurer as well as individual claim considerations. At December 31, 2002, AFC's insurance subsidiaries had allowances of approximately \$38 million for doubtful collection of reinsurance recoverables.

Premiums written for reinsurance ceded and assumed are presented in the following table (in millions):

	<u>2002</u>	<u>2001</u>	<u>2000</u>
Reinsurance ceded	\$1,693	\$1,114	\$803
Reinsurance assumed - including			
involuntary pools and associations	80	94	76

In connection with the sales of the Japanese division to Mitsui in 2001 and the Commercial lines division to Ohio Casualty in 1998, Great American agreed to issue and renew policies related to the businesses transferred until each purchaser received the required approvals and licensing to begin writing business on their own behalf. Under these agreements, which last for a few years, Great American cedes 100% of these premiums to the respective purchaser. In 2002, 2001, and 2000, premiums of \$173 million, \$143 million, and \$213 million, respectively, were ceded under these agreements.

### **Loss and Loss Adjustment Expense Reserves**

The consolidated financial statements include the estimated liability for unpaid losses and LAE of AFC's insurance subsidiaries. This liability represents estimates of the ultimate net cost of all unpaid losses and LAE and is determined by using case-basis evaluations and actuarial projections. These estimates are subject to the effects of changes in claim amounts and frequency and are periodically reviewed and adjusted as additional information becomes known. In accordance with industry practices, such adjustments are reflected in current year operations.

Generally, reserves for reinsurance and involuntary pools and associations are reflected in AFC's results at the amounts reported by those entities.

The following discussion of insurance reserves includes the reserves of American Premier's subsidiaries for only those periods following its acquisition in 1995. See Note N to the Financial Statements for an analysis of changes in AFC's estimated liability for losses and LAE, net and gross of reinsurance, over the past three years on a GAAP basis.

The following table presents the development of AFC's liability for losses and LAE, net of reinsurance, on a GAAP basis for the last ten years, excluding reserves of American Premier subsidiaries prior to 1995. The top line of the table shows the estimated liability (in millions) for unpaid losses and LAE recorded at the balance sheet date for the indicated years. The second line shows the re-estimated liability as of December 31, 2002. The remainder of the table presents intervening development as percentages of the initially estimated liability. The development results from additional information and experience in subsequent years. The middle line shows a cumulative deficiency (redundancy) which represents the aggregate percentage increase (decrease) in the liability initially estimated. The lower portion of the table indicates the cumulative amounts paid as of successive periods as a percentage of the original loss reserve liability. For purposes of this table, reserves of businesses sold are considered paid at the date of sale. For example, the percentage of the December 31, 1997 reserve liability paid in 1998 includes approximately 10 percentage points for reserves ceded in connection with the sale of the Commercial lines division.

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
<u>Liability for unpaid losses and loss adjustment expenses:</u>											
As originally estimated	\$2,123	\$2,113	\$2,187	\$3,393	\$3,404	\$3,489	\$3,305	\$3,224	\$3,192	\$3,253	\$3,400
As re-estimated at December 31, 2002	2,551	2,464	2,545	3,654	3,667	3,687	3,172	3,194	3,355	3,424	N/A
<u>Liability re-estimated:</u>											
One year later	99.9%	98.1%	95.9%	98.7%	100.9%	104.5%	97.8%	98.1%	105.1%	105.2%	
Two years later	98.2%	94.1%	99.3%	98.5%	105.9%	104.6%	96.3%	100.1%	105.1%		
Three years later	95.2%	97.4%	99.9%	103.9%	105.2%	102.9%	97.4%	99.0%			
Four years later	100.3%	98.9%	109.4%	103.1%	103.6%	105.4%	96.0%				
Five years later	102.6%	109.7%	109.0%	102.9%	106.9%	105.7%					
Six years later	113.6%	108.8%	108.5%	106.8%	107.7%						
Seven years later	112.3%	108.5%	115.3%	107.7%							
Eight years later	112.2%	115.5%	116.4%								
Nine years later	119.1%	116.6%									
Ten years later	120.2%										
<u>Cumulative deficiency (redundancy):</u>											
Aggregate	<u>20.2%</u>	<u>16.6%</u>	<u>16.4%</u>	<u>7.7%</u>	<u>7.7%</u>	<u>5.7%</u>	<u>(4.0%)</u>	<u>(1.0%)</u>	<u>5.1%</u>	<u>5.2%</u>	<u>N/A</u>
Excluding the 2002 A.P. Green settlement charge and special A&E charges and reallocations in 1994, 1996, 1998 and 2001	<u>(0.9%)</u>	<u>(3.5%)</u>	<u>(3.0%)</u>	<u>(4.8%)</u>	<u>(2.4%)</u>	<u>(4.2%)</u>	<u>(8.0%)</u>	<u>(5.0%)</u>	<u>1.0%</u>	<u>4.3%</u>	<u>N/A</u>
<u>Cumulative paid as of:</u>											
One year later	26.7%	25.2%	26.8%	33.1%	33.8%	41.7%	28.3%	34.8%	38.3%	33.6%	
Two years later	43.7%	40.6%	42.5%	51.6%	58.0%	56.6%	51.7%	52.7%	52.2%		
Three years later	54.2%	50.9%	54.4%	67.2%	66.7%	70.8%	62.4%	60.0%			
Four years later	60.8%	59.1%	66.3%	72.0%	77.3%	78.6%	65.6%				
Five years later	67.0%	68.0%	69.8%	80.4%	82.8%	81.1%					
Six years later	74.0%	70.8%	80.0%	84.7%	84.6%						
Seven years later	76.3%	80.6%	84.9%	86.0%							
Eight years later	85.9%	85.1%	86.1%								
Nine years later	89.5%	86.3%									
Ten years later	90.7%										

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

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
<u>As originally estimated:</u>										
Net liability shown above	\$2,113	\$2,187	\$3,393	\$3,404	\$3,489	\$3,305	\$3,224	\$3,192	\$3,253	\$3,400
Add reinsurance recoverables	611	730	704	720	736	1,468	1,571	1,324	1,525	1,804
Gross liability	<u>\$2,724</u>	<u>\$2,917</u>	<u>\$4,097</u>	<u>\$4,124</u>	<u>\$4,225</u>	<u>\$4,773</u>	<u>\$4,795</u>	<u>\$4,516</u>	<u>\$4,778</u>	<u>\$5,204</u>
<u>As re-estimated at December 31, 2002:</u>										
Net liability shown above	\$2,464	\$2,545	\$3,654	\$3,667	\$3,687	\$3,172	\$3,194	\$3,355	\$3,424	
Add reinsurance recoverables	956	885	1,126	1,142	1,219	1,841	1,942	1,569	1,681	
Gross liability	<u>\$3,420</u>	<u>\$3,430</u>	<u>\$4,780</u>	<u>\$4,809</u>	<u>\$4,906</u>	<u>\$5,013</u>	<u>\$5,136</u>	<u>\$4,924</u>	<u>\$5,105</u>	<u>N/A</u>
<u>Gross cumulative deficiency (redundancy)</u>	<u>25.5%</u>	<u>17.7%</u>	<u>16.7%</u>	<u>16.6%</u>	<u>16.1%</u>	<u>5.0%</u>	<u>7.1%</u>	<u>9.0%</u>	<u>6.8%</u>	<u>N/A</u>



These tables do not present accident or policy year development data. Furthermore, in evaluating the re-estimated liability and cumulative deficiency (redundancy), it should be noted that each percentage includes the effects of changes in amounts for prior periods. For example, AFC's \$100 million special charge for A&E claims related to losses recorded in 2001, but incurred before 1992, is included in the re-estimated liability and cumulative deficiency (redundancy) percentage for each of the previous years shown. Conditions and trends that have affected development of the liability in the past may not necessarily exist in the future. Accordingly, it may not be appropriate to extrapolate future redundancies or deficiencies based on this table.

The adverse development in the tables is due primarily to A&E exposures for which AFC has been held liable under general liability policies written years ago where such coverage was not intended. Other factors affecting development included higher than projected inflation on medical, hospitalization, material, repair and replacement costs. Additionally, changes in the legal environment have influenced the development patterns over the past ten years. For example, changes in the California workers' compensation law in 1993 and subsequent court decisions, primarily in late 1996, greatly limited the ability of insurers to challenge medical assessments and treatments. These limitations, together with changes in work force characteristics and medical delivery costs, are contributing to an increase in claims severity.

The differences between the liability for losses and LAE reported in the annual statements filed with the state insurance departments in accordance with statutory accounting principles ("SAP") and that reported in the accompanying consolidated financial statements in accordance with GAAP at December 31, 2002 are as follows (in millions):

Liability reported on a SAP basis, net of \$238 million of retroactive reinsurance	\$3,368
Additional discounting of GAAP reserves in excess of the statutory limitation for SAP reserves	(13)
Reserves of foreign operations	7
Reinsurance recoverables, net of allowance	1,804
Reclassification of allowance for uncollectible Reinsurance	<u>38</u>
Liability reported on a GAAP basis	<u>\$5,204</u>

**Asbestos and Environmental Reserves ("A&E")** In addressing asbestos and environmental reserves, the insurance industry typically includes claims relating to polluted waste sites and asbestos as well as other mass tort claims such as those relating to breast implants, repetitive stress on keyboards, DES (a drug used in pregnancies years ago alleged to cause cancer and birth defects) and other latent injuries.

Establishing reserves for A&E claims is subject to uncertainties that are significantly greater than those presented by other types of claims. For a discussion of these uncertainties, see *Management's Discussion and Analysis - "Uncertainties - Asbestos and Environmental-related Reserves"*, and *"Special A&E Charge" and Note L - "Commitments and Contingencies" to the Financial Statements*.

The survival ratio, which is an industry measure of A&E claim reserves, is derived by dividing reserves for A&E exposures by annual paid losses. At December 31, 2002, AFC's three year survival ratio (after adjusting for the sale of Stonewall and excluding amounts associated with the A.P. Green settlement) is approximately 22.4 times paid losses for the remaining asbestos reserves and 11.6 times paid losses for total A&E reserves. In October 2002, A.M. Best reported its estimate that the property and casualty insurance industry's three year survival ratio for A&E reserves was approximately 7.2 times paid losses at December 31, 2001.

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

	<u>2002</u>	<u>2001</u>	<u>2000</u>
Reserves at beginning of year	\$446.8	\$357.7	\$576.7
Incurred losses and LAE (a)	48.6	108.0	(1.9)
Paid losses and LAE	(28.7)	(28.1)	(48.7)
Reserves not classified as A&E prior to 2001:			
Reserves	-	1.4	-
Allowance for uncollectible reinsurance applicable to ceded A&E reserves	-	7.8	-
Reserves transferred with sale of Stonewall	-	-	(168.4)
Reserves at end of year, net of reinsurance recoverable	<u>466.7</u>	<u>446.8</u>	<u>357.7</u>
Reinsurance recoverable, net of allowance	<u>105.1</u>	<u>101.4</u>	<u>105.7</u>
Gross reserves at end of year	<u>\$571.8</u>	<u>\$548.2</u>	<u>\$463.4</u>

(a) Includes \$30 million in 2002 related to the settlement of the A.P. Green asbestos litigation and a special charge of \$100 million in 2001.

## **Annuity and Life Operations**

### **General**

AFC's annuity and life operations are conducted through Great American Financial Resources, Inc. ("GAFRI"), a holding company which markets retirement products, primarily fixed and variable annuities, and various forms of life and supplemental health insurance through the following subsidiaries which were acquired in the years shown. GAFRI and its subsidiaries employ approximately 1,600 persons.

Great American Life Insurance Company ("GALIC") - 1992(\*)  
 Annuity Investors Life Insurance Company ("AILIC") - 1994  
 Loyal American Life Insurance Company ("Loyal") - 1995  
 Great American Life Assurance Company of Puerto Rico ("GAPR") - 1997  
 United Teacher Associates Insurance Company ("UTA") - 1999  
 Manhattan National Life Insurance Company ("MNL") - 2002

(\*) Acquired from Great American Insurance.

Acquisitions in recent years have supplemented GAFRI's internal growth as the assets of the holding company and its operating subsidiaries have increased from \$4.5 billion at the end of 1992 to \$9.3 billion at the end of 2002. Premiums over the last three years were as follows (in millions):

<u>Insurance Product(*)</u>	<u>2002</u>	<u>2001</u>	<u>2000</u>
Annuities	\$1,001	\$ 751	\$ 747
Life and supplemental health	313	310	261
	<u>\$1,314</u>	<u>\$1,061</u>	<u>\$1,008</u>

(\*) Table does not include premiums of subsidiaries or divisions until their first full year following acquisition or formation.

### **Annuities**

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

The following table (in millions) presents combined financial information of GAFRI's principal annuity operations.

	<u>2002</u>	<u>2001</u>	<u>2000</u>
<u>GAAP Basis</u>			
Total Assets	\$8,014	\$7,456	\$7,052
Fixed Annuity Reserves	6,111	5,632	5,365
Variable Annuity Reserves	455	530	534
Stockholder's Equity	1,139	1,023	915
<u>Statutory Basis</u>			
Total Assets	\$7,319	\$6,896	\$6,620
Fixed Annuity Reserves	6,192	5,729	5,536
Variable Annuity Reserves	455	530	534
Capital and Surplus	419	388	363
Asset Valuation Reserve (a)	63	79	77
Interest Maintenance Reserve (a)	27	11	3
Annuity Receipts:			
Flexible Premium:			
First Year	\$ 60	\$ 67	\$ 71
Renewal	191	176	157
	<u>251</u>	<u>243</u>	<u>228</u>
Single Premium	750	508	519
Total Annuity Receipts	<u>\$1,001</u>	<u>\$ 751</u>	<u>\$ 747</u>

(a) Allocation of surplus.

Sales of annuities are affected by many factors, including: (i) competitive annuity products and rates; (ii) the general level of interest rates; (iii) the favorable tax treatment of annuities; (iv) commissions paid to agents; (v) services offered; (vi) ratings from independent insurance rating agencies; (vii) other alternative investments; (viii) performance of the equity markets and (ix) general economic conditions. At December 31, 2002, GAFRI had over 300,000 annuity policies in force.

Annuity contracts are generally classified as either fixed rate (including equity-indexed) or variable. The following table presents premiums by classification:

	<u>2002</u>	<u>2001</u>	<u>2000</u>
<u>Premiums</u>			
Traditional fixed	77%	68%	50%
Variable	18	27	43
Equity-indexed	5	5	7
	<u>100%</u>	<u>100%</u>	<u>100%</u>

With a traditional fixed rate annuity, the interest crediting rate is initially set by the issuer and thereafter may be changed from time to time by the issuer subject to any guaranteed minimum interest crediting rates or any guaranteed term in the policy.

GAFRI seeks to maintain a desired spread between the yield on its investment portfolio and the rate it credits to its fixed rate annuities. GAFRI accomplishes this by: (i) offering crediting rates which it has the option to change after any initial guarantee period; (ii) designing annuity products that encourage persistency and (iii) maintaining an appropriate matching of assets and liabilities. GAFRI designs its products with certain provisions to encourage policyholders to maintain their funds with GAFRI for at least five to ten years.

Virtually all of GAFRI's traditional fixed rate annuities offer a minimum interest rate guarantee of 3% or 4% (as determined by applicable law); the majority permit GAFRI to change the crediting rate at any time (subject to the minimum guaranteed interest rates). In determining the frequency and extent of changes in the crediting rate, GAFRI takes into account the economic environment and the relative competitive position of its products. Historically, management has been able to react to changes in market interest rates and maintain a desired interest

rate spread. The recent interest rate environment has resulted in a compression of the spread, which could continue at least through 2003.

Sales of GAFRI's fixed rate annuities have increased over the past three years, due to the weak stock market environment, as well as the development of new products.

In addition to traditional fixed rate annuities, GAFRI offers variable and equity-indexed annuities. Industry sales of such annuities increased substantially in the 1990s as investors sought to obtain the returns available in the equity markets while enjoying the tax-deferred status of annuities. With a variable annuity, the earnings credited to the policy vary based on the investment results of the underlying investment options chosen by the policyholder, generally without any guarantee of principal except in the case of death of the insured annuitant. Premiums directed to the variable options in policies issued by GAFRI are invested in funds maintained in separate accounts managed by various independent investment managers. GAFRI earns a fee on amounts deposited into variable accounts. Policyholders may also choose to direct all or a portion of their premiums to various fixed rate options, in which case GAFRI earns a spread on amounts deposited. With the downturn in the stock market during the past three years, industry wide sales of variable annuities, including GAFRI's sales, have decreased substantially.

An equity-indexed fixed annuity provides policyholders with a crediting rate tied, in part, to the performance of an existing stock market index while protecting them against the related downside risk through a guarantee of principal. GAFRI purchases call options designed to offset substantially all of the increase in the liabilities associated with equity-indexed annuities. In 2002, GAFRI chose to suspend new sales of equity-indexed annuities due primarily to a lack of volume.

No individual state accounted for more than 10% of GAFRI's annuity premiums in the past three years except as follows:

	<u>2002</u>	<u>2001</u>	<u>2000</u>
California	16%	17%	24%
Washington	10	-	-
Ohio	-	13	-

GAFRI's FPDAs are sold primarily to employees of not-for-profit and commercial organizations who are eligible to save for retirement through contributions made on a before-tax or after-tax basis. Contributions are made at the discretion of the participants through payroll deductions or through tax-free "rollovers" of funds from other qualified investments. Federal income taxes are not payable on pretax contributions or earnings until amounts are withdrawn.

GAFRI distributes its fixed rate products primarily through a network of 130 managing general agents ("MGAs") who, in turn, direct more than 1,300 actively producing independent agents. The top 15 MGAs accounted for nearly two-thirds of GAFRI's fixed annuity premiums in 2002. No one MGA represented more than 9% of total fixed annuity premiums in 2002. In addition, GAFRI offers all of its annuity product lines through financial institutions. Sales of annuities through financial institutions were approximately 6% of total annuity premiums in 2002.

In 2002, GAFRI exited the highly competitive single premium, non-qualified segment of the variable annuity market due primarily to insufficient returns and a lack of critical mass. GAFRI intends to redesign its variable product and offer it as an ancillary product solely through its fixed annuity sales channels. Approximately one-third of GAFRI's variable annuity sales in 2002 were made through a wholly-owned subsidiary, Great American Advisors, Inc. ("GAA"). GAA is a broker/dealer licensed in all 50 states to sell stocks, bonds, options, mutual funds and variable insurance contracts through independent representatives and financial institutions. GAA also acts as the principal underwriter and distributor for GAFRI's variable annuity products.

## Life and Supplemental Insurance

GAFRI offers a variety of life and supplemental health products through GALIC's life operations, MNL, Loyal, GAPR and UTA. This group produced \$313 million of statutory premiums in 2002.

GALIC offers traditional term, universal and whole life insurance products through national marketing organizations. In 2002, GAFRI issued over \$8.0 billion gross (\$1.9 billion net) face amount of insurance through its life operations; at year-end 2002, this operation had approximately 228,000 policies and \$39 billion gross (\$12 billion net) face amount of insurance in force.

UTA, provides supplemental health products and annuities through independent agents. UTA's principal health products include coverage for Medicare supplement, cancer and long-term care. In 2000, UTA purchased a block of approximately 50,000 Medicare supplement and cancer policies.

Loyal offers a variety of supplemental health and life products. The principal products sold by Loyal include cancer, accidental injury, short-term disability, hospital indemnity, universal life and traditional whole life. In 2001, Loyal reinsured a substantial portion of its life insurance business, reduced its operating expenses, and redirected its marketing efforts in that line of business. In 2002, Loyal's operations were consolidated with UTA's operations.

At year-end 2002, GAFRI's operating units writing supplemental insurance products had assets of nearly \$800 million and approximately 354,000 policies with annualized health premiums in force of \$185 million and gross life insurance in force of \$1.4 billion.

GAPR sells in-home service life and supplemental health products through a network of company-employed agents. Ordinary life, cancer, credit and group life products are sold through independent agents.

## Independent Ratings

GAFRI's principal insurance subsidiaries are rated by A.M. Best and Standard & Poor's. In addition, GALIC is rated A+ (strong) by Fitch and A3 (good financial security) by Moody's. Such ratings are generally based on concerns of policyholders and agents and are not directed toward the protection of investors. Following are the ratings as of March 1, 2003:

	<u>A.M. Best</u>	<u>Standard &amp; Poor's</u>
GALIC	A (Excellent)	A-(Strong)
AILIC	A (Excellent)	A-(Strong)
Loyal	A (Excellent)	Not rated
UTA	A-(Excellent)	Not rated
GAPR	A (Excellent)	Not rated

GAFRI believes that the ratings assigned by independent insurance rating agencies are important because potential policyholders often use a company's rating as an initial screening device in considering annuity products. GAFRI believes that (i) a rating of "A" by A.M. Best (its third highest rating) is necessary to successfully market tax-deferred annuities to public education employees and other not-for-profit groups and (ii) a rating in the "A" category by at least one rating agency is necessary to successfully compete in other annuity markets.

GAFRI's insurance ratings were recently affirmed by Fitch (with a stable outlook), and affirmed by Moody's (with a negative outlook); its ratings were downgraded by Standard & Poor's (with a negative outlook). GAFRI's operations could be materially and adversely affected by additional downgrades. In connection with recent reviews by independent rating agencies, management indicated that it intends to maintain the capital of its significant insurance subsidiaries at levels currently indicated by the rating agencies as appropriate for the current ratings. Items which could adversely affect capital levels include (i) a sustained decrease in the stock market in 2003 or beyond; (ii) a significant period of low interest rates and a resulting significant narrowing of annuity "spread"; (iii) investment impairments; (iv) a change in statutory reserving requirements for guaranteed

minimum death benefits on variable annuities, (v) adverse mortality, and (vi) higher than planned dividends paid due to liquidity needs by GAFRI's holding companies.

## Competition

GAFRI's insurance companies operate in highly competitive markets. They compete with other insurers and financial institutions based on many factors, including: (i) ratings; (ii) financial strength; (iii) reputation; (iv) service to policyholders and agents; (v) product design (including interest rates credited and premium rates charged); and (vi) commissions. Since policies are marketed and distributed primarily through independent agents (except at GAFRI), the insurance companies must also compete for agents.

No single insurer dominates the markets in which GAFRI's insurance companies compete. Competitors include (i) individual insurers and insurance groups, (ii) mutual funds and (iii) other financial institutions. In a broader sense, GAFRI's insurance companies compete for retirement savings with a variety of financial institutions offering a full range of financial services. Financial institutions have demonstrated a growing interest in marketing investment and savings products other than traditional deposit accounts.

## Other Companies

Through subsidiaries, AFC is engaged in a variety of other operations, including The Golf Center at Kings Island in the Greater Cincinnati area; commercial real estate operations in Cincinnati (office buildings and The Cincinnati Hotel), New Orleans (Le Pavillon Hotel), Cape Cod (Chatham Bars Inn), Austin (Driskill Hotel), Chesapeake Bay (Skipjack Cove Yachting Resort), Charleston (Charleston Harbor Resort and Marina) and apartments in Louisville, Pittsburgh, St. Paul and Tampa Bay. These operations employ approximately 800 full-time employees.

## Investment Portfolio

**General** The following tables present the percentage distribution and yields of AFC's investment portfolio (excluding investment in equity securities of investee corporations) as reflected in its financial statements.

	2002	2001	2000	1999	1998
Cash and Short-term Investments	6.4%	4.5%	3.8%	3.5%	2.5%
Fixed Maturities:					
U.S. Government and Agencies	9.9	8.3	4.7	4.9	4.4
State and Municipal	4.3	3.4	3.6	2.7	1.2
Public Utilities	7.6	6.4	5.5	5.1	6.0
Mortgage-Backed Securities	22.8	21.8	22.7	22.0	20.8
Corporate and Other	39.6	47.3	51.4	55.3	53.2
Redeemable Preferred Stocks	.4	.5	.5	.6	.5
	<u>84.6</u>	<u>87.7</u>	<u>88.4</u>	<u>90.6</u>	<u>86.1</u>
Net Unrealized Gains (Losses)	3.3	1.3	.1	(2.1)	3.5
	<u>87.9</u>	<u>89.0</u>	<u>88.5</u>	<u>88.5</u>	<u>89.6</u>
Other Stocks, Options and Warrants	2.2	2.6	3.4	3.7	3.7
Policy Loans	1.6	1.7	1.9	1.9	1.9
Real Estate and Other Investments	1.9	2.2	2.4	2.4	2.3
	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>
Yield on Fixed Income Securities:					
Excluding realized gains and losses	7.2%	7.6%	7.7%	7.7%	7.8%
Including realized gains and losses	6.7%	7.5%	7.4%	7.6%	8.0%
Yield on Stocks:					
Excluding realized gains and losses	5.4%	4.5%	5.0%	5.9%	5.4%
Including realized gains and losses	(4.6%)	(.3%)	3.9%	20.7%	(5.3%)
Yield on Investments (*):					
Excluding realized gains and losses	7.2%	7.6%	7.6%	7.7%	7.8%
Including realized gains and losses	6.5%	7.4%	7.4%	7.9%	7.8%

(\*) Excludes "Real Estate and Other Investments".

## Fixed Maturity Investments

AFC's bond portfolio is invested primarily in taxable bonds. The NAIC assigns quality ratings which range from Class 1 (highest quality) to Class 6 (lowest quality). The following table shows AFC's bonds and redeemable preferred stocks, by NAIC designation (and comparable Standard & Poor's Corporation rating) as of December 31, 2002 (dollars in millions).

NAIC Rating	Comparable S&P Rating	Amortized Cost	Market Value	
			Amount	%
1	AAA, AA, A	\$ 8,335	\$ 8,772	73%
2	BBB	2,304	2,395	20
	Total investment grade	<u>10,639</u>	<u>11,167</u>	<u>93</u>
3	BB	495	435	4
4	B	299	292	2
5	CCC, CC, C	76	74	1
6	D	41	39	*
	Total noninvestment grade	<u>911</u>	<u>840</u>	<u>7</u>
	Total	<u>\$11,550</u>	<u>\$12,007</u>	<u>100%</u>

(\*) Less than 1%

Risks inherent in connection with fixed income securities include loss upon default and market price volatility. Factors which can affect the market price of securities include: creditworthiness, changes in interest rates, the number of market makers and investors and defaults by major issuers of securities.

AFC's primary investment objective for fixed maturities is to earn interest and dividend income rather than to realize capital gains. AFC invests in bonds and redeemable preferred stocks that have primarily intermediate-term maturities. This practice allows flexibility in reacting to fluctuations of interest rates.

## Equity Investments

At December 31, 2002, AFC held \$299 million in stocks and warrants; approximately 63% represents an investment in Provident Financial Group, Inc., a Cincinnati-based commercial banking and financial services company; another 12% consists of three investments of more than \$8 million each. Such equity investments, because of their size, may not be as readily marketable as the typical small investment position. Alternatively, a large equity position may be attractive to persons seeking to control or influence the policies of a company.

## Foreign Operations

AFC sells life and supplemental health products in Puerto Rico and property and casualty products in Mexico, Canada, Puerto Rico, Europe and Asia. In addition, GAFRI has an office in India where employees perform computer programming and certain back office functions. Less than 3% of AFC's revenues and costs and expenses are derived from sources outside of the United States.

## Regulation

AFC's insurance company subsidiaries are subject to regulation in the jurisdictions where they do business. In general, the insurance laws of the various states establish regulatory agencies with broad administrative powers governing, among other things, premium rates, solvency standards, licensing of insurers, agents and brokers, trade practices, forms of policies, maintenance of specified reserves and capital for the protection of policyholders, deposits of securities for the benefit of policyholders, investment activities and relationships between insurance subsidiaries and their parents and affiliates. Material transactions between insurance subsidiaries and their parents and affiliates generally must be disclosed and prior approval of the applicable insurance regulatory authorities generally is required for any such transaction which may be deemed to be material or extraordinary. In addition, while differing from state to state, these regulations typically restrict the maximum amount of dividends that may be paid by an insurer to its shareholders in

any twelve-month period without advance regulatory approval. Such limitations are generally based on net earnings or statutory surplus. Under applicable restrictions, the maximum amount of dividends available to AFC in 2003 from its insurance subsidiaries without seeking regulatory clearance is approximately \$24 million. During 2002, those companies received approval and paid \$92 million in dividends in excess of the applicable limitation.

Changes in state insurance laws and regulations have the potential to materially affect the revenues and expenses of the insurance operations. For example, between July 1993 and January 1995, the California Commissioner ordered reductions in workers' compensation insurance premium rates totaling more than 30% and subsequently replaced the workers' compensation insurance minimum rate law with an "open rating" policy. The Company is unable to predict whether or when other state insurance laws or regulations may be adopted or enacted or what the impact of such developments would be on the future operations and revenues of its insurance businesses.

Most states have created insurance guaranty associations to provide for the payment of claims of insurance companies that become insolvent. Annual assessments for AFC's insurance companies have not been material. In addition, many states have created "assigned risk" plans or similar arrangements to provide state mandated minimum levels of automobile liability coverage to drivers whose driving records or other relevant characteristics make it difficult for them to obtain insurance otherwise. Automobile insurers in those states are required to provide such coverage to a proportionate number of those drivers applying as assigned risks. Premium rates for assigned risk business are established by the regulators of the particular state plan and are frequently inadequate in relation to the risks insured, resulting in underwriting losses. Assigned risks accounted for less than one percent of AFC's net written premiums in 2002.

The NAIC is an organization which is comprised of the chief insurance regulator for each of the 50 states and the District of Columbia. The NAIC model law for Risk Based Capital applies to both life and property and casualty companies. The risk-based capital formulas determine the amount of capital that an insurance company needs to ensure that it has an acceptably low expectation of becoming financially impaired. The model law provides for increasing levels of regulatory intervention as the ratio of an insurer's total adjusted capital and surplus decreases relative to its risk-based capital, culminating with mandatory control of the operations of the insurer by the domiciliary insurance department at the so-called "mandatory control level". At December 31, 2002, the capital ratios of all AFC insurance companies substantially exceeded the risk-based capital requirements.

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## ITEM 2

### Properties

Subsidiaries of AFC own several buildings in downtown Cincinnati. AFC and its affiliates occupy about three-fourths of the aggregate 660,000 square feet of commercial and office space.

AFC's insurance subsidiaries lease the majority of their office and storage facilities in numerous cities throughout the United States, including Great American's and GAFRI's home offices in Cincinnati. A GAFRI subsidiary owns a 40,000 square foot office building in Austin, Texas, most of which is used by the company for its operations.

AFC subsidiaries own transferable rights to develop approximately 800,000 square feet of floor space in the Grand Central Terminal area in New York City. The development rights were derived from ownership of the land upon which the terminal is constructed. Since the beginning of 1999, AFC has sold approximately 420,000 square feet of such air rights for total consideration of \$22.2 million.



### ITEM 3

#### Legal Proceedings

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

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

AFC's insurance company subsidiaries and American Premier are parties to litigation and receive claims asserting alleged injuries and damages from asbestos, environmental and other substances and workplace hazards and have established loss accruals for such potential liabilities. The ultimate loss for these claims may vary materially from amounts currently recorded as the conditions surrounding resolution of these claims continue to change.

American Premier is a party or named as a potentially responsible party in a number of proceedings and claims by regulatory agencies and private parties under various environmental protection laws, including the Comprehensive Environmental Response, Compensation and Liability Act ("CERCLA"), seeking to impose responsibility on American Premier for hazardous waste remediation costs at certain railroad sites formerly owned by its predecessor, Penn Central Transportation Company ("PCTC"), and at certain other sites where hazardous waste allegedly generated by PCTC's railroad operations and APU's former manufacturing operations is present. It is difficult to estimate American Premier's liability for remediation costs at these sites for a number of reasons, including the number and financial resources of other potentially responsible parties involved at a given site, the varying availability of evidence by which to allocate responsibility among such parties, the wide range of costs for possible remediation alternatives, changing technology and the period of time over which these matters develop. Nevertheless, American Premier believes that its accruals for potential environmental liabilities are adequate to cover the probable amount of such liabilities, based on American Premier's estimates of remediation costs and related expenses and its estimates of the portions of such costs that will be borne by other parties. Such estimates are based on information currently available to American Premier and are subject to future change as additional information becomes available. American Premier seeks reimbursement from certain insurers for portions of whatever remediation costs it incurs.

As previously reported, Great American Insurance Company and certain other insurers have been parties to asbestos-related coverage litigation under insurance policies issued during the 1970's and 1980's to Bigelow-Liptak Corporation and related companies, subsequently known as A.P. Green Industries, Inc. ("A.P. Green"). These claims (some of which are direct actions against Great American) allege that the refractory materials manufactured, sold or installed by A.P. Green contained asbestos and resulted in bodily injury from exposure to asbestos. A.P. Green has sought to recover defense and indemnity expenses related to those claims from a number of insurers, including Great American, and in an effort to maximize coverage has asserted that Great American's policies are not subject to aggregate limits on liability, and that each insurer is liable for all sums that A.P. Green becomes legally obliged to pay.

In February 2002, A.P. Green filed petitions for bankruptcy under Chapter 11 of the Bankruptcy Code in the United States Bankruptcy Court for the Western District of Pennsylvania (In Re Global Industrial Technologies, Inc., et al, filed February 14, 2002). Prior to the bankruptcy filing, Great American sought to have these coverage issues decided as part of the contribution and declaratory judgment action that it brought several years earlier (Great American Insurance Company, et al v. The Royal Insurance Company, et al, United States District Court, Southern District of Ohio, filed January 29, 1998) (the "District Court Action"). The bankruptcy filing, however, stayed the District Court action.

In March 2002, Great American and other insurers filed a motion in the Bankruptcy Court to modify the stay so as to permit the District Court action to

proceed. During the same month, A.P. Green filed adversary proceedings in the Bankruptcy Court to decide the coverage issues. In June of 2002, the Bankruptcy Court entered orders continuing proceedings on both the stay motion and the adversary proceeding and referred the insurance coverage dispute to non-binding mediation. The mediation resulted in the negotiated settlement discussed below.

On February 19, 2003, AFG announced that Great American Insurance Company has entered into an agreement for the settlement of the A.P. Green litigation. The settlement is for \$123.5 million (Great American has the option to pay in cash or over time with 5.25% interest), all but \$30 million of which will be covered by reserves established prior to September 30, 2002, and anticipated reinsurance recoverables. The remaining \$30 million has been recorded as of December 31, 2002. The agreement allows up to 10% of the settlement to be paid in AFG common stock. The settlement, however, is subject to a number of contingencies, including approval of the Bankruptcy Court supervising the reorganization of A.P. Green and subsequent confirmation of a plan of reorganization that includes an injunction prohibiting the assertion against Great American of any present or future asbestos personal injury claims under policies issued to A.P. Green and related companies. This process could take a year or more and no assurance can be made that all of these consents and approvals will be obtained; no payments are required until completion of the process. If not obtained, the outcome of this litigation will again be subject to the complexities and uncertainties associated with a Chapter 11 proceeding and asbestos coverage litigation.

UTA was named a defendant in a purported class action lawsuit. (Peggy Berry, et al. v. United Teacher Associates Insurance Company, Travis County District Court, Case No. GN100461, filed February 11, 2001). The complaint sought unspecified damages based on the alleged misleading disclosure of UTA's interest crediting practices on its fixed rate annuities. UTA has entered into an agreement to resolve this matter. The settlement is subject to approval of the trial court. The resolution of this matter is not expected to have a material impact on UTA.

**PART II**

**ITEM 5**

**Market for Registrant's Common Equity and Related Stockholder Matters**

Not applicable - Registrant's Common Stock is owned by American Financial Group, Inc. See Consolidated Financial Statements for information regarding dividends.

## ITEM 6

### Selected Financial Data

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

	<u>2002</u>	<u>2001</u>	<u>2000</u>	<u>1999</u>	<u>1998</u>
<u>Earnings Statement Data:</u>					
Total Revenues	\$3,745	\$3,929	\$3,820	\$3,359	\$4,084
Operating Earnings Before Income Taxes	195	70	120	310	269
Earnings (Loss) Before Extraordinary Items and Accounting Changes	134	13	(23)	153	130
Extraordinary Items	-	-	-	(4)	(1)
Cumulative Effect of Accounting Changes (a)	(40)	(10)	(9)	(4)	-
Net Earnings (Loss)	94	3	(32)	145	129
Ratio of Earnings to Fixed Charges (b):					
Including Annuity Benefits	1.48	1.14	1.26	1.81	1.69
Excluding Annuity Benefits	3.36	1.56	2.02	4.01	3.44
Ratio of Earnings to Fixed Charges and Preferred Dividends (b):					
Including Annuity Benefits	1.46	1.12	1.23	1.76	1.65
Excluding Annuity Benefits	3.09	1.45	1.87	3.67	3.15
<u>Balance Sheet Data:</u>					
Total Assets	\$19,502	\$17,398	\$16,407	\$16,024	\$15,848
Long-term Debt:					
Holding Companies	268	228	204	113	315
Subsidiaries	297	271	195	240	177
Minority Interest	494	461	510	490	524
Shareholders' Equity	1,730	1,478	1,454	1,324	1,531

(a) Reflects the implementation in the following years of accounting changes mandated by recently enacted accounting standards:

- 2002 - SFAS #142 (Goodwill and Other Intangibles)
- 2001 - EITF 99-20 (Asset-backed Securities)
- 2000 - SFAS #133 (Derivatives)
- 1999 - SOP 98-5 (Start-up Costs)

(b) Fixed charges are computed on a "total enterprise" basis. For purposes of calculating the ratios, "earnings" have been computed by adding to pretax earnings the fixed charges and the minority interest in earnings of subsidiaries having fixed charges and the undistributed equity in losses of investees. Fixed charges include interest (including or excluding interest credited to annuity policyholders' accounts as indicated), amortization of debt premium/discount and expense, preferred dividend and distribution requirements of subsidiaries and a portion of rental expense deemed to be representative of the interest factor. Although the ratio of earnings to fixed charges *excluding* interest on annuities is not required or encouraged to be disclosed under Securities and Exchange Commission rules, some investors and lenders may not consider interest credited to annuity policyholders' accounts a borrowing cost for an insurance company, and accordingly, believe this ratio is meaningful.

## ITEM 7

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

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

#### **GENERAL**

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

#### **CRITICAL ACCOUNTING POLICIES**

Significant accounting policies are summarized in Note A to the financial statements. The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that can have a significant effect on amounts reported in the financial statements. As more information becomes known, these estimates and assumptions could change and thus impact amounts reported in the future. Management believes that the establishment of insurance reserves, especially asbestos and environmental-related reserves, and the determination of "other than temporary" impairment on investments are the two areas where the degree of judgment required to determine amounts recorded in the financial statements make the accounting policies critical. For further discussion of these policies, see "*Liquidity and Capital Resources - Investments*" and "*Liquidity and Capital Resources - Uncertainties.*"

#### **LIQUIDITY AND CAPITAL RESOURCES**

**Ratios** AFC's debt to total capital ratio at the parent holding company level (excluding amounts due AFG) was approximately 13% at December 31, 2002 and 2001. Including amounts due AFG, the ratio was 25% at the end of 2002 and 28% at the end of 2000. AFC used a portion of the proceeds from the Infinity sale in February 2003 to repay parent debt. Adjusting to reflect this repayment reduces the ratio to 6% excluding amounts due AFG and 20% including amounts due AFG at December 31, 2002.

AFC's ratio of earnings to fixed charges excluding and including preferred dividends, on a total enterprise basis for the year ended December 31, 2002, was 3.36 and 3.09, respectively. Including annuity benefits as a fixed charge, this ratio was 1.48 and 1.46 respectively. Although not required to be disclosed, the ratio excluding interest on annuities is presented because interest credited to annuity policyholder accounts is not always considered a borrowing cost for an insurance company.

The National Association of Insurance Commissioners' model law for risk based capital ("RBC") applies to both life and property and casualty companies. RBC formulas determine the amount of capital that an insurance company needs to ensure that it has an acceptable expectation of not becoming financially impaired. At December 31, 2002, the capital ratios of all AFC insurance companies substantially exceeded the RBC requirements (the lowest capital ratio of any AFC subsidiary was 2.3 times its authorized control level RBC; weighted average of all AFC subsidiaries was 5.0 times).

**Sources of Funds** AFC and American Premier are organized as holding companies with almost all of their operations being conducted by subsidiaries. These parent corporations, however, have continuing cash needs for administrative expenses, the payment of principal and interest on borrowings, shareholder dividends, and taxes. Funds to meet these obligations come primarily from dividend and tax payments from their subsidiaries.

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

AFC has a reciprocal Master Credit Agreement with various AFG holding companies under which these companies make funds available to each other for general corporate purposes.

In November 2002, AFC replaced its \$300 million bank credit line with a new bank credit agreement. Currently, AFC may borrow up to \$280 million under the new agreement; the line may be expanded to \$300 million through the end of 2003. The new line consists of two facilities: a 364-day revolving facility, extendable annually, for one-third of the total line and a three-year revolving facility for the remaining two-thirds. Amounts borrowed bear interest at rates ranging from 1.25% to 2.25% over LIBOR based on AFG's credit rating. This credit agreement provides ample liquidity and can be used to obtain funds for operating subsidiaries or, if necessary, for the parent companies. At December 31, 2002, there was \$248 million borrowed under the agreement. At March 14, 2003, there was \$95 million borrowed under the line.

In December 2000, AFC borrowed \$155 million under its credit agreement with AFG to make capital contributions to its property and casualty operations.

For statutory accounting purposes, equity securities of non-affiliates are generally carried at market value. At December 31, 2002, AFC's insurance companies owned publicly traded equity securities with a market value of \$297 million. In addition, Great American owns GAFRI common stock with a market value of \$603 million and a carrying value of \$422 million. Since significant amounts of these are concentrated in a relatively small number of companies, decreases in the market prices could adversely affect the insurance group's capital, potentially impacting the amount of dividends available or necessitating a capital contribution. Conversely, increases in the market prices could have a favorable impact on the group's dividend-paying capability.

Under tax allocation agreements with AFC, its 80%-owned U.S. subsidiaries generally compute tax provisions as if filing separate returns based on book taxable income computed in accordance with generally accepted accounting principles. The resulting provision (or credit) is currently payable to (or receivable from) AFC.

**Investments** Approximately two-thirds of AFC's consolidated assets are invested in marketable securities. AFC's investment portfolio at December 31, 2002, contained \$12 billion in "Fixed maturities" and \$299 million in "Other stocks", all carried at market value with unrealized gains and losses reported as a separate component of shareholders' equity on an after-tax basis. At December 31, 2002, AFC had pretax net unrealized gains of \$457.2 million on fixed maturities and \$125.2 million on other stocks. AFC attempts to optimize investment income while building the value of its portfolio, placing emphasis upon long-term performance. AFC's goal is to maximize return on an ongoing basis rather than focusing on short-term performance.

Fixed income investment funds are generally invested in securities with intermediate-term maturities with an objective of optimizing total return while allowing flexibility to react to changes in market conditions. At December 31, 2002, the average life of AFC's fixed maturities was about six years.

Approximately 93% of the fixed maturities held by AFC were rated "investment grade" (credit rating of AAA to BBB) by nationally recognized rating agencies at December 31, 2002. Investment grade securities generally bear lower yields and lower degrees of risk than those that are unrated or noninvestment grade. Management believes that the high quality investment portfolio should generate a stable and predictable investment return.

Investments in mortgage backed securities ("MBSs") represented approximately one-fourth of AFC's fixed maturities at December 31, 2002. MBSs are subject to significant prepayment risk due to the fact that, in periods of declining interest rates, mortgages may be repaid more rapidly than scheduled as borrowers refinance higher rate mortgages to take advantage of lower rates. Due to the significant decline in the general level of interest rates in 2002, AFC has experienced an increase in the level of prepayments on its MBSs; these prepayments have not been reinvested at interest rates comparable to the rates earned on the prepaid MBSs. Substantially all of AFC's MBSs are investment grade quality, with over 95% rated "AAA" at December 31, 2002.

Summarized information for the unrealized gains and losses recorded in AFC's balance sheet at December 31, 2002, is shown in the following table (dollars in millions). Approximately \$170 million of "Fixed maturities" and \$21 million of "Other stocks" had no unrealized gains or losses at December 31, 2002.

	Securities With Unrealized Gains	Securities With Unrealized Losses
<u>Fixed Maturities</u>		
Market value of securities	\$10,458	\$1,379
Amortized cost of securities	\$ 9,868	\$1,512
Gross unrealized gain (loss)	\$ 590	(\$ 133)
Market value as % of amortized cost	106%	91%
Number of security positions	1,725	328
Number individually exceeding \$2 million gain or loss	23	18
Concentration of gains (losses) by type or industry (exceeding 5% of unrealized):		
Mortgage-backed securities	\$ 134.6	(\$ 9.1)
Banks and savings institutions	55.2	(1.3)
U.S. government and government agencies	49.5	(1.1)
State and municipal	36.4	(5.6)
Electric services	31.6	(15.2)
Asset-backed securities	14.4	(10.6)
Air transportation (generally collateralized)	5.3	(47.7)
Percentage rated investment grade	97%	65%
<u>Other Stocks</u>		
Market value of securities	\$ 260	\$ 18
Cost of securities	\$ 130	\$ 23
Gross unrealized gain (loss)	\$ 130	(\$ 5)
Market value as % of cost	200%	78%
Number individually exceeding \$2 million gain or loss	3	1

AFC's investment in equity securities of Provident Financial Group, a Cincinnati-based commercial banking and financial services company, represents \$117 million of the \$130 million in unrealized gains on other stocks at December 31, 2002. At March 14, 2003, the unrealized gain on Provident was approximately \$86 million.

The table below sets forth the scheduled maturities of fixed maturity securities at December 31, 2002, based on their market values. Asset backed securities and other securities with sinking funds are reported at average maturity. Actual maturities may differ from contractual maturities because certain securities may be called or prepaid by the issuers.

<u>Maturity</u>	Securities with Unrealized Gains	Securities With Unrealized Losses
One year or less	6%	5%
After one year through five years	22	27
After five years through ten years	33	39
After ten years	10	17
	<u>71</u>	<u>88</u>
Mortgage-backed securities	29	12
	<u>100%</u>	<u>100%</u>

AFC realized aggregate losses of \$11.1 million during 2002 on \$72.9 million in sales of fixed maturity securities (14 issues; 12 issuers) that had individual unrealized losses greater than \$500,000 at December 31, 2001. Market values of eleven of the securities increased an aggregate of \$8 million from year-end 2001 to date of sale. The market value of one of the securities did not change from year-end 2001 to the date of sale. One of the securities was a Conseco bond that decreased in value by \$5 million from year-end 2001 to the date of sale due to the continued decline in Conseco's financial condition. The market value of the remaining security decreased \$920,000 from year-end 2001 to the sale date.

Although AFC had the ability to continue holding these investments, its intent to hold them changed due primarily to deterioration in the issuers' creditworthiness, decisions to lessen exposure to a particular credit or industry, or to modify asset allocation within the portfolio.

The table below (dollars in millions) summarizes the length of time securities have been in an unrealized gain or loss position at December 31, 2002.

	Aggregate Market Value	Aggregate Unrealized Gain (Loss)	Market Value as % of Cost Basis
<u>Fixed Maturities</u>			
<b>Securities with unrealized gains:</b>			
Exceeding \$500,000 at 12/31/02 and for:			
Less than one year (354 issues)	\$ 4,561	\$327	108%
More than one year (64 issues)	762	83	112
Less than \$500,000 at 12/31/02 (1,307 issues)	<u>5,135</u>	<u>180</u>	104
	<u>\$10,458</u>	<u>\$590</u>	106%
<b>Securities with unrealized losses:</b>			
Exceeding \$500,000 at 12/31/02 and for:			
Less than one year (50 issues)	\$ 379	(\$ 75)	84%
More than one year (17 issues)	118	(35)	77
Less than \$500,000 at 12/31/02 (261 issues)	<u>882</u>	<u>(23)</u>	98
	<u>\$ 1,379</u>	<u>(\$133)</u>	91%
<u>Other Stocks</u>			
<b>Securities with unrealized gains:</b>			
Exceeding \$500,000 at 12/31/02 and for:			
Less than one year (4 issues)	\$ 26	\$ 6	130%
More than one year (4 issues)	207	121	241
Less than \$500,000 at 12/31/02 (66 issues)	<u>27</u>	<u>3</u>	113
	<u>\$ 260</u>	<u>\$130</u>	200%
<b>Securities with unrealized losses:</b>			
Exceeding \$500,000 at 12/31/02 and for:			
Less than one year (1 issue)	\$ 2	(\$ 1)	67%
More than one year (none)	-	-	-
Less than \$500,000 at 12/31/02 (75 issues)	<u>16</u>	<u>(4)</u>	80
	<u>\$ 18</u>	<u>(\$ 5)</u>	78%



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

- a) whether the unrealized loss is credit-driven or a result of changes in market interest rates,
- b) the extent to which market value is less than cost basis,
- c) historical operating, balance sheet and cash flow data contained in issuer SEC filings,
- d) issuer news releases,
- e) near-term prospects for improvement in the issuer and/or its industry,
- f) industry research and communications with industry specialists,
- g) third party research and credit rating reports,
- h) internally generated financial models and forecasts,
- i) discussions with issuer management, and
- j) ability and intent to hold the investment for a period of time sufficient to allow for any anticipated recovery in market value.

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

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

	Net Realized Gains (Losses) on Sales	Charges for Impairment	Other (a)	Total
2002	\$112.9	(\$179.4)	(\$12.4)	(\$78.9)
2001	89.8	(125.5) (b)	11.6	(24.1)
2000	(1.7)	(27.5)	2.6	(26.6)
1999	31.0	(13.0)	2.1	20.1
1998	40.2	(32.2)	(1.7)	6.3

- (a) Includes adjustments to carry derivatives at market and to reflect the impact of realized gains and losses on the amortization of deferred policy acquisition costs.
- (b) Does not include \$16.9 million writedown of certain collateralized debt obligations which was recorded as the cumulative effect of an adoption of an accounting change at April 1, 2001.

Increased impairment charges in recent years reflect a rise in corporate defaults in the marketplace resulting from the weakened economy.

**Uncertainties** As more fully explained in the following paragraphs, management believes that the areas posing the greatest risk of material loss are the adequacy of its insurance reserves and American Premier's contingencies arising out of its former operations.

**Property and Casualty Insurance Reserves** The liability for unpaid losses and loss adjustment expenses was as follows (in millions):

	December 31,	
	2002	2001
Specialty	\$3,712	\$3,295
Personal	838	843
Other lines (including asbestos and environmental)	654	640
	<u>\$5,204</u>	<u>\$4,778</u>

The liabilities for unpaid claims and for expenses of investigation and adjustment of unpaid claims are based upon: (a) the accumulation of case estimates for losses reported prior to the close of the accounting periods on direct business written; (b) estimates received from ceding reinsurers and insurance pools and associations; (c) estimates of unreported losses based on past experience; (d) estimates based on experience of expense for investigating and adjusting claims; and (e) the current state of law and coverage litigation. Using these items as well as historical trends adjusted for changes in underwriting standards, policy provisions, product mix and other factors, company actuaries determine a single or "point" estimate which management utilizes in recording its best estimate of the liabilities. Ranges of loss reserves are not developed by company actuaries.

Estimating the liability for unpaid losses and LAE is inherently judgmental and is influenced by factors which are subject to significant variation. Through the use of analytical reserve development techniques, management utilizes items such as the effect of inflation on medical, hospitalization, material, repair and replacement costs, general economic trends and the legal environment.

Quarterly reviews of unpaid loss and LAE reserves are prepared using standard actuarial techniques. These may include: Case Incurred Development Method; Paid Development Method; Bornhuetter-Ferguson Method; and Incremental Paid LAE to Paid Loss Methods. Generally, data is segmented by major product or coverage within product using countrywide data; however, in some situations data may be reviewed by state for large volume states.

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

While management believes that AFC's reserves for A&E claims are a reasonable estimate of ultimate liability for such claims, actual results may vary materially from the amounts currently recorded due to the difficulty in predicting the number of future claims and the impact of recent bankruptcy filings, and unresolved issues such as whether coverage exists, whether policies are subject to aggregate limits on coverage, whether claims are to be allocated among triggered policies and implicated years, and whether claimants who exhibit no signs of illness will be successful in pursuing their claims.

In February 2003, Great American Insurance Company entered into an agreement for the settlement of asbestos related coverage litigation under insurance policies issued during the 1970's and 1980's and Bigelow-Liptak Corporation and related companies, subsequently known as A.P. Green Industries, Inc. ("A.P. Green"). Management believes that this settlement will enhance financial certainty and provides resolution to litigation that represents AFC's largest known asbestos-related claim and the only such claim that management believes to be material.

The settlement is for \$123.5 million (Great American has the option to pay in cash or over time with 5.25% interest), all but \$30 million of which will be covered by reserves established prior to September 30, 2002, and anticipated reinsurance recoverables for this matter. As a result, AFC recorded a \$30 million pretax charge (\$19.5 million after tax) in the fourth quarter of 2002. The agreement allows up to 10% of the settlement to be paid in AFG common stock.

The settlement is subject to a number of contingencies, including the approval of the bankruptcy court supervising the reorganization of A.P. Green and subsequent confirmation of a plan of reorganization that includes an injunction prohibiting the assertion against Great American of any present or future asbestos personal injury claims under policies issued to A.P. Green and related companies. This process could take a year or more and no assurance can be made that all of these consents and approvals will be obtained; no payments are required until completion of the process. If not obtained, the outcome of this litigation will again be subject to the complexities and uncertainties associated with a Chapter 11 proceeding and asbestos coverage litigation.

The payments, reserve balances and policy count information for asbestos, environmental and other mass torts were as follows (dollars in millions):

	Net	Net	Policyholder Counts			
	Amounts Paid in 2002	Reserve Balance 12/31/02	12/31/01	New	Closed	12/31/02
Asbestos	\$16.8	\$302.3	429	82	39	472
Environmental	9.6	139.4	715	95	152	658
Other Mass Tort	2.3	25.0	109	23	28	104
Total	<u>\$28.7</u>	<u>\$466.7</u>	<u>1,253</u>	<u>200</u>	<u>219</u>	<u>1,234</u>

Of the open asbestos accounts, approximately 270 are holders of policies written by AFC subsidiaries and approximately 200 represent assumed reinsurance business. The direct policyholders with asbestos claims consist of limited exposures, dominated by small to mid-sized commercial entities that are mostly regional policyholders with few national target defendants. With respect to non-products exposures, there are few accounts with potentially significant exposure, none of which is considered to be material to the Company.

The assumed reinsurance business includes exposures for the periods 1954 to 1983. The asbestos and environmental assumed claims are ceded by various insurance companies under reinsurance treaties. A majority of the individual assumed claims have exposures of less than \$100,000 to AFC. Asbestos losses assumed include some of the industry known manufacturers, distributors and installers. Pollution losses include industry known insured names and sites.

Other mass tort losses include Agent Orange, breast implants, DES, Dalkon Shield, lead, silicon and various chemical exposures.

**Exposure to Market Risk** Market risk represents the potential economic loss arising from adverse changes in the fair value of financial instruments. AFC's exposures to market risk relate primarily to its investment portfolio and annuity contracts which are exposed to interest rate risk and, to a lesser extent, equity price risk. To a much lesser extent, AFC's long-term debt is also exposed to interest rate risk.

**Fixed Maturity Portfolio** The fair value of AFC's fixed maturity portfolio is directly impacted by changes in market interest rates. AFC's fixed maturity portfolio is comprised of substantially all fixed rate investments with primarily intermediate-term maturities. This practice allows flexibility in reacting to fluctuations of interest rates. The portfolios of AFC's insurance operations are managed with an attempt to achieve an adequate risk-adjusted return while maintaining sufficient liquidity to meet policyholder obligations. AFC's life and annuity operations attempt to align the duration of their invested assets to the projected cash flows of policyholder liabilities.

The following table provides information about AFC's fixed maturity investments at December 31, 2002 and 2001, that are sensitive to interest rate risk. The table shows principal cash flows (in millions) and related weighted average interest rates by expected maturity date for each of the five subsequent years and for all years thereafter. Callable bonds and notes are included based on call date or maturity date depending upon which date produces the most conservative yield. Mortgage-backed securities ("MBSs") and sinking fund issues are included based on maturity year adjusted for expected payment patterns. Actual cash flows may differ from those expected.

	<u>December 31, 2002</u>			<u>December 31, 2001</u>	
	<u>Principal Cash Flows</u>	<u>Rate</u>		<u>Principal Cash Flows</u>	<u>Rate</u>
2003	\$ 1,301	10.09%	2002	\$ 956	8.62%
2004	848	8.31	2003	1,407	7.84
2005	1,035	7.05	2004	860	8.56
2006	1,135	6.69	2005	1,082	7.50
2007	1,158	6.12	2006	1,110	6.89
Thereafter	<u>5,939</u>	6.13	Thereafter	<u>5,263</u>	7.08
Total	<u>\$11,416</u>	6.88%		<u>\$10,678</u>	7.46%
Fair Value	<u>\$12,007</u>			<u>\$10,749</u>	

**Equity Price Risk** Equity price risk is the potential economic loss from adverse changes in equity security prices. Although AFC's investment in "Other stocks" is less than 3% of total investments, two-thirds of "Other stocks" is invested in Provident Financial Group which exposes AFC to the risk of price declines in a single position.

Included in "Other stocks" at December 31, 2002 were warrants (valued at \$13.8 million) to purchase common stock of various companies. Under Statement of Financial Accounting Standards ("SFAS") No. 133, which was adopted as of October 1, 2000, these warrants are generally considered derivatives and marked to market through current earnings as realized gains and losses.

**Annuity Contracts** Substantially all of GAFRI's fixed rate annuity contracts permit GAFRI to change crediting rates (subject to minimum interest rate guarantees of 3% to 4% per annum as determined by applicable law) enabling management to react to changes in market interest rates and maintain an adequate spread. Nonetheless, due to the sharp drop in interest rates in 2002, GAFRI's spreads have narrowed and will likely continue to narrow through at least 2003. Actuarial assumptions used to estimate DPAC and Annuity Benefits, as well as GAFRI's ability to maintain spread, could be impacted if the current interest rate environment continues for an extended period and causes policyholder behavior to be altered.

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

	<u>First</u>	<u>Second</u>	<u>Third</u>	<u>Fourth</u>	<u>Fifth</u>	<u>Thereafter</u>	<u>Total</u>	<u>Fair Value</u>
2002	\$550	\$610	\$740	\$810	\$700	\$3,044	\$6,454	\$6,284
2001	750	680	650	630	610	2,512	5,832	5,659

Nearly half of GAFRI's fixed annuity liabilities at December 31, 2002, were two-tier in nature in that policyholders can receive a higher amount if they annuitize rather than surrender their policy, even if the surrender charge period has expired. At December 31, 2002, the average crediting rate on GAFRI's principal fixed annuity products was approximately 4.3% and current stated crediting rates (excluding bonus interest) on GAFRI's active products generally range from 3.0% to 3.6%. GAFRI estimates that its effective weighted-average crediting rate over the next five years will approximate 4.3%. This rate reflects actuarial assumptions as to (i) expected investment spread, (ii) deaths, (iii) annuitizations, (iv) surrenders and (v) renewal premiums. Actual experience and changes in actuarial assumptions may result in different effective crediting rates than those above.

GAFRI's equity-indexed fixed annuities provide policyholders with a crediting rate tied, in part, to the performance of an existing stock market index. GAFRI attempts to mitigate the risk in the equity-based component of these products through the purchase of call options on the appropriate index. GAFRI's strategy is designed so that an increase in the liabilities due to an increase in the market index will be substantially offset by unrealized gains on the call options. Under SFAS No. 133, both the equity-based component of the annuities and the related call options are considered derivatives and marked to market through current earnings as annuity benefits. Adjusting these derivatives to market value had a net effect of less than 1% of annuity benefits in 2002 and 2001. In 2002, GAFRI chose to suspend new sales of equity-indexed annuities due primarily to lack of volume.

**Debt and Preferred Securities** The following table shows scheduled principal payments (in millions) on fixed-rate long-term debt of AFC and its subsidiaries and related weighted average interest rates for each of the subsequent five years and for all years thereafter.

	<u>December 31, 2002</u>			<u>December 31, 2001</u>	
	<u>Scheduled</u>			<u>Scheduled</u>	
	<u>Principal</u>	<u>Rate</u>		<u>Principal</u>	<u>Rate</u>
	<u>Payments</u>			<u>Payments</u>	
2003	*		2002	\$ 4.3	7.02%
2004	*		2003	*	
2005	\$ 10.1	9.09%	2004	*	
2006	18.7	6.74	2005	10.1	9.07
2007	*		2006	18.7	6.73
Thereafter	<u>126.5</u>	7.19	Thereafter	<u>126.8</u>	7.17
Total	<u>\$157.4</u>	7.26%		<u>\$161.6</u>	7.23%
Fair Value	<u>\$148.5</u>			<u>\$156.5</u>	

(\*) Less than \$2 million.

At December 31, 2002 and 2001, respectively, AFC and its subsidiaries had \$406 million and \$337 million in variable-rate debt maturing primarily in 2003 through 2005. The weighted average interest rate on AFC's variable-rate debt was 2.84% at December 31, 2002 compared to 2.67% at December 31, 2001. There were \$143 million of subsidiary trust preferred securities with a weighted average interest rate of 9.07% outstanding at December 31, 2002 and 2001, none of which is scheduled for maturity or mandatory redemption during the next five years.

## RESULTS OF OPERATIONS - THREE YEARS ENDED DECEMBER 31, 2002

**General** Results of operations as shown in the accompanying financial statements are prepared in accordance with generally accepted accounting principles. Many investors and analysts focus on "core earnings" of companies, setting aside certain items included in net earnings such as realized gains and losses, the cumulative effect of accounting changes and certain other unusual items. Realized gains and losses are excluded from "core earnings" because they are unpredictable and not necessarily indicative of current operating fundamentals. Other items such as the 2002 asbestos litigation settlement and tax resolution benefits and the 2001 special A&E charge and World Trade Center losses are excluded to assist investors in analyzing their impact on the trend in operating results. Nonetheless, these items are significant components of AFC's overall financial results.

The following table shows AFC's net earnings as stated in the Statement of Operations as well as the after-tax effect of other items included in these GAAP measures that are typically excluded in deriving "core earnings" (in millions):

	<u>2002</u>	<u>2001</u>	<u>2000</u>
<b>Net earnings (loss)</b>	\$94.4	\$ 2.6	(\$32.1)
After tax income (expense) items included in net earnings:			
Asbestos litigation settlement	(19.5)	-	-
Tax resolution benefits	31.0	-	-
A&E charge and WTC losses	-	(81.3)	-
Net losses from investee corporations	(9.0)	(16.5)	(91.4)
Realized investment gains (losses)	(44.0)	(12.6)	2.8
Cumulative effect of accounting changes	(40.4)	(10.0)	(9.1)

In addition to the effects of items shown in the table above, net earnings increased in 2002 primarily due to significantly improved underwriting results and income from the sale of real estate, partially offset by reduced earnings in the annuity and life operations. Net earnings for 2001 and 2000 include goodwill amortization expense of \$13.8 million and \$16.5 million, respectively.

Aside from the asbestos charges and losses from the World Trade Center, underwriting results improved in 2001 but were partially offset by a \$15 million charge to increase reserves for environmental costs related to certain former operations.

**Property and Casualty Insurance - Underwriting** AFC's property and casualty operations have consisted of two major business groups: Specialty and Personal. See Note P, "Subsequent Events", to the Financial Statements for a discussion of the sale of nearly all of the Personal group.

The Specialty group includes a highly diversified group of business lines. Some of the more significant areas are inland and ocean marine, California workers' compensation, agricultural-related coverages, executive and professional liability, fidelity and surety bonds, collateral protection, and umbrella and excess coverages.

The Personal group sells nonstandard and preferred/standard private passenger auto insurance and, to a lesser extent, homeowners' insurance. Nonstandard automobile insurance covers risks not typically accepted for standard automobile coverage because of the applicant's driving record, type of vehicle, age or other criteria.

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) have quick loss payouts which reduce the time funds are held, thereby limiting investment income earned thereon. On the other hand, "long-tail" lines of business (primarily liability coverages and workers' compensation) have payouts that are either structured over many years or take many years to settle, thereby significantly increasing investment income earned on related premiums received.

Underwriting profitability is measured by the combined ratio which is a sum of the ratios of underwriting losses, loss adjustment expenses, underwriting expenses and policyholder dividends to premiums. When the combined ratio is under 100%, underwriting results are generally considered profitable; when the ratio is over 100%, underwriting results are generally considered unprofitable. The combined ratio does not reflect investment income, other income or federal income taxes.

For certain lines of business and products where the credibility of the range of loss projections is less certain (primarily many of the various specialty businesses listed above), management believes that it is prudent and appropriate to use conservative assumptions until such time as the data, experience and projections have more credibility, as evidenced by data volume, consistency and maturity of the data. While this practice mitigates the risk of adverse development on this business, it does not eliminate it.

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

Since mid-2000, AFC has been actively realigning its mix of business and resetting its rate structure with a goal of achieving underwriting profits, even if it entails sacrificing volume. Management believes these efforts have been successful and expects further improvement in underwriting profitability in 2003 resulting from these strategic actions.

AFC's combined ratio has been better than the industry average for sixteen of the last seventeen years and, excluding AFC's special A&E charges, for all seventeen years. AFC's insurance operations have performed better than the industry by focusing on growth opportunities in the more profitable areas of its specialty and nonstandard auto businesses.

Net written premiums and combined ratios for AFC's property and casualty insurance subsidiaries were as follows (dollars in millions):

	<u>2002</u>	<u>2001</u>	<u>2000</u>
<u>Gross Written Premiums (GAAP)</u>			
Specialty	\$2,713	\$2,236	\$1,889
Personal	1,221	1,284	1,339
Other Lines	1	-	3
	<u>\$3,935</u>	<u>\$3,520</u>	<u>\$3,231</u>
<u>Net Written Premiums (GAAP)</u>			
Specialty	\$1,577	\$1,542	\$1,324
Personal	836 (a)	1,040 (a)	1,311
Other Lines	1	-	3
	<u>\$2,414</u>	<u>\$2,582</u>	<u>\$2,638</u>
<u>Combined Ratios (GAAP)</u>			
Specialty	98.4%	101.7% (b)	107.9%
Personal	99.8	107.9	108.6
Aggregate (including discontinued lines)	101.1% (c)	108.8% (c)	108.0%

(a) Reflects the ceding of \$375 million and \$220 million in premiums in 2002 and 2001, respectively under a reinsurance agreement (effective April 1, 2001).

(b) Includes 1.8% for 2001 relating to the attack on the World Trade Center.

(c) Includes 1.2% for 2002 relating to the A.P. Green asbestos litigation charge and 4.8% for 2001 relating to the A&E charge and the attack on the World Trade Center.

As shown in Note N under "Insurance Reserves," AFC's property and casualty operations recorded loss development of \$171 million in 2002 and \$163 million in 2001 related to prior accident years. Major areas of adverse development were as follows (in millions):

	<u>2002</u>	<u>2001</u>
Asbestos	\$ 49	\$108
Executive liability	26	26
Other liability	21	*
Personal lines	15	*
Other discontinued specialty businesses	41	32
Other	19	(3)
	<u>\$171</u>	<u>\$163</u>

(\*) Amounts are immaterial and included in Other

"Asbestos" development was due primarily to charges for settlement of litigation (2002) and the special \$100 million A&E charge (2001), both of which are discussed below. See *"Uncertainties - Asbestos and Environmental-related Reserves"* for additional information about these claims.

"Executive liability" development resulted primarily from claim severity on policy coverages for 1999 and 2000. Both settlement costs and defense costs related to shareholder lawsuits have increased beyond estimates.

"Other liability" development was the result of an unexpected shift of the judicial climate in some previously relatively conservative states. Verdicts, judgments, and settlements have increased and reserves were adjusted accordingly.

In the "Personal lines," personal injury and uninsured motorist claims have experienced increased severity. During 2002, claims remained open longer and settlement amounts have been higher than in previous years.

Development in the "Other discontinued specialty businesses" related primarily to excess casualty and homebuilders' product liability. During 2002, both experienced higher frequency of claims, primarily related to the 1999 and 2000 accident years for the excess casualty line, and 1993 through 2001 for the homebuilders' liability. Development in 2001, and to a lesser extent in 2002, was affected by increased severity in excess casualty resulting from a rigorous claims review of case reserves established by former management.

"Other" development represents an aggregation of all other lines. While both increases and decreases occurred in these individual lines, none experienced development greater than the smallest listed in the table above. Aggregate adverse development in the "Other" lines was approximately \$44 million in 2002, and \$25 million in 2001. Aggregate positive development was \$25 million in 2002 and \$28 million in 2001.

**Asbestos Litigation Settlement Charge** As more fully discussed under *"Uncertainties - Asbestos and Environmental-related Reserves,"* AFC recorded a fourth quarter 2002 pretax charge of \$30 million related to the settlement of asbestos-related coverage litigation.

**2001 Special A&E Charge** During the third quarter of 2001, AFC recorded an A&E charge of \$100 million after experiencing an increase in the number and severity of asbestos claims and observing the developments of adverse trends in the property and casualty insurance industry concerning asbestos losses. This charge, accompanied by a transfer of \$36 million from excess reserves for other environmental claims, resulted in an increase of \$136 million in asbestos reserves. *For a discussion of uncertainties relative to asbestos and environmental claims, see "Uncertainties - Asbestos and Environmental-related Reserves".*



**Specialty** The Specialty group's gross written premiums increased 21% in 2002 compared to 2001, reflecting the effect of rate increases and the volume growth in certain businesses, partially offset by planned reductions in less profitable lines of business. Specialty rate increases averaged about 27% during 2002 and are targeted to be 25% or more going into 2003. Net written premiums increased 2% in 2002 compared to 2001. Strong growth in gross written premiums was offset by the impact of expanding the Personal group automobile physical damage reinsurance agreement discussed below to include several Specialty business lines as well as increased reinsurance coverage in certain other lines.

Excluding the effect of the attack on the World Trade Center, the Specialty group's combined ratio improved 1.5 points for 2002. The improvement reflects strategic changes in the mix of specialty businesses and the impact of rate increases, partially offset by the effects of prior year loss development.

The Specialty group's increase in gross and net written premiums in 2001 reflects the impact of rate increases implemented in 2000 and 2001 and the realization of growth opportunities in certain commercial markets, partially offset by the decision to discontinue certain lines of business that were not achieving adequate returns. Specialty rate increases averaged over 20% in 2001. The improvement in the combined ratio compared to 2000 reflects the impact of rate increases and unusually strong results in several businesses. Due primarily to adverse development in prior year losses, AFC recorded a \$35 million pretax charge in 2000 to strengthen loss reserves in its California workers' compensation business (a combined ratio effect of 2.9 points). Excluding the effect of the attack on the World Trade Center, the Specialty group reported an underwriting profit with a combined ratio of 99.9% for 2001.

**Personal** The Personal group's gross written premiums for 2002 decreased about 5% compared to 2001 due primarily to intentional reductions in new business volume in certain non-core markets and through the direct channel, partially offset by the effect of continuing rate increases and volume growth in target markets. Rate increases implemented in 2002 were approximately 10%.

Since April 2001, AFC has reinsured 90% of the automobile physical damage business written by certain of its insurance subsidiaries. In September 2002, AFC's use of the existing agreement was expanded to include physical damage business written through the agency channel of Great American Insurance pool companies. This agreement enables AFC to reallocate some of its capital to the more profitable specialty operations. The decline in net written premiums in 2001 and 2002 reflects the impact of this reinsurance agreement.

Due primarily to rate increases and a \$12.6 million reduction in marketing and media cost of the direct business, the Personal group's combined ratio improved by 8.1 points compared to 2001. More than 80% of the Personal group's business is written by the insurance operations included in the recent public offering of Infinity Property and Casualty Corporation. Business written through these operations achieved an underwriting profit with a combined ratio of 96.1% for 2002.

The Personal group's gross written premiums declined about 4% in 2001 compared to 2000 as lower business volume was partially offset by the impact of significant rate increases in 2000 and 2001. The group implemented rate increases of about 14% in 2001. As a result of rate increases in 2001 and 2000, the combined ratio improved to 107.9% for 2001.

**Life, Accident and Health Premiums and Benefits** Life, accident and health premiums and benefits increased in 2002 due primarily to the acquisition of Manhattan National Life ("MNL") in June 2002 and increased in 2001 due primarily to the acquisition of a block of supplemental health insurance business in November 2000. In addition to these acquisitions, life, accident and health benefits for 2002 reflect the effects of adverse mortality in GAFRI's life insurance operations.

**Investment Income** Changes in investment income reflect fluctuations in market rates and changes in average invested assets. Investment income increased in 2002 and 2001 due primarily to higher average investment in fixed maturity securities, partially offset by lower average yields on those investments.

**Gains (Losses) on Securities** Realized gains (losses) on sales of securities include provisions for other than temporary impairment of securities still held of \$179.4 million in 2002, \$125.5 million in 2001 and \$27.5 million in 2000. The provision for 2001 includes \$8 million for the writedown of AFC's investment in Chiquita from \$1.00 per share to \$.67 per share.

Realized gains (losses) on securities include losses of \$11.9 million in 2002, and gains of \$5.2 million in 2001 and \$1.5 million in the fourth quarter of 2000 to adjust the carrying value of AFC's investment in warrants to market value under SFAS No. 133.

**Gains on Sales of Subsidiaries** See Note P, to the financial statements for a discussion of the anticipated loss in connection with the 2003 public offering of Infinity.

In 2002, AFC recognized a \$10.8 million pretax loss on the disposal of its New Jersey private passenger auto business.

In 2001, AFC recognized a \$7.1 million pretax gain on the sale of a small insurance subsidiary. In connection with the sale of the Japanese division in 2001, AFC recognized a \$6.9 million pretax loss and deferred a gain of approximately \$21 million on ceded insurance which is being recognized over the estimated settlement period (weighted average of 4 years) of the ceded claims.

In 2000, AFC recognized (i) a \$25 million pretax gain representing an earn-out related to the 1998 sale of its Commercial lines division, (ii) a \$10.3 million pretax loss on the sale of Stonewall Insurance Company and (iii) a \$10.7 million estimated pretax loss related to the agreement to sell its Japanese division (completed in 2001).

**Gain on Sale of Other Investments** In September 2000, GAFRI realized a \$27.2 million pretax gain on the sale of its minority ownership in a company engaged in the production of ethanol. GAFRI's investment was repurchased by the ethanol company which, following the purchase, became wholly-owned by AFC's Chairman.

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

	<u>2002</u>	<u>2001</u>	<u>2000</u>
Other income	\$115.0	\$102.6	\$95.9
Other operating and general expenses	71.7	64.9	65.6
Interest charges on borrowed money	2.6	2.3	2.6
Minority interest expense, net	1.2	3.9	1.9

Other income includes net pretax gains on the sale of real estate assets of \$31.0 million in 2002, \$27.2 million in 2001 and \$12.4 million in 2000.

### **Other Income**

**2002 compared to 2001** Other income increased \$38.7 million (18%) in 2002 due primarily to higher income from real estate operations (including the effect of property sales and a hotel acquired in May 2002), increased fees earned by the Specialty group's new warranty business and higher fee income in certain other specialty insurance operations.

**2001 compared to 2000** Other income declined in 2001 compared to 2000 due primarily to the absence of income from the sale of lease rights, lease residuals and other operating assets.

**Annuity Benefits** For GAAP financial reporting purposes, annuity receipts are accounted for as interest-bearing deposits ("annuity benefits accumulated") rather than as revenues. Under these contracts, policyholders' funds are credited with interest on a tax-deferred basis until withdrawn by the policyholder. Annuity benefits reflect

amounts accrued on annuity policyholders' funds accumulated. The rate at which GAFRI credits interest on most of its annuity policyholders' funds is subject to change based on management's judgment of market conditions. Historically, management has been able to react to changes in market interest rates and maintain a desired interest rate spread. The recent interest rate environment has resulted in spread compression which could continue at least through 2003. In 2000, annuity benefits also includes a second quarter charge of \$14.2 million related to the settlement of a policyholder class action lawsuit.

On its deferred annuities (annuities in the accumulation phase), GAFRI generally credits interest to policyholders' accounts at their current stated "surrender" interest rates. Furthermore, for "two-tier" deferred annuities (annuities under which a higher interest amount can be earned if a policy is annuitized rather than surrendered), GAFRI accrues an additional liability to provide for expected deaths and annuitizations. Changes in crediting rates, actual surrender, death and annuitization experience or modifications in actuarial assumptions can affect this accrual. In 2002, this accrual was reduced by approximately \$2 million due to decreases in crediting rates on certain fixed annuity products, partially offset by a modification in projected investment yields. Significant changes in projected investment yields could result in additional benefits or charges to earnings.

**Annuity and Life Acquisition Expenses** Annuity and life acquisition expenses include amortization of annuity and life, accident and health deferred policy acquisition costs ("DPAC") as well as a portion of commissions on sales of insurance products. Annuity and life acquisition expenses also include amortization of the present value of future profits of businesses acquired.

**2002 compared to 2001** The increase in annuity and life acquisition expenses in 2002 compared to 2001 reflects (i) a writeoff of DPAC; (ii) the amortization costs associated with GAFRI's purchase of MNL in June 2002 and (iii) higher commission expense due to GAFRI's growth in premiums. Included in 2002 and 2001 were DPAC writeoffs related to variable annuities of \$13.5 million and \$3.0 million, respectively, resulting from the actual performance of the equity markets and a reduction of assumed future returns. Poor performance in the equity markets could lead to additional DPAC writeoffs or a charge to earnings in order to accrue for guaranteed minimum death benefits included in the variable products. (See "*Proposed Accounting Standard*"). Included in 2002 is a DPAC writeoff of \$4 million related primarily to adverse mortality in GAFRI's life operations. Partially offsetting the DPAC writeoffs in 2002 was a reduction of approximately \$7 million in DPAC amortization on fixed annuities relating to decreases in crediting rates on certain fixed annuity products. Continued adverse mortality could lead to additional DPAC writeoffs. Significant changes in projected investment yields could result in additional benefits or charges to earnings.

**2001 compared to 2000** The increase in annuity and life acquisition expenses resulted primarily from (i) increased lapses and increased sales of traditional life insurance and (ii) the effect of the equity markets on variable annuity DPAC.

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

**2002 compared to 2001** Interest expense decreased significantly in 2002 as lower average rates on AFC's variable rate debt (including AFC's payable to AFG) more than offset the effect of higher average indebtedness and higher average payable to reinsurers balances.

**2001 compared to 2000** Interest expense decreased in 2001 as lower average interest rates on AFC's variable rate debt and lower average subsidiary indebtedness more than offset higher average borrowings under the AFC bank line.

### **Other Operating and General Expenses**

**2002 compared to 2001** Other operating and general expenses for 2001 include goodwill amortization of \$13.8 million. Under SFAS No. 142, which was implemented January 1, 2002, goodwill is no longer amortized. Excluding 2001 goodwill

amortization, other operating and general expenses increased \$36.0 million (10%) in 2002. Expenses of the Specialty group's new warranty business, higher expenses in real estate operations (due primarily to the acquisition of a new hotel in May 2002) and higher expenses related to growth in certain other Specialty operations were partially offset by lower charges for environmental reserves related to former operations and lower IT-related expenses.

**2001 compared to 2000** Excluding the 2000 litigation charges discussed below, other operating and general expenses increased \$12.0 million (3%) due primarily to a \$14.8 million increase in environmental reserves related to former operations.

Other operating and general expenses for 2000 include second quarter charges of \$18.3 million related to an agreement to settle a lawsuit against a GAFRI subsidiary and \$8.8 million for an adverse California Supreme Court ruling against an AFC property and casualty subsidiary.

**Income Taxes** The 2002 provision for income taxes includes \$31 million in tax benefits for the reduction of previously accrued amounts due to the resolution of certain tax matters. See Note J to the Financial Statements for an analysis of items affecting AFC's effective tax rate.

## **Investee Corporations**

**Start-up Manufacturing Businesses** AFC's pretax operating earnings for 2000 include losses of \$6.7 million from two start-up manufacturing businesses acquired in 2000 from their former owners. AFC sold the equity interests in these businesses in the fourth quarter of 2000 for a nominal cash consideration plus warrants to repurchase a significant ownership interest. Due to the absence of significant financial investment by the buyers relative to the amount of loans (\$61.5 million at December 31, 2000) owed to AFC subsidiaries, AFC retained the financial risk in these businesses and continued accounting for their operations under the equity method as investees.

Beginning in the fourth quarter of 2000, AFC's equity in the results of operations of these businesses is included in investee earnings. In 2002, 2001 and 2000, equity in net losses of investee corporations includes \$9.0 million, \$16.6 million and \$4.1 million, respectively, in losses of these businesses.

Investee losses in 2001 include litigation judgments of \$4.7 million against one of these companies. In December 2002, this company sold its fixed assets, ceased operations and transferred approximately \$30 million in cash and other assets to AFC. The amount transferred approximated AFC's carrying value of loans to this business. Amounts included in equity in net losses of investee corporations for this business were \$5.4 million in 2002, \$13.7 million in 2001 and \$3.1 million in 2000.

**Chiquita** Equity in net losses of investee corporations for 2000 includes AFC's proportionate share of the results of Chiquita Brands International. Chiquita reported net losses attributable to common shareholders of \$112 million in 2000.

Equity in net losses of investees for 2000 includes a \$95.7 million pretax charge to writedown AFC's investment in Chiquita to a market value of approximately \$1 per share. In 2001, AFC suspended accounting for Chiquita under the equity method due to Chiquita's pending restructuring. In March 2002, Chiquita completed its reorganization under Chapter 11 of the U.S. Bankruptcy Code. As a result of the restructuring, AFC's ownership percentage of Chiquita was reduced to less than one-half of 1%.

**Cumulative Effect of Accounting Changes** Effective January 1, 2002, AFC implemented Statement of Financial Accounting Standards ("SFAS") No. 142, "Goodwill and Other Intangible Assets", under which goodwill is no longer amortized, but is subject to an impairment test at least annually. The initial impairment testing resulted in a charge of \$40.4 million (net of minority interest and taxes) for the cumulative effect of a change in accounting principle.

In 2001, the cumulative effect of accounting change represents the implementation of a new accounting standard (EITF 99-20) which resulted in a writedown of \$10.0 million (net of minority interest and taxes) of the carrying value of certain collateralized debt obligations as of April 1, 2001.

In October 2000, AFC implemented Statement of Financial Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging Activities", which requires all derivatives to be recognized in the balance sheet at fair value and that the initial effect of recognizing derivatives at fair value be reported as a cumulative effect of a change in accounting principle. Accordingly, AFC recorded a charge of \$9.1 million (net of minority interest and taxes) to record its derivatives at fair value at the beginning of the fourth quarter of 2000.

**Recent Accounting Standards** The following accounting standards have been or may be implemented by AFC. The implementation of these standards is discussed under various subheadings of Note A to the Financial Statements; effects of each are shown in the relevant Notes.

<u>Accounting Standard</u>	<u>Subject of Standard (Year Implemented)</u>	<u>Reference</u>
SFAS #133	Derivatives (2000)	"Derivatives"
EITF 99-20	Asset-backed Securities (2001)	"Investments"
SFAS #141	Business Combinations (2001)	"Business Combinations"
SFAS #142	Goodwill and Other Intangibles (2002)	"Goodwill"

Other standards issued in recent years did not apply to AFC or had only negligible effects on AFC.

In January 2003, the Financial Accounting Standards Board issued Interpretation No.46, Consolidation of Variable Interest Entities ("FIN 46"). This interpretation will require companies to consolidate entities without sufficient equity based on ownership of expected gains and losses. FIN 46 is effective immediately to variable interest entities acquired after January 31, 2003. For entities acquired before that date, the guidance becomes effective for periods beginning after June 15, 2003.

AFC is currently assessing the application of FIN 46 as it relates to its investments in two collateralized debt obligations ("CDOs"), for which AFC also acts as investment manager. Under the CDOs, securities were issued in various senior and subordinate classes and the proceeds were invested primarily in bank loans, and to a lesser extent, high yield bonds, all of which serve as collateral for the securities issued by the CDOs. None of the collateral was purchased from AFC. The market value of the collateral at December 31, 2002 was approximately \$800 million.

AFC's investments in the two CDOs are subordinate to the senior classes (approximately 92% of the total securities) issued by the CDOs. To the extent there are defaults and unrecoverable losses on the underlying collateral resulting in reduced cash flows, AFC's class would bear losses first. Holders of the CDO debt securities have no recourse against AFC for the liabilities of the CDOs; accordingly, AFC's exposure to loss on these investments is limited to its investment. AFC's investments in the CDOs are carried at estimated market value of \$13.7 million at December 31, 2002 and are included in fixed maturities in AFC's balance sheet.

**Proposed Accounting Standard** GAFRI's variable annuity contracts contain a guaranteed minimum death benefit ("GMDB") (which may exceed the value of the policyholder's account) to be paid if the annuityholder dies before the annuity payout period commences. At December 31, 2002, the aggregate GMDB values (assuming every policyholder died on that date) exceeded the market value of the underlying variable annuities by \$233 million. Industry practice varies, but GAFRI does not establish GAAP reserves for this mortality risk. If a proposed accounting standard becomes effective, GAFRI would be required to record a liability for the present value of expected GMDB payments. Initial recognition of a GAAP liability (estimated to be less than 4% of the difference between the underlying market value of the variable annuities and GMDB value) would be accounted for as the cumulative effect of a change in accounting principles. Death benefits paid in excess of the variable annuity account balance were \$1.1 million in 2002.

## ITEM 7A

### Quantitative and Qualitative Disclosures About Market Risk

The information required by Item 7A is included in Management's Discussion and Analysis of Financial Condition and Results of Operations.

## ITEM 8

### Financial Statements and Supplementary Data

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Report of Independent Auditors	F-1
Consolidated Balance Sheet: December 31, 2002 and 2001	F-2
Consolidated Statement of Operations: Years ended December 31, 2002, 2001, and 2000	F-3
Consolidated Statement of Changes in Shareholders' Equity Years ended December 31, 2002, 2001, and 2000	F-4
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"Selected Quarterly Financial Data" has been included in Note M to the Consolidated Financial Statements.

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

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## PART III

The information required by the following Items will be provided within 120 days after the end of Registrant's fiscal year.

**ITEM 10**      **Directors and Executive Officers of the Registrant**

**ITEM 11**      **Executive Compensation**

**ITEM 12**      **Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters**

**ITEM 13**      **Certain Relationships and Related Transactions**

## ITEM 14

### **Controls and Procedures**

AFC's chief executive officer and chief financial officer, with assistance from management, have evaluated AFC's disclosure controls and procedures (as defined in Exchange Act Rule 13a-14(c)) as of a date within 90 days prior to filing this report. Based on that evaluation, they concluded that the controls and procedures are effective. There have been no significant changes in AFC's internal controls or in other factors that could significantly affect these controls subsequent to the date of their evaluation.

## REPORT OF INDEPENDENT AUDITORS

### Board of Directors American Financial Corporation

We have audited the accompanying consolidated balance sheet of American Financial Corporation and subsidiaries as of December 31, 2002 and 2001, and the related consolidated statements of operations, changes in shareholders' equity and cash flows for each of the three years in the period ended December 31, 2002. Our audits also included the financial statement schedules listed in the Index at Item 15(a). These financial statements and schedules are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedules based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of American Financial Corporation and subsidiaries at December 31, 2002 and 2001, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2002, in conformity with accounting principles generally accepted in the United States. Also, in our opinion, the related financial statement schedules, when considered in relation to the basic financial statements taken as a whole, present fairly in all material respects the information set forth therein.

As discussed in Notes A and E to the consolidated financial statements, in 2002, the Company implemented Statement of Financial Accounting Standards No. 142, which required a change in the method of accounting for goodwill.

**ERNST & YOUNG LLP**

Cincinnati, Ohio  
February 19, 2003

**AMERICAN FINANCIAL CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEET**  
(Dollars in Thousands)

	December 31,	
	2002	2001
<b>Assets:</b>		
Cash and short-term investments	\$ 870,797	\$ 543,644
Investments:		
Fixed maturities - at market (amortized cost - \$11,549,710 and \$10,593,205)	12,006,910	10,748,605
Other stocks - at market (cost - \$173,933 and \$187,810)	299,133	313,710
Policy loans	214,852	211,288
Real estate and other investments	257,731	262,801
Total investments	12,778,626	11,536,404
Recoverables from reinsurers and prepaid reinsurance premiums	2,866,780	2,286,509
Agents' balances and premiums receivable	708,327	666,171
Deferred acquisition costs	842,070	818,323
Other receivables	306,904	254,137
Variable annuity assets (separate accounts)	455,142	529,590
Prepaid expenses, deferred charges and other assets	425,127	451,362
Goodwill	248,683	312,134
	\$19,502,456	\$17,398,274
<b>Liabilities and Capital:</b>		
Unpaid losses and loss adjustment expenses	\$ 5,203,831	\$ 4,777,580
Unearned premiums	1,847,924	1,640,955
Annuity benefits accumulated	6,453,881	5,832,120
Life, accident and health reserves	902,393	638,522
Payable to reinsurers	508,718	296,462
Payable to American Financial Group, Inc.	310,010	356,689
Long-term debt:		
Holding companies	267,512	228,252
Subsidiaries	296,771	270,752
Variable annuity liabilities (separate accounts)	455,142	529,590
Accounts payable, accrued expenses and other liabilities	1,032,079	888,684
Total liabilities	17,278,261	15,459,606
Minority interest	494,472	460,737
Shareholders' Equity:		
Preferred Stock - at liquidation value	72,154	72,154
Common Stock, no par value		
- 20,000,000 shares authorized		
- 10,593,000 shares outstanding	9,625	9,625
Capital surplus	987,539	984,125
Retained earnings	343,705	255,127
Unrealized gain on marketable securities, net	316,700	156,900
Total shareholders' equity	1,729,723	1,477,931
	\$19,502,456	\$17,398,274

See notes to consolidated financial statements.



**AMERICAN FINANCIAL CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENT OF OPERATIONS**  
(In Thousands)

	Year ended December 31,		
	2002	2001	2000
<b>Income:</b>			
Property and casualty insurance premiums	\$2,402,600	\$2,593,938	\$2,494,892
Life, accident and health premiums	305,647	280,122	230,441
Investment income	867,618	859,484	837,361
Realized gains (losses) on:			
Securities	(78,935)	(24,140)	(26,581)
Subsidiaries	(10,769)	170	4,032
Other investments	-	-	27,230
Other income	258,560	219,891	252,735
	<u>3,744,721</u>	<u>3,929,465</u>	<u>3,820,110</u>
<b>Costs and Expenses:</b>			
Property and casualty insurance:			
Losses and loss adjustment expenses	1,814,699	2,080,057	1,961,538
Commissions and other underwriting expenses	614,225	741,396	735,241
Annuity benefits	300,966	294,654	293,171
Life, accident and health benefits	245,271	213,022	175,174
Annuity and life acquisition expenses	114,507	79,297	62,259
Interest charges on borrowed money	47,459	60,556	67,310
Other operating and general expenses	412,338	390,102	405,158
	<u>3,549,465</u>	<u>3,859,084</u>	<u>3,699,851</u>
Operating earnings before income taxes	195,256	70,381	120,259
Provision for income taxes	23,996	15,287	32,812
Net operating earnings	171,260	55,094	87,447
Minority interest expense, net of tax	(27,560)	(25,954)	(18,051)
Equity in net losses of investees, net of tax	(8,990)	(16,550)	(92,449)
Earnings (loss) before cumulative effect of accounting changes	134,710	12,590	(23,053)
Cumulative effect of accounting changes	(40,360)	(10,040)	(9,072)
<b>Net Earnings (Loss)</b>	<u>\$ 94,350</u>	<u>\$ 2,550</u>	<u>(\$ 32,125)</u>

See notes to consolidated financial statements.

**AMERICAN FINANCIAL CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY**  
(Dollars In Thousands)

	Preferred Stock	Common Stock And Capital Surplus	Retained Earnings	Unrealized Gain (Loss) on Securities	Total
<b>Balance at December 31, 1999</b>	\$72,154	\$970,407	\$296,246	(\$ 14,700)	\$1,324,107
Net loss	-	-	( 32,125)	-	(32,125)
Change in unrealized Comprehensive income	-	-	-	153,900	<u>153,900</u>
					121,775
Dividends on Preferred Stock	-	-	(5,772)	-	(5,772)
Capital Contribution from parent	-	12,267	-	-	12,267
Other	-	<u>1,739</u>	-	-	<u>1,739</u>
<b>Balance at December 31, 2000</b>	<u>\$72,154</u>	<u>\$984,413</u>	<u>\$258,349</u>	<u>\$139,200</u>	<u>\$1,454,116</u>
Net earnings	\$ -	\$ -	\$ 2,550	\$ -	\$ 2,550
Change in unrealized Comprehensive income	-	-	-	17,700	<u>17,700</u>
					20,250
Dividends on Preferred Stock	-	-	(5,772)	-	(5,772)
Capital Contribution from parent	-	12,267	-	-	12,267
Other	-	<u>(2,930)</u>	-	-	<u>(2,930)</u>
<b>Balance at December 31, 2001</b>	<u>\$72,154</u>	<u>\$993,750</u>	<u>\$255,127</u>	<u>\$156,900</u>	<u>\$1,477,931</u>
Net earnings	\$ -	\$ -	\$ 94,350	\$ -	\$ 94,350
Change in unrealized Comprehensive income (loss)	-	-	-	159,800	<u>159,800</u>
					254,150
Dividends on Preferred Stock	-	-	(5,772)	-	(5,772)
Capital Contribution from parent	-	6,133	-	-	6,133
Other	-	<u>(2,719)</u>	-	-	<u>(2,719)</u>
<b>Balance at December 31, 2002</b>	<u>\$72,154</u>	<u>\$997,164</u>	<u>\$343,705</u>	<u>\$316,700</u>	<u>\$1,729,723</u>

See notes to consolidated financial statements.

**AMERICAN FINANCIAL CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENT OF CASH FLOWS**  
(In Thousands)

	Year ended December 31,		
	2002	2001	2000
<b>Operating Activities:</b>			
Net earnings (loss)	\$ 94,350	\$ 2,550	(\$ 32,125)
Adjustments:			
Cumulative effect of accounting changes	40,360	10,040	9,072
Equity in net losses of investees	8,990	16,550	92,449
Depreciation and amortization	174,525	125,814	99,867
Annuity benefits	300,966	294,654	293,171
Realized (gains) losses on investing activities	58,202	(2,604)	(25,173)
Deferred annuity and life policy acquisition costs	(170,194)	(137,724)	(146,686)
Decrease (increase) in reinsurance and other receivables	(669,790)	(299,802)	74,885
Decrease (increase) in other assets	29,545	(20,136)	(70,191)
Increase in insurance claims and reserves	703,244	546,522	189,587
Increase in payable to reinsurers	212,256	154,384	14,270
Increase (decrease) in other liabilities	45,567	8,193	(34,563)
Increase (decrease) in minority interest	16,603	18,491	(445)
Other, net	(4,820)	12,904	1,927
	<u>839,804</u>	<u>729,836</u>	<u>466,045</u>
<b>Investing Activities:</b>			
Purchases of and additional investments in:			
Fixed maturity investments	(6,199,022)	(3,827,768)	(1,635,578)
Equity securities	(16,583)	(9,071)	(45,800)
Subsidiary	(48,447)	-	-
Real estate, property and equipment	(53,639)	(90,111)	(88,371)
Maturities and redemptions of fixed maturity investments	1,807,482	902,820	689,691
Sales of:			
Fixed maturity investments	3,566,812	2,468,492	810,942
Equity securities	23,669	15,814	84,147
Investees and subsidiaries	-	40,395	30,694
Real estate, property and equipment	22,417	71,002	30,150
Cash and short-term investments of acquired (former) subsidiaries, net	4,684	(134,237)	(132,163)
Decrease (increase) in other investments	14,223	(7,827)	5,637
	<u>(878,404)</u>	<u>(570,491)</u>	<u>(250,651)</u>
<b>Financing Activities:</b>			
Fixed annuity receipts	874,470	616,628	496,742
Annuity surrenders, benefits and withdrawals	(549,919)	(622,474)	(731,856)
Net transfers from (to) variable annuity assets	20,807	(363)	(50,475)
Additional long-term borrowings	224,560	242,613	182,462
Reductions of long-term debt	(159,926)	(143,840)	(141,577)
Borrowings from AFG	14,300	17,077	174,500
Payments to AFG	(62,100)	(100,500)	(108,413)
Repurchases of trust preferred securities	-	(75,000)	(1,427)
Capital contributions	9,333	18,667	18,667
Cash dividends paid	(5,772)	(5,772)	(5,772)
	<u>365,753</u>	<u>(52,964)</u>	<u>(167,149)</u>
<b>Net Increase in Cash and Short-term Investments</b>	327,153	106,381	48,245
Cash and short-term investments at beginning of period	<u>543,644</u>	<u>437,263</u>	<u>389,018</u>
Cash and short-term investments at end of period	<u>\$ 870,797</u>	<u>\$ 543,644</u>	<u>\$ 437,263</u>

See notes to consolidated financial statements.

# AMERICAN FINANCIAL CORPORATION AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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### INDEX TO NOTES

A. Accounting Policies	I. Shareholders' Equity
B. Acquisitions and Sales of Subsidiaries and Investees	J. Income Taxes
C. Segments of Operations	K. Equity in Losses of Investees
D. Investments	L. Commitments and Contingencies
E. Goodwill and Other Intangibles	M. Quarterly Operating Results
F. Payable to American Financial Group	N. Insurance
G. Long-Term Debt	O. Additional Information
H. Minority Interest	P. Subsequent Events

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#### A. Accounting Policies

**Basis of Presentation** The consolidated financial statements include the accounts of American Financial Corporation ("AFC") and its subsidiaries. Certain reclassifications have been made to prior years to conform to the current year's presentation. All significant intercompany balances and transactions have been eliminated. All acquisitions have been treated as purchases. The results of operations of companies since their formation or acquisition are included in the consolidated financial statements.

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

**Investments** All fixed maturity securities are considered "available for sale" and reported at fair value with unrealized gains and losses reported as a separate component of shareholders' equity. Short-term investments are carried at cost; loans receivable are carried primarily at the aggregate unpaid balance. Premiums and discounts on mortgage-backed securities are amortized over a period based on estimated future principal payments, including prepayments. Prepayment assumptions are reviewed periodically and adjusted to reflect actual prepayments and changes in expectations. The most significant determinants of prepayments are the difference between interest rates on the underlying mortgages and current mortgage loan rates and the structure of the security. Other factors affecting prepayments include the size, type and age of underlying mortgages, the geographic location of the mortgaged properties and the credit worthiness of the borrowers. Variations from anticipated prepayments will affect the life and yield of these securities.

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

Emerging Issues Task Force Issue No. 99-20 established a new standard for recognizing interest income and impairment on certain asset-backed investments. Interest income on these investments is recorded at a yield based on projected cash flows. The yield is adjusted prospectively to reflect actual cash flows and changes in projected amounts. Impairment losses on these investments must be recognized when (i) the fair value of the security is less than its cost basis and (ii) there has been an adverse change in the expected cash flows. The new standard became effective on April 1, 2001. Impairment losses at initial application of this rule were recognized as the cumulative effect of an accounting change. Subsequent impairments are recognized as a component of net realized gains and losses.

## AMERICAN FINANCIAL CORPORATION AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

**Investment in Investee Corporations** Investments in securities of 20%- to 50%-owned companies are generally carried at cost, adjusted for AFC's proportionate share of their undistributed earnings or losses.

Due to Chiquita's announced intention to pursue a plan to restructure its public debt, AFC wrote down its investment in Chiquita common stock to market value at December 31, 2000. In 2001, AFC suspended accounting for the investment under the equity method due to the expected restructuring, and reclassified the investment to "Other stocks." In a 2002 reorganization of Chiquita, AFC's ownership was reduced to less than one-half of 1%.

**Goodwill** Goodwill represents the excess of cost of subsidiaries over AFC's equity in their underlying net assets. Through December 31, 2001, goodwill was being amortized over periods of 20 to 40 years. Effective January 1, 2002, AFC implemented Statement of Financial Accounting Standards ("SFAS") No. 142, under which goodwill is no longer amortized but is subject to an impairment test at least annually. As required under SFAS No. 142, AFC completed the transitional test for goodwill impairment (as of January 1, 2002) in the fourth quarter of 2002. The resulting write-down was reported by restating first quarter 2002 results for the cumulative effect of a change in accounting principle.

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

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

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

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

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

**Annuity and Life Acquisition Expenses** Annuity and life acquisition expenses on the Statement of Operations consists primarily of amortization of DPAC related to the annuity and life, accident and health businesses. This line item also includes certain marketing and commission costs that are expensed as paid.

## AMERICAN FINANCIAL CORPORATION AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

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

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

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

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

**Variable Annuity Assets and Liabilities** Separate accounts related to variable annuities represent deposits invested in underlying investment funds on which Great American Financial Resources, Inc. ("GAFRI"), an 83%-owned subsidiary, earns a fee. Investment funds are selected and may be changed only by the policyholder, who retains all investment risk.

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

**Policyholder Dividends** Dividends payable to policyholders are included in "Accounts payable, accrued expenses and other liabilities" and represent estimates of amounts payable on participating policies which share in favorable underwriting results. Estimates are accrued during the period in which premiums are earned. Changes in estimates are included in income in the period determined. Policyholder dividends do not become legal liabilities unless and until declared by the boards of directors of the insurance companies.

## AMERICAN FINANCIAL CORPORATION AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

**Minority Interest** For balance sheet purposes, minority interest represents (i) the interests of noncontrolling shareholders in AFC subsidiaries, including preferred securities issued by trust subsidiaries of GAFRI and (ii) American Financial Group, Inc.'s ("AFG") direct ownership interest in American Premier Underwriters, Inc. ("American Premier" or "APU") and American Financial Enterprises, Inc. For income statement purposes, minority interest expense represents those shareholders' interest in the earnings of AFC subsidiaries as well as accrued distributions on the trust preferred securities.

**Income Taxes** AFC files consolidated federal income tax returns which include all 80%-owned U.S. subsidiaries, except for certain life insurance subsidiaries and their subsidiaries. Deferred income taxes are calculated using the liability method. Under this method, deferred income tax assets and liabilities are determined based on differences between financial reporting and tax bases and are measured using enacted tax rates. Deferred tax assets are recognized if it is more likely than not that a benefit will be realized.

**Benefit Plans** AFC provides retirement benefits to qualified employees of participating companies through the AFG Retirement and Savings Plan, a defined contribution plan. The Company makes all contributions to the retirement fund portion of the Plan and matches a percentage of employee contributions to the savings fund. Employees have been permitted to direct the investment of their contributions to independently managed investment funds, while Company contributions have been invested primarily in securities of AFG and affiliates. Employees may direct the investment of a portion of their vested retirement fund account balances (increasing from 12.5% in July 2002 to 100% in April 2004) from securities of AFG and its affiliates to independently managed investment funds. As of December 31, 2002, the Plan owned 12% of AFG's outstanding common stock. Company contributions are expensed in the year for which they are declared.

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

**Derivatives** Effective October 1, 2000, AFC implemented SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities", which established accounting and reporting standards for derivative instruments (including derivative instruments that are embedded in other contracts) and for hedging activities. Prior year financial statements were not restated. SFAS No. 133 generally requires that derivatives (both assets and liabilities) be recognized in the balance sheet at fair value with changes in fair value included in current earnings. The cumulative effect of implementing SFAS No. 133, which resulted from the initial recognition of AFC's derivatives at fair value, was a loss of \$9.1 million (net of minority interest and taxes).

Derivatives are included in AFC's Balance Sheet and consist primarily of investments in common stock warrants (valued at \$13.8 million at December 31, 2002; included in other stocks), 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.

**Statement of Cash Flows** For cash flow purposes, "investing activities" are defined as making and collecting loans and acquiring and disposing of debt or equity instruments and property and equipment. "Financing activities" include obtaining resources from owners and providing them with a return on their investments, borrowing money and repaying amounts borrowed. Annuity receipts, benefits and withdrawals are also reflected as financing activities. All other

## AMERICAN FINANCIAL CORPORATION AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

activities are considered "operating". Short-term investments having original maturities of three months or less when purchased are considered to be cash equivalents for purposes of the financial statements.

- B. Acquisitions and Sales of Subsidiaries and Investees** See Note P, "Subsequent Events" for information on the 2003 sales of Infinity and the direct-to-consumer auto business.

**New Jersey private passenger automobile insurance business** In September 2002, an AFC subsidiary entered into an agreement under which an unrelated insurer will assume the subsidiary's obligations to renew its private passenger automobile insurance business written in New Jersey. AFC recognized a \$10.8 million pretax loss on the transaction. As of September 9, 2002, AFC no longer accepts any new private passenger automobile insurance in that state.

**Manhattan National Life Insurance** On June 28, 2002, GAFRI acquired Manhattan National Life Insurance Company ("MNL") from Conseco, Inc. for \$48.5 million in cash. At December 31, 2002, MNL reinsured 90% of its in force business.

**Seven Hills Insurance Company** In July 2001, AFC sold Seven Hills Insurance Company for \$18.4 million, realizing a pretax gain of \$7.1 million. AFC retained all liability for Seven Hills' business related to the period AFC owned the company.

**Japanese division** In December 2000, AFC agreed to sell its Japanese property and casualty division to Mitsui Marine & Fire Insurance Company of America for \$22 million in cash and recorded an estimated \$10.7 million pretax loss. Upon completion of the sale in March 2001, AFC realized an additional pretax loss of \$6.9 million (including post closing adjustments) and deferred a gain of approximately \$21 million on ceded insurance; the deferred gain is being recognized over the estimated settlement period (weighted average of 4 years) of the ceded claims. At the same time, a reinsurance agreement under which Great American Insurance ceded a portion of its pool of insurance to Mitsui was terminated. The Japanese division generated net written premiums of approximately \$60 million per year to Great American while Great American ceded approximately \$45 million per year to Mitsui.

**Stonewall Insurance Company** In September 2000, AFC sold Stonewall Insurance Company for \$31.2 million (net of post closing adjustments), realizing a pretax loss of \$10.3 million. Stonewall was a non-operating property and casualty subsidiary with approximately \$320 million in assets, engaged primarily in the run-off of approximately \$170 million in asbestos and environmental liabilities associated with policies written through 1991.

**Commercial lines division** In 1998, AFC sold its Commercial lines division to Ohio Casualty Corporation for \$300 million cash plus warrants to purchase shares of Ohio Casualty common stock. AFC received an additional \$25 million (included in gains on sales of subsidiaries) in August 2000 under a provision in the sale agreement related to the retention and growth of the insurance businesses sold.

**Start-up manufacturing businesses** Since 1998, AFC subsidiaries have made loans to two start-up manufacturing businesses which were previously owned by unrelated third-parties. During 2000, the former owners chose to forfeit their equity interests to AFC rather than invest additional capital. Total loans extended to these businesses prior to forfeiture amounted to \$49.7 million and the accumulated losses of the two businesses were approximately \$29.7 million.

During the fourth quarter of 2000, AFC sold the equity interests to a group of employees for nominal cash consideration plus warrants to repurchase a significant ownership interest. Due to the absence of significant financial investment by the buyers relative to the amount of loans (\$61.5 million at December 31, 2000) owed to AFC subsidiaries, the sale was not recognized as a



## AMERICAN FINANCIAL CORPORATION AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

divestiture for accounting purposes and AFC continued accounting for their operations under the equity method as investees. In December 2002, one of the businesses sold substantially all of its assets for \$29.5 million, which proceeds and approximately \$675,000 in receivables and other assets were transferred to AFC. The amount transferred approximated AFC's carrying value of loans to this business. At December 31, 2001, \$41.6 million in assets of this business were included in other assets and \$9.8 million in liabilities of this business (after consolidation and elimination of loans from AFC subsidiaries) were included in other liabilities in AFC's consolidated balance sheet.

Assets of the remaining start-up business (\$15.3 million at December 31, 2002, and \$15.5 million at December 31, 2001) are included in other assets; liabilities of the business (\$2.0 million at December 31, 2002 and 2001, after consolidation and elimination of loans from AFC subsidiaries) are included in other liabilities.

AFC's equity in the losses of these two companies during 2002, 2001 and the fourth quarter of 2000 was \$9.0 million, \$16.6 million and \$4.1 million, respectively, and is included in investee losses in the Statement of Operations.

**AMERICAN FINANCIAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

**C. Segments of Operations** AFC's property and casualty group has been engaged primarily in specialty commercial insurance and private passenger automobile insurance business. The Specialty group includes a highly diversified group of specialty business units. Some of the more significant areas are inland and ocean marine, California workers' compensation, agricultural-related coverages, executive and professional liability, fidelity and surety bonds, collateral protection, and umbrella and excess coverages. In 2003, AFC sold a substantial portion of its Personal segment; see Note P - "Subsequent Events." The Personal group wrote nonstandard and preferred/standard private passenger auto and other personal insurance coverage. AFC's annuity, life and health business markets primarily retirement products as well as life and supplemental health insurance. AFC's businesses operate throughout the United States. In 2002, 2001, and 2000, AFC derived less than 2% of its revenues from the sale of life and supplemental health products in Puerto Rico and less than 1% of its revenues from the sale of property and casualty insurance in Mexico, Canada, Puerto Rico, Europe and Asia.

The following tables (in thousands) show AFC's assets, revenues and operating profit (loss) by significant business segment. Operating profit (loss) represents total revenues less operating expenses.

	<u>2002</u>	<u>2001</u>	<u>2000</u>
<b>Assets</b>			
Property and casualty insurance (a)	\$ 9,960,769	\$ 8,796,909	\$ 8,200,683
Annuities and life	9,349,280	8,370,904	7,934,851
Other	<u>192,407</u>	<u>230,461</u>	<u>247,942</u>
	19,502,456	17,398,274	16,383,476
Investment in investees	<u>-</u>	<u>-</u>	<u>23,996</u>
	<u>\$19,502,456</u>	<u>\$17,398,274</u>	<u>\$16,407,472</u>
<b>Revenues (b)</b>			
Property and casualty insurance:			
Premiums earned:			
Specialty	\$ 1,497,088	\$ 1,409,497	\$ 1,223,435
Personal	905,246	1,182,651	1,270,328
Other lines (c)	<u>266</u>	<u>1,790</u>	<u>1,129</u>
	2,402,600	2,593,938	2,494,892
Investment and other income	<u>410,947</u>	<u>458,410</u>	<u>450,537</u>
	2,813,547	3,052,348	2,945,429
Annuities and life (d)	897,365	855,733	823,586
Other	<u>33,809</u>	<u>21,384</u>	<u>51,095</u>
	<u>\$ 3,744,721</u>	<u>\$ 3,929,465</u>	<u>\$ 3,820,110</u>
<b>Operating Profit (Loss)</b>			
Property and casualty insurance:			
Underwriting:			
Specialty	\$ 24,544	(\$ 23,274)	(\$ 94,857)
Personal	1,339	(93,254)	(108,372)
Other lines (c) (e)	<u>(52,207)</u>	<u>(110,987)</u>	<u>1,342</u>
	(26,324)	(227,515)	(201,887)
Investment and other income	<u>211,424</u>	<u>296,725</u>	<u>289,549</u>
	185,100	69,210	87,662
Annuities and life	61,553	100,864	96,211
Other (f)	<u>(51,397)</u>	<u>(99,693)</u>	<u>(63,614)</u>
	<u>\$ 195,256</u>	<u>\$ 70,381</u>	<u>\$ 120,259</u>

- (a) Not allocable to segments.
- (b) Revenues include sales of products and services as well as other income earned by the respective segments.
- (c) Represents development of lines in "run-off"; AFC has ceased underwriting new business in these operations.
- (d) Represents primarily investment income.
- (e) Includes a special charge of \$100 million in 2001 related to asbestos and other environmental matters ("A&E").
- (f) Includes holding company expenses.

**AMERICAN FINANCIAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

**D. Investments** Fixed maturities and other stocks at December 31 consisted of the following (in millions):

	2002				2001			
	<u>Amortized Cost</u>	<u>Market Value</u>	<u>Gross Gains</u>	<u>Unrealized Losses</u>	<u>Amortized Cost</u>	<u>Market Value</u>	<u>Gross Gains</u>	<u>Unrealized Losses</u>
Fixed maturities:								
United States Government and government agencies and authorities	\$ 1,353.6	\$ 1,402.0	\$ 49.5	(\$ 1.1)	\$ 1,000.1	\$ 1,017.8	\$ 21.7	(\$ 4.0)
States, municipalities and political subdivisions	584.4	615.2	36.4	(5.6)	405.6	414.9	16.2	(6.9)
Foreign government	163.3	169.9	6.6	-	105.5	108.8	3.5	(.2)
Public utilities	1,038.9	1,058.3	43.4	(24.0)	772.0	778.8	14.4	(7.6)
Mortgage-backed securities	3,106.6	3,232.1	134.6	(9.1)	2,632.9	2,702.5	89.5	(19.9)
All other corporate	5,241.8	5,462.7	312.0	(91.1)	5,616.6	5,673.5	160.2	(103.3)
Redeemable preferred stocks	61.1	66.7	7.8	(2.2)	60.5	52.3	.8	(9.0)
	<u>\$11,549.7</u>	<u>\$12,006.9</u>	<u>\$590.3</u>	<u>(\$133.1)</u>	<u>\$10,593.2</u>	<u>\$10,748.6</u>	<u>\$306.3</u>	<u>(\$150.9)</u>
Other stocks	<u>\$ 173.9</u>	<u>\$ 299.1</u>	<u>\$129.9</u>	<u>(\$ 4.7)</u>	<u>\$ 187.8</u>	<u>\$ 313.7</u>	<u>\$135.7</u>	<u>(\$ 9.8)</u>

The table below sets forth the scheduled maturities of fixed maturities based on market value as of December 31, 2002. Asset-backed securities and other securities with sinking funds are reported at average maturity. Data based on amortized cost is generally the same. Actual maturities may differ from contractual maturities because certain securities may be called or prepaid by the issuers. Mortgage-backed securities had an average life of approximately five years at December 31, 2002.

<u>Maturity</u>	
One year or less	6%
After one year through five years	23
After five years through ten years	33
After ten years	<u>11</u>
	73
Mortgage-backed securities	<u>27</u>
	<u>100%</u>

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

The only investment which exceeds 10% of Shareholders' Equity is an equity investment in Provident Financial Group, Inc., having a market value of \$189 million and \$191 million at December 31, 2002 and 2001, respectively.

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

	<u>Fixed Maturities</u>	<u>Equity Securities</u>	<u>Tax Effects</u>	<u>Total</u>
<u>2002</u>				
Realized	(\$ 61,081)	(\$17,854)	\$ 27,582	(\$ 51,353)
Change in Unrealized	301,800	(700)	(103,800)	197,300
<u>2001</u>				
Realized	(15,315)	(8,825)	8,451	(15,689)
Change in Unrealized	139,000	(84,500)	(19,200)	35,300
<u>2000</u>				
Realized	(24,186)	(2,395)	9,303	(17,278)
Change in Unrealized	255,200	29,900	(98,200)	186,900

**AMERICAN FINANCIAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

Gross gains and losses on fixed maturity investment transactions included in the Statement of Cash Flows consisted of the following (in millions):

	<u>2002</u>	<u>2001</u>	<u>2000</u>
Gross Gains	\$155.4	\$108.9	\$15.9
Gross Losses	(\$216.5)	(\$124.2)	(\$40.1)

- E. Goodwill and Other Intangibles** Effective January 1, 2002, goodwill is no longer amortized but is subject to annual impairment testing under a two step process. Under the first step, an entity's net assets are classified by reporting units and compared to their fair value. Fair value was estimated based primarily on the present value of expected future cash flows. If the carrying amount of a reporting unit exceeds its fair value, the second step of the goodwill impairment test is performed to measure the amount of impairment loss, if any. In the second quarter of 2002, AFC completed the first step of its transitional impairment test and identified potential impairment of goodwill in its annuities and life insurance segment and the personal lines segment of its property and casualty insurance business. The second step of the impairment test, measuring the amount of impairment loss, was completed in the fourth quarter with a resulting \$40.4 million impairment charge reported by restating first quarter 2002 results for the cumulative effect of a change in accounting principle. The impairment charge for the annuities and life insurance segment was related to a decrease in estimated future earnings based upon lower forecasted new business sales over the next few years. The impairment charge for the personal lines segment related primarily to planned future reductions in new business volume written through the direct channel.

If the goodwill amortization of \$13.8 million and \$16.5 million in the years 2001 and 2000, respectively, had not been expensed, net earnings (loss) for the periods would have been earnings of \$16.3 million and a loss of \$15.6 million.

Changes in the carrying value of goodwill during 2002, by reporting segment, are presented in the following table (in thousands):

	<u>Property and Casualty</u>		<u>Annuities</u>	<u>Total</u>
	<u>Specialty</u>	<u>Personal</u>	<u>and Life</u>	
Balance December 31, 2001	\$154,339	\$117,391	\$40,404	\$312,134
Goodwill from acquisitions	-	-	1,461	1,461
Transitional impairment charge	-	(39,600)	(21,184)	(60,784)
Other	(4,128)	-	-	(4,128)
Balance December 31, 2002	<u>\$150,211</u>	<u>\$ 77,791</u>	<u>\$20,681</u>	<u>\$248,683</u>

Included in deferred acquisition costs in AFC's Balance Sheet are \$66.8 million and \$71.2 million at December 31, 2002 and 2001, respectively, representing the present value of future profits ("PVFP") related to acquisitions by AFC's annuity and life business. The PVFP amounts are net of \$57.3 million and \$45.5 million of accumulated amortization. Amortization of the PVFP was \$11.8 million in 2002, \$9.2 million in 2001 and \$10.7 million in 2000. During each of the next five years, the PVFP is expected to decrease at a rate of approximately 13% of the balance at the beginning of each respective year.

- F. Payable to American Financial Group** AFC has a reciprocal Master Credit Agreement with various AFG holding companies under which these companies make funds available to each other for general corporate purposes. Amounts borrowed under the agreement bear interest at 1% over LIBOR.

**AMERICAN FINANCIAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

**G. Long-Term Debt** Long-term debt consisted of the following at December 31, (in thousands):

	<u>2002</u>	<u>2001</u>
<b>Holding Companies:</b>		
AFC notes payable under bank line	\$248,000	\$203,000
American Premier Underwriters, Inc. ("APU") 10-7/8% Subordinated Notes due May 2011, including premium of \$777 and \$836 (imputed rate - 9.6%)	11,498	11,557
Other	<u>8,014</u>	<u>13,695</u>
	<u>\$267,512</u>	<u>\$228,252</u>
<b>Subsidiaries:</b>		
GAFRI 6-7/8% Senior Notes due June 2008	\$100,000	\$100,000
GAFRI notes payable under bank line	148,600	121,100
Notes payable secured by real estate	35,610	36,253
Other	<u>12,561</u>	<u>13,399</u>
	<u>\$296,771</u>	<u>\$270,752</u>

At December 31, 2002, sinking fund and other scheduled principal payments on debt for the subsequent five years were as follows (in millions):

	<u>Holding Companies</u>	<u>Subsidiaries</u>	<u>Total</u>
2003	\$ 78.0	\$ 2.1	\$ 80.1
2004	-	150.8	150.8
2005	170.0	11.3	181.3
2006	-	19.6	19.6
2007	5.1	.2	5.3

In November 2002, AFC replaced its \$300 million bank credit line with a new bank credit agreement. Currently, AFC may borrow up to \$280 million under the new agreement; the line may be expanded to \$300 million through the end of 2003. The new line consists of two facilities: a 364-day revolving facility, extendable annually, for one-third of the total line and a three-year revolving facility for the remaining two-thirds. Amounts borrowed bear interest at rates ranging from 1.25% to 2.25% over LIBOR based on AFG's credit rating. In addition, GAFRI has an unsecured credit agreement under which it can borrow up to \$155 million at floating rates based on prime or Eurodollar rates through December 2004.

Cash interest payments of \$32 million, \$50 million and \$58 million were made on long-term debt in 2002, 2001 and 2000, respectively. Interest expense in the Statement of Operations includes interest credited on funds held by AFC's insurance subsidiaries under reinsurance contracts and other similar agreements as follows: 2002 - \$11.7 million; 2001 - \$7.1 million; and 2000 - \$9.5 million.

**AMERICAN FINANCIAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

**H. Minority Interest** Minority interest in AFC's balance sheet is comprised of the following (in thousands):

	<u>2002</u>	<u>2001</u>
Interest of AFG (parent) and noncontrolling shareholders in subsidiaries' common stock	\$351,559	\$317,824
Preferred securities issued by subsidiary trusts	<u>142,913</u>	<u>142,913</u>
	<u>\$494,472</u>	<u>\$460,737</u>

**Subsidiary Preferred Securities** Wholly-owned subsidiary trusts of GAFRI have issued preferred securities and, in turn, purchased a like amount of subordinated debt which provides interest and principal payments to fund the respective trusts' obligations. The preferred securities must be redeemed upon maturity or redemption of the subordinated debt. GAFRI effectively provides unconditional guarantees of its trusts' obligations.

The preferred securities consisted of the following (in thousands):

<u>Date of Issuance</u>	<u>Issue (Maturity Date)</u>	<u>2002</u>	<u>2001</u>	<u>Optional Redemption Dates</u>
November 1996	GAFRI 9-1/4% TOPrs (2026)	\$72,913	\$72,913	Currently redeemable
March 1997	GAFRI 8-7/8% Pfd (2027)	70,000	70,000	On or after 3/1/2007

**Minority Interest Expense** Minority interest expense is comprised of (in thousands):

	<u>2002</u>	<u>2001</u>	<u>2000</u>
Interest of AFG (parent) and noncontrolling shareholders in earnings of subsidiaries	\$19,136	\$14,879	\$ 6,092
Accrued distributions by subsidiaries on preferred securities, net of tax	<u>8,424</u>	<u>11,075</u>	<u>11,959</u>
	<u>\$27,560</u>	<u>\$25,954</u>	<u>\$18,051</u>

**I. Shareholders' Equity** At December 31, 2002, and 2001, American Financial Group beneficially owned all of the outstanding shares of AFC's Common Stock.

**Preferred Stock** Under provisions of both the Nonvoting (4.0 million shares authorized) and Voting (4.0 million shares authorized) Cumulative Preferred Stock, the Board of Directors may divide the authorized stock into series and set specific terms and conditions of each series. At December 31, 2002 and 2001, the outstanding voting shares of AFC's Preferred Stock consisted of the following:

**Series J**, no par value; \$25.00 liquidating value per share; annual dividends per share \$2.00; redeemable at AFC's option at \$25.75 per share beginning December 2005 declining to \$25.00 at December 2007 and thereafter; 2,886,161 shares (stated value \$72.2 million) outstanding at December 31, 2002 and 2001.

**AMERICAN FINANCIAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

**Unrealized Gain (Loss) on Marketable Securities, Net** The change in unrealized gain (loss) on marketable securities included the following (in millions):

	<u>Pretax</u>	<u>Tax Effects</u>	<u>Minority Interest</u>	<u>Net</u>
<u>2002</u>				
Unrealized holding gains on securities arising during the period	\$195.2	(\$66.4)	(\$15.5)	\$113.3
Realized losses included in net income	<u>78.9</u>	<u>(27.7)</u>	<u>(4.7)</u>	<u>46.5</u>
Change in unrealized gain on marketable securities, net	<u>\$274.1</u>	<u>(\$94.1)</u>	<u>(\$20.2)</u>	<u>\$159.8</u>
<u>2001</u>				
Unrealized holding gains (losses) on securities arising during the period	\$ 0.8	(\$ 0.3)	(\$ 5.0)	(\$ 4.5)
Adoption of EITF 99-20	16.9	(6.0)	(0.9)	10.0
Realized losses included in net income and unrealized gains of subsidiary sold	<u>23.6</u>	<u>(8.3)</u>	<u>(3.1)</u>	<u>12.2</u>
Change in unrealized gain on marketable securities, net	<u>\$ 41.3</u>	<u>(\$14.6)</u>	<u>(\$ 9.0)</u>	<u>\$ 17.7</u>
<u>2000</u>				
Unrealized holding gains on securities arising during the period	\$221.1	(\$75.8)	(\$18.8)	\$126.5
Adoption of SFAS No. 133	15.0	(5.3)	-	9.7
Realized gains included in net income and unrealized losses of subsidiary sold	<u>31.3</u>	<u>(10.9)</u>	<u>(2.7)</u>	<u>17.7</u>
Change in unrealized gain on marketable securities, net	<u>\$267.4</u>	<u>(\$92.0)</u>	<u>(\$21.5)</u>	<u>\$153.9</u>

**J. Income Taxes** The following is a reconciliation of income taxes at the statutory rate of 35% and income taxes as shown in the Statement of Operations (in thousands):

	<u>2002</u>	<u>2001</u>	<u>2000</u>
Earnings (loss) before income taxes:			
Operating	\$195,256	\$70,381	\$120,259
Minority interest expense	(32,096)	(31,917)	(24,491)
Equity in net losses of investees	(13,830)	(25,462)	(142,230)
Accounting changes	<u>(57,716)</u>	<u>(15,948)</u>	<u>(13,882)</u>
Total	<u>\$ 91,614</u>	<u>(\$ 2,946)</u>	<u>(\$ 60,344)</u>
Income taxes at statutory rate	\$ 32,065	(\$ 1,031)	(\$ 21,120)
Effect of:			
Adjustment to prior year taxes	(33,192)	(6,317)	-
Minority interest	5,602	4,881	2,177
Effect of foreign operations	(4,212)	(3,421)	951
Amortization and writeoff of intangibles	3,711	4,568	5,537
Losses utilized	(3,300)	(1,245)	(7,000)
Dividends received deduction	(2,313)	(2,317)	(2,378)
Tax exempt interest	(1,367)	(1,233)	(1,571)
Nondeductible meals, etc.	992	1,381	1,300
State income taxes	153	781	298
Tax credits	-	(1,243)	(5,757)
Other	<u>(875)</u>	<u>(300)</u>	<u>(656)</u>
Total Provision (Credit)	<u>(2,736)</u>	<u>(5,496)</u>	<u>(28,219)</u>
Amounts applicable to:			
Minority interest expense	4,536	5,963	6,440
Equity in net losses of investees	4,840	8,912	49,781
Accounting changes	<u>17,356</u>	<u>5,908</u>	<u>4,810</u>
Provision for income taxes as shown on the Statement of Operations	<u>\$ 23,996</u>	<u>\$15,287</u>	<u>\$ 32,812</u>

**AMERICAN FINANCIAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

Total earnings before income taxes include income subject to tax in foreign jurisdictions of \$17.8 million in 2002, \$8.3 million in 2001 and \$10.6 million in 2000.

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

	<u>2002</u>	<u>2001</u>	<u>2000</u>
Current taxes:			
Federal	\$17,535	\$44,715	\$10,324
Foreign	2,293	-	1,106
State	236	1,201	459
Deferred taxes:			
Federal	(24,492)	(50,679)	(39,588)
Foreign	<u>1,692</u>	<u>(733)</u>	<u>(520)</u>
	<u>(\$ 2,736)</u>	<u>(\$ 5,496)</u>	<u>(\$28,219)</u>

For income tax purposes, certain members of the AFC consolidated tax group had the following carryforwards available at December 31, 2002 (in millions):

	<u>Expiring</u>	<u>Amount</u>
Operating Loss	{ 2003 - 2007	\$11
	{ 2008 - 2017	-
	{ 2018 - 2020	89
Other - Tax Credits		11

Deferred income tax assets and liabilities reflect temporary differences between the carrying amounts of assets and liabilities recognized for financial reporting purposes and the amounts recognized for tax purposes. The significant components of deferred tax assets and liabilities included in the Balance Sheet at December 31, were as follows (in millions):

	<u>2002</u>	<u>2001</u>
Deferred tax assets:		
Net operating loss carryforwards	\$ 35.4	\$ 68.3
Insurance claims and reserves	278.6	268.2
Other, net	<u>108.8</u>	<u>96.4</u>
	422.8	432.9
Valuation allowance for deferred tax assets	<u>(34.9)</u>	<u>(40.9)</u>
	387.9	392.0
Deferred tax liabilities:		
Deferred acquisition costs	(242.6)	(231.5)
Investment securities	<u>(188.3)</u>	<u>(109.0)</u>
	(430.9)	(340.5)
Net deferred tax asset (liability)	<u>(\$ 43.0)</u>	<u>\$ 51.5</u>

The gross deferred tax asset has been reduced by a valuation allowance based on an analysis of the likelihood of realization. Factors considered in assessing the need for a valuation allowance include: (i) recent tax returns, which show neither a history of large amounts of taxable income nor cumulative losses in recent years, (ii) opportunities to generate taxable income from sales of appreciated assets, and (iii) the likelihood of generating larger amounts of taxable income in the future. The likelihood of realizing this asset will be reviewed periodically; any adjustments required to the valuation allowance will be made in the period in which the developments on which they are based become known.

Cash payments for income taxes, net of refunds, were \$30.0 million, \$10.0 million and \$24.4 million for 2002, 2001 and 2000, respectively.



## AMERICAN FINANCIAL CORPORATION AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

- K. Equity in Losses of Investees** In addition to the start-up manufacturing operations discussed in Note B, and prior to Chiquita's March 2002 restructuring, AFC owned 24 million shares (31% as of December 31, 2001) of Chiquita common stock. Chiquita is a leading international marketer, producer and distributor of quality fresh fruits and vegetables and processed foods.

In January 2001, Chiquita announced a restructuring initiative that included discontinuing all interest and principal payments on its public debt. Due to the expected restructuring, AFC recorded a fourth quarter 2000 pretax charge of \$95.7 million to write down its investment in Chiquita to quoted market value at December 31, 2000. In 2001, AFC suspended accounting for the investment under the equity method and reclassified the investment to "Other stocks". In the third quarter of 2001, AFC wrote down its investment in Chiquita by an additional \$8 million (to \$.67 per share). In March 2002, the court approved Chiquita's plan of reorganization under Chapter 11 of the U.S. Bankruptcy Code. Under the plan, over \$700 million in principal and accrued interest related to Chiquita's public debt was converted into common equity. As a result of the restructuring, AFC received approximately 171,000 "new" shares (less than one-half of 1%) in the reorganized company plus warrants expiring in 2009 to purchase an additional 2.9 million shares at \$19.23 per share. All of the shares and approximately 4% of the warrants have been sold.

For the year ended December 31, 2000, Chiquita reported net sales of \$2.25 billion, operating income of \$27 million, a net loss of \$95 million, and a net loss attributable to common shares of \$112 million.

- L. Commitments and Contingencies** Loss accruals (included in other liabilities) have been recorded for various environmental and occupational injury and disease claims and other contingencies arising out of the railroad operations disposed of by American Premier's predecessor, Penn Central Transportation Company ("PCTC"), prior to its bankruptcy reorganization in 1978 and certain manufacturing operations disposed of by American Premier.

At December 31, 2002, American Premier had liabilities for environmental and personal injury claims aggregating \$66.4 million. The environmental claims consist of a number of proceedings and claims seeking to impose responsibility for hazardous waste remediation costs related to certain sites formerly owned or operated by the railroad and manufacturing operations. Remediation costs are difficult to estimate for a number of reasons, including the number and financial resources of other potentially responsible parties, the range of costs for remediation alternatives, changing technology and the time period over which these matters develop. The personal injury claims include pending and expected claims, primarily by former employees of PCTC, for injury or disease allegedly caused by exposure to excessive noise, asbestos or other substances in the workplace. In December 2001, American Premier recorded a \$12.1 million charge to increase its environmental reserves due to an increase in expected ultimate claim costs. At December 31, 2002, American Premier had \$46.4 million of offsetting recovery assets (included in other assets) for such environmental and personal injury claims based upon estimates of probable recoveries from insurance carriers.

AFC has accrued approximately \$7 million at December 31, 2002, for environmental costs and certain other matters associated with the sales of former operations.

AFC's insurance subsidiaries continue to receive claims related to environmental exposures, asbestos and other mass tort claims. Establishing reserves for these claims is subject to uncertainties that are significantly greater than those presented by other types of claims. The liability for asbestos and environmental reserves at December 31, 2002 and 2001, respectively, was \$572 million and \$548 million; related recoverables from reinsurers (net of allowances for doubtful accounts) at those dates were \$105 million and \$101 million, respectively.

**AMERICAN FINANCIAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

While management believes AFC has recorded adequate reserves for the items discussed in this note, the outcome is uncertain and could result in liabilities exceeding amounts AFC has currently recorded. Additional amounts could have a material adverse effect on AFC's future results of operations and financial condition.

**M. Quarterly Operating Results (Unaudited)** The operations of certain of AFC's business segments are seasonal in nature. While insurance premiums are recognized on a relatively level basis, claim losses related to adverse weather (snow, hail, hurricanes, tornadoes, etc.) may be seasonal. Quarterly results necessarily rely heavily on estimates. These estimates and certain other factors, such as the nature of investees' operations and discretionary sales of assets, cause the quarterly results not to be necessarily indicative of results for longer periods of time.

The following are quarterly results of consolidated operations for the two years ended December 31, 2002 (in millions, except per share amounts).

	1st <u>Quarter</u>	2nd <u>Quarter</u>	3rd <u>Quarter</u>	4th <u>Quarter</u>	<u>Total Year</u>
<u>2002</u>					
Revenues	\$925.6	\$920.1	\$935.4	\$963.6	\$3,744.7
Earnings before accounting change	46.1	16.4	24.1	48.2	134.8
Cumulative effect of accounting change	(40.4)	-	-	-	(40.4)
Net earnings	5.7	16.4	24.1	48.2	94.4
<u>2001</u>					
Revenues	\$973.5	\$995.0	\$1,016.4	\$944.6	\$3,929.5
Earnings (loss) before accounting change	17.0	12.6	(51.9)	34.9	12.6
Cumulative effect of accounting change	-	(10.0)	-	-	(10.0)
Net earnings (loss)	17.0	2.6	(51.9)	34.9	2.6

Results for 2002 include a \$16 million tax benefit in the first quarter and a \$15 million tax benefit in the fourth quarter resulting from the reduction of previously accrued amounts due to the resolution of certain tax matters. Fourth quarter 2002 results also include a \$30 million charge related to the settlement of asbestos-related litigation.

The results for 2001 include goodwill amortization of approximately \$3.4 million per quarter.

The 2001 third quarter results include a \$100 million pretax charge to strengthen asbestos and environmental insurance reserves and pretax losses of \$25 million resulting from the World Trade Center terrorist attack.

AFC has realized gains (losses) on sales of subsidiaries in recent years (see Note B). Realized gains (losses) on securities, affiliates and other investments amounted to (in millions):

	1st <u>Quarter</u>	2nd <u>Quarter</u>	3rd <u>Quarter</u>	4th <u>Quarter</u>	<u>Total Year</u>
2002	(\$17.8)	(\$47.5)	(\$33.9)	\$9.5	(\$89.7)
2001	(8.5)	(26.4)	7.0	3.9	(24.0)

**AMERICAN FINANCIAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

**N. Insurance** Securities owned by insurance subsidiaries having a carrying value of just over \$1 billion at December 31, 2002, were on deposit as required by regulatory authorities.

**Insurance Reserves** The liability for losses and loss adjustment expenses for certain long-term scheduled payments under workers' compensation, auto liability and other liability insurance has been discounted at about 8%, an approximation of long-term investment yields. As a result, the total liability for losses and loss adjustment expenses at December 31, 2002, has been reduced by \$25 million.

The following table provides an analysis of changes in the liability for losses and loss adjustment expenses, net of reinsurance (and grossed up), over the past three years on a GAAP basis (in millions). Adverse development recorded in 2002 and 2001 in prior year reserves related primarily to charges for asbestos and certain Specialty lines in run-off.

	<u>2002</u>	<u>2001</u>	<u>2000</u>
Balance at beginning of period	\$3,253	\$3,192	\$3,224
Provision for losses and LAE occurring in the current year	1,664	1,950	2,056
Net increase (decrease) in provision for claims of prior years	<u>171</u>	<u>163</u>	<u>(60)</u>
Total losses and LAE incurred (*)	1,835	2,113	1,996
Payments for losses and LAE of:			
Current year	(594)	(831)	(905)
Prior years	<u>(1,094)</u>	<u>(1,036)</u>	<u>(936)</u>
Total payments	(1,688)	(1,867)	(1,841)
Reserves of businesses sold	-	(120)	(187)
Reclass to unearned premiums	<u>-</u>	<u>(65)</u>	<u>-</u>
Balance at end of period	<u>\$3,400</u>	<u>\$3,253</u>	<u>\$3,192</u>
Add back reinsurance recoverables, net of allowance	<u>1,804</u>	<u>1,525</u>	<u>1,324</u>
Gross unpaid losses and LAE included in the Balance Sheet	<u>\$5,204</u>	<u>\$4,778</u>	<u>\$4,516</u>

(\*) Before amortization of deferred gains on retroactive reinsurance of \$20 million in 2002, \$33 million in 2001 and \$34 million in 2000.

**Net Investment Income** The following table shows (in millions) investment income earned and investment expenses incurred by AFC's insurance companies.

	<u>2002</u>	<u>2001</u>	<u>2000</u>
Insurance group investment income:			
Fixed maturities	\$850.9	\$841.0	\$815.5
Equity securities	9.6	8.1	10.4
Other	<u>.6</u>	<u>1.1</u>	<u>4.3</u>
	861.1	850.2	830.2
Insurance group investment expenses (*)	<u>(40.4)</u>	<u>(36.8)</u>	<u>(41.4)</u>
	<u>\$820.7</u>	<u>\$813.4</u>	<u>\$788.8</u>

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

**AMERICAN FINANCIAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

**Statutory Information** AFC's insurance subsidiaries are required to file financial statements with state insurance regulatory authorities prepared on an accounting basis prescribed or permitted by such authorities (statutory basis). Net earnings and policyholders' surplus on a statutory basis for the insurance subsidiaries were as follows (in millions):

	<u>Net Earnings (Loss)</u>			<u>Policyholders'</u> <u>Surplus</u>	
	<u>2002</u>	<u>2001</u>	<u>2000</u>	<u>2002</u>	<u>2001</u>
Property and casualty companies	\$116	\$34	\$10	\$1,742	\$1,669
Life insurance companies	(24)	(25)	40	445	414

**Reinsurance** In the normal course of business, AFC's insurance subsidiaries cede reinsurance to other companies to diversify risk and limit maximum loss arising from large claims. To the extent that any reinsuring companies are unable to meet obligations under agreements covering reinsurance ceded, AFC's insurance subsidiaries would remain liable. The following table shows (in millions) (i) amounts deducted from property and casualty written and earned premiums in connection with reinsurance ceded, (ii) written and earned premiums included in income for reinsurance assumed and (iii) reinsurance recoveries deducted from losses and loss adjustment expenses.

	<u>2002</u>	<u>2001</u>	<u>2000</u>
Direct premiums written	\$4,027	\$3,573	\$3,365
Reinsurance assumed	80	94	76
Reinsurance ceded	<u>(1,693)</u>	<u>(1,114)</u>	<u>(803)</u>
Net written premiums	<u>\$2,414</u>	<u>\$2,553</u> (*)	<u>\$2,638</u>
Direct premiums earned	\$3,798	\$3,393	\$3,306
Reinsurance assumed	91	92	45
Reinsurance ceded	<u>(1,486)</u>	<u>(891)</u>	<u>(856)</u>
Net earned premiums	<u>\$2,403</u>	<u>\$2,594</u>	<u>\$2,495</u>
Reinsurance recoveries	<u>\$1,142</u>	<u>\$ 773</u>	<u>\$ 567</u>

(\*) Net of \$29.7 million unearned premium transfer related to the sale of the Japanese division.

- O. Additional Information** Total rental expense for various leases of office space and equipment was \$52 million, \$53 million and \$44 million for 2002, 2001 and 2000, respectively. Sublease rental income related to these leases totaled \$612,000 in 2002, \$2.4 million in 2001 and \$2.5 million in 2000.

Future minimum rentals, related principally to office space, required under operating leases having initial or remaining noncancelable lease terms in excess of one year at December 31, 2002, were as follows: 2003 - \$57 million; 2004 - \$50 million; 2005 - \$35 million; 2006 - \$26 million; 2007 - \$17 million and \$33 million thereafter. In addition, AFC has 99-year land leases (approximately 94 years remaining) at one of its real estate properties. Minimum lease payments under these leases are expected to be approximately \$180,000 in 2003 and are adjusted annually for inflation.

Other operating and general expenses included charges for possible losses on agents' balances, other receivables and other assets in the following amounts: 2002 - \$2.7 million; 2001 - \$3.5 million; and 2000 - \$9.7 million. Losses and loss adjustment expenses included charges for possible losses on reinsurance recoverables of \$6.6 million in 2002 and \$11 million in 2001. The aggregate allowance for all such losses amounted to approximately \$72 million and \$67 million at December 31, 2002 and 2001, respectively.

**AMERICAN FINANCIAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

**Unrealized Gain (Loss) on Marketable Securities, Net** In addition to adjusting equity securities and fixed maturity securities classified as "available for sale" to fair value, SFAS 115 requires that certain other balance sheet amounts be adjusted to the extent that unrealized gains and losses from securities would result in adjustments had those gains or losses actually been realized. The components of the Consolidated Balance Sheet caption "Unrealized gain on marketable securities, net" in shareholders' equity are summarized as follows (in millions):

	Unadjusted Asset (Liability)	Effect of SFAS 115	Adjusted Asset (Liability)
<u>2002</u>			
Fixed maturities	\$11,549.7	\$457.2	\$12,006.9
Other stocks	173.9	125.2	299.1
Deferred acquisition costs	873.1	(31.0)	842.1
Annuity benefits accumulated	(6,444.7)	(9.2)	(6,453.9)
Pretax unrealized		<u>542.2</u>	
Deferred taxes	144.3	(187.3)	(43.0)
Minority interest	(456.3)	<u>(38.2)</u>	(494.5)
Unrealized gain		<u>\$316.7</u>	
<u>2001</u>			
Fixed maturities	\$10,593.2	\$155.4	\$10,748.6
Other stocks	187.8	125.9	313.7
Deferred acquisition costs	827.3	(9.0)	818.3
Annuity benefits accumulated	(5,827.9)	(4.2)	(5,832.1)
Pretax unrealized		<u>268.1</u>	
Deferred taxes	144.7	(93.2)	51.5
Minority interest	(442.7)	<u>(18.0)</u>	(460.7)
Unrealized gain		<u>\$156.9</u>	

**Fair Value of Financial Instruments** The following table presents (in millions) the carrying value and estimated fair value of AFC's financial instruments at December 31.

	<u>2002</u>		<u>2001</u>	
	<u>Carrying Value</u>	<u>Fair Value</u>	<u>Carrying Value</u>	<u>Fair Value</u>
<b>Assets:</b>				
Fixed maturities	\$12,007	\$12,007	\$10,749	\$10,749
Other stocks	299	299	314	314
<b>Liabilities:</b>				
Annuity benefits accumulated	\$ 6,454	\$ 6,284	\$ 5,832	\$ 5,659
Long-term debt:				
Holding companies	268	268	228	229
Subsidiaries	297	287	271	264
<b>Minority Interest:</b>				
Trust preferred securities	\$ 143	\$ 139	\$ 143	\$ 143
AFC preferred stock	72	54	72	61

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

## AMERICAN FINANCIAL CORPORATION AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

**Financial Instruments with Off-Balance-Sheet Risk** On occasion, AFC and its subsidiaries have entered into financial instrument transactions which may present off-balance-sheet risks of both a credit and market risk nature. These transactions include commitments to fund loans, loan guarantees and commitments to purchase and sell securities or loans. At December 31, 2002, AFC and its subsidiaries had commitments to fund credit facilities and contribute limited partnership capital totaling up to \$18 million.

**Restrictions on Transfer of Funds and Assets of Subsidiaries** Payments of dividends, loans and advances by AFC's subsidiaries are subject to various state laws, federal regulations and debt covenants which limit the amount of dividends, loans and advances that can be paid. Under applicable restrictions, the maximum amount of dividends available to AFC in 2003 from its insurance subsidiaries without seeking regulatory clearance is approximately \$24 million. Additional amounts of dividends, loans and advances require regulatory approval.

**Benefit Plans** AFC expensed approximately \$20 million in 2002, \$19 million in 2001 and \$22 million in 2000 for its retirement and employee savings plans.

**Transactions With Affiliates** AFG purchased a \$3.7 million minority interest in a residential homebuilding company from an unrelated party in 1995. At that same time, a brother of AFC's chairman purchased a minority interest in the company for \$825,000. In 2000, that brother and another brother of AFC's chairman acquired the remaining shares from the third parties. In addition, GAFRI had extended a line of credit to this company under which the homebuilder could borrow up to \$8 million at 13%. At December 31, 2001, \$6.4 million was due under the credit line. In September 2002, the homebuilding company was sold to an unrelated party and GAFRI's line of credit was repaid and terminated.

In 2001, an AFC subsidiary purchased a 29% interest in an aircraft for \$1.6 million (fair value as determined by independent third party) from a company owned by a brother of AFC's chairman. The remaining interests in the aircraft are owned by AFC's chairman and his two brothers. Costs of operating the aircraft are being borne proportionately.

In September 2000, GAFRI's minority ownership in a company engaged in the production of ethanol was repurchased by that company for \$7.5 million in cash and \$21.9 million liquidation value of non-voting redeemable preferred stock. Following the repurchase, AFC's Chairman beneficially owns 100% of the ethanol company. In December 2000, the ethanol company retired \$3 million of the preferred stock at liquidation value plus accrued dividends and issued an \$18.9 million subordinated note in exchange for the remaining preferred stock. The subordinated note bears interest at 12-1/4% with scheduled repayments through 2005. During 2002 and 2001, respectively, \$1 million and \$6 million of this note was repaid. The ethanol company also owes GAFRI \$4.0 million under a subordinated note bearing interest at 14%. In addition, Great American has extended a \$10 million line of credit to this company; no amounts have been borrowed under the credit line.

#### **P. Subsequent Events (unaudited)**

**Infinity Property and Casualty Corporation** On December 31, 2002, AFC transferred to Infinity Property and Casualty Corporation ("Infinity", a newly formed subsidiary) the following subsidiaries involved primarily in the issuance of nonstandard auto policies: Atlanta Casualty Company, Infinity Insurance Company, Leader Insurance Company and Windsor Insurance Company. Effective January 1, 2003, Great American Insurance Company, an AFC subsidiary, transferred to Infinity its personal insurance business written through independent agents. In February 2003, AFC sold 61% of Infinity in a public offering. The businesses transferred generated aggregate net written premiums

## AMERICAN FINANCIAL CORPORATION AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

of approximately \$690 million, \$900 million and \$1.2 billion for the years ended December 31, 2002, 2001, and 2000, respectively. AFC expects to realize a pretax loss of about \$40 million on the sale in the first quarter of 2003. In addition, a substantial tax benefit related to AFC's book versus tax basis in Infinity stock may be available.

**Direct automobile insurance business** In January 2003, AFC reached an agreement to sell two of its subsidiaries that market automobile insurance directly to customers. The transaction will include the transfer of Great American Insurance's right to renew certain of its personal automobile insurance business written on a direct basis in selected markets. Premiums generated by the businesses being sold were approximately \$79 million in 2002. AFC does not expect to report a significant gain or loss on the sale.

**PART IV**

**ITEM 15**

**Exhibits, Financial Statement Schedules and Reports on Form 8-K**

(a) Documents filed as part of this Report:

1. Financial Statements are included in Part II, Item 8.

2. Financial Statement Schedules:

A. Selected Quarterly Financial Data is included in Note M to the Consolidated Financial Statements.

B. Schedules filed herewith for 2002, 2001 and 2000:

I - Condensed Financial Information of Registrant	<u>Page</u> S-2
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V - Supplemental Information Concerning Property-Casualty Insurance Operations	S-4
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All other schedules for which provisions are made in the applicable regulation of the Securities and Exchange Commission have been omitted as they are not applicable, not required, or the information required thereby is set forth in the Financial Statements or the notes thereto.

3. Exhibits - see Exhibit Index on page E-1.

(b) Report on Form 8-K: none



**AMERICAN FINANCIAL CORPORATION - PARENT ONLY (\*)**  
**SCHEDULE I - CONDENSED FINANCIAL INFORMATION OF REGISTRANT**  
(In Thousands)

**Condensed Balance Sheet**

	December 31	
	2002	2001
<b>Assets:</b>		
Cash and short-term investments	\$ 5,778	\$ 13,636
Investment in securities	1,152	2,502
Receivables from affiliates	11,376	45,565
Investment in subsidiaries	3,446,378	3,005,541
Other assets	94,232	43,742
	<u>\$3,558,916</u>	<u>\$3,110,986</u>
<b>Liabilities and Shareholders' Equity:</b>		
Accounts payable, accrued expenses and other liabilities	\$ 65,257	\$ 100,201
Payables to affiliates	1,507,922	1,316,159
Long-term debt	256,014	216,695
Shareholders' equity	1,729,723	1,477,931
	<u>\$3,558,916</u>	<u>\$3,110,986</u>

**Condensed Statement of Operations**

	Year Ended December 31,		
	2002	2001	2000
<b>Income:</b>			
Dividends from subsidiaries	\$ 75,722	\$ 60,000	\$25,000
Equity in undistributed earnings of subsidiaries	141,686	45,046	37,570
Realized gains (losses) on investments	(33)	849	(9)
Investment and other income	5,242	11,288	16,833
	<u>222,617</u>	<u>117,183</u>	<u>79,394</u>
<b>Costs and Expenses:</b>			
Interest charges on intercompany borrowings	28,599	44,212	58,283
Interest charges on other borrowings	6,400	11,794	12,415
Other operating and general expenses	38,288	48,175	55,158
	<u>73,287</u>	<u>104,181</u>	<u>125,856</u>
Earnings (loss) before income taxes and accounting changes	149,330	13,002	(46,462)
Provision (credit) for income taxes	14,620	412	(23,409)
Earnings (loss) before accounting changes	134,710	12,590	(23,053)
Cumulative effect of accounting changes	(40,360)	(10,040)	(9,072)
<b>Net Earnings (Loss)</b>	<u>\$94,350</u>	<u>\$ 2,550</u>	<u>(\$ 32,125)</u>

**AMERICAN FINANCIAL CORPORATION - PARENT ONLY**  
**SCHEDULE I - CONDENSED FINANCIAL INFORMATION OF REGISTRANT - CONTINUED**  
(In Thousands)

**Condensed Statement of Cash Flows**

	<u>Year Ended December 31,</u>		
	<u>2002</u>	<u>2001</u>	<u>2000</u>
<b>Operating Activities:</b>			
Net earnings (loss)	\$ 94,350	\$ 2,550	(\$ 32,125)
Adjustments:			
Cumulative effect of accounting changes	40,360	10,040	9,072
Equity in earnings of subsidiaries	(118,116)	(65,126)	(47,903)
Depreciation and amortization	3,510	4,249	1,647
Realized losses (gains) on investments	412	(2,432)	9
Change in receivables from and payables to affiliates	54,404	54,243	41,095
Increase in other assets	(75,655)	(33,901)	(4,744)
Increase (decrease) in payables	(32,931)	32,536	(35,548)
Dividends from subsidiaries	48,450	60,000	25,000
Other, net	1,424	83	894
	<u>16,208</u>	<u>62,242</u>	<u>(42,603)</u>
<b>Investing Activities :</b>			
Capital contributions to subsidiaries	(156,041)	(67,514)	-
Purchases of property and equipment	(1,429)	(4,620)	(8,940)
Other, net	1,542	1,233	(1,634)
	<u>(155,928)</u>	<u>(70,901)</u>	<u>(10,574)</u>
<b>Financing Activities:</b>			
Additional long-term borrowings	192,060	135,338	165,800
Reductions of long-term debt	(153,414)	(112,152)	(56,485)
Borrowings from affiliates	128,155	104,377	80,388
Repayments of borrowings from affiliates	(38,500)	(119,000)	(149,525)
Capital contributions from parent	9,333	18,667	18,667
Cash dividends paid	(5,772)	(5,772)	(5,772)
	<u>131,862</u>	<u>21,458</u>	<u>53,073</u>
<b>Net Increase (Decrease) in Cash and Short-term Investments</b>	(7,858)	12,799	(104)
Cash and short-term investments at beginning of period	<u>13,636</u>	<u>837</u>	<u>941</u>
Cash and short-term investments at end of period	<u>\$ 5,778</u>	<u>\$ 13,636</u>	<u>\$ 837</u>

**AMERICAN FINANCIAL CORPORATION AND SUBSIDIARIES**  
**SCHEDULE V - SUPPLEMENTAL INFORMATION CONCERNING**  
**PROPERTY-CASUALTY INSURANCE OPERATIONS**  
**THREE YEARS ENDED DECEMBER 31, 2002**  
**(IN MILLIONS)**

COLUMN A	COLUMN B	COLUMN C	COLUMN D	COLUMN E	COLUMN F	COLUMN G	COLUMN H		COLUMN I	COLUMN J	COLUMN K
AFFILIATION WITH REGISTRANT	DEFERRED POLICY ACQUISITION COSTS	(a) RESERVES FOR UNPAID CLAIMS AND CLAIMS ADJUSTMENT EXPENSES	(b) DISCOUNT DEDUCTED IN COLUMN C	(c) UNEARNED PREMIUMS	EARNED PREMIUMS	NET INVESTMENT INCOME	CLAIMS AND CLAIM ADJUSTMENT EXPENSES INCURRED RELATED TO		AMORTIZATION OF DEFERRED POLICY ACQUISITION COSTS	PAID CLAIMS AND CLAIM ADJUSTMENT EXPENSES	PREMIUMS WRITTEN
							CURRENT YEARS	PRIOR YEARS			

CONSOLIDATED PROPERTY-CASUALTY ENTITIES

2002	<u>\$251</u>	<u>\$5,204</u>	<u>\$25</u>	<u>\$1,848</u>	<u>\$2,403</u>	<u>\$294</u>	<u>\$1,664</u>	<u>\$171</u>	<u>\$429</u>	<u>\$1,688</u>	<u>\$2,414</u>
2001	<u>\$262</u>	<u>\$4,778</u>	<u>\$24</u>	<u>\$1,641</u>	<u>\$2,594</u>	<u>\$309</u>	<u>\$1,950</u>	<u>\$163</u>	<u>\$556</u>	<u>\$1,867</u>	<u>\$2,553</u>
2000					<u>\$2,495</u>	<u>\$297</u>	<u>\$2,056</u>	<u>(\$ 60)</u>	<u>\$560</u>	<u>\$1,841</u>	<u>\$2,638</u>

(a) Grossed up for reinsurance recoverables of \$1,804 and \$1,525 at December 31, 2002 and 2001, respectively.

(b) Discounted at approximately 8%.

(c) Grossed up for prepaid reinsurance premiums of \$679 and \$477 at December 31, 2002 and 2001, respectively.

## Signatures

Pursuant to the requirements of Section 13 of the Securities Exchange Act of 1934, American Financial Corporation has duly caused this Report to be signed on its behalf by the undersigned, duly authorized.

American Financial Corporation

Signed: March 27, 2003

BY: s/CARL H. LINDNER  
Carl H. Lindner  
Chairman of the Board and  
Chief Executive Officer

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Pursuant to the requirements of the Securities Exchange Act of 1934, this Report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated:

<u>Signature</u>	<u>Capacity</u>	<u>Date</u>
<u>s/CARL H. LINDNER</u> Carl H. Lindner	Chairman of the Board of Directors	March 27, 2003
<u>s/THEODORE H. EMMERICH</u> Theodore H. Emmerich	Director*	March 27, 2003
<u>s/JAMES E. EVANS</u> James E. Evans	Director	March 27, 2003
<u>s/CARL H. LINDNER III</u> Carl H. Lindner III	Director	March 27, 2003
<u>s/KEITH E. LINDNER</u> Keith E. Lindner	Director	March 27, 2003
<u>s/S. CRAIG LINDNER</u> S. Craig Lindner	Director	March 27, 2003
<u>s/WILLIAM R. MARTIN</u> William R. Martin	Director*	March 27, 2003
<u>s/WILLIAM W. VERITY</u> William W. Verity	Director*	March 27, 2003
<u>s/FRED J. RUNK</u> Fred J. Runk	Senior Vice President and Treasurer (principal financial and accounting officer)	March 27, 2003

\* Member of the Audit Committee

**AMERICAN FINANCIAL CORPORATION**

**SARBANES-OXLEY SECTION 302(a) CERTIFICATIONS**

I, Carl H. Lindner, certify that:

1. I have reviewed this annual report on Form 10-K of American Financial Corporation;
2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this annual report;
3. Based on my knowledge, the financial statements, and other financial information included in this annual report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this annual report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:
  - a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this annual report is being prepared;
  - b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this annual report (the "Evaluation Date"); and
  - c) presented in this annual report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):
  - a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
  - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. The registrant's other certifying officer and I have indicated in this annual report whether there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

March 27, 2003

BY: /s/Carl H. Lindner  
Carl H. Lindner  
Chairman of the Board and  
Chief Executive Officer  
(principal executive officer)

AMERICAN FINANCIAL CORPORATION

SARBANES-OXLEY SECTION 302(a) CERTIFICATIONS - CONTINUED

I, Fred J. Runk, certify that:

1. I have reviewed this annual report on Form 10-K of American Financial Corporation;
2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this annual report;
3. Based on my knowledge, the financial statements, and other financial information included in this annual report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this annual report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:
  - a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this annual report is being prepared;
  - b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this annual report (the "Evaluation Date"); and
  - c) presented in this annual report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):
  - a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
  - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. The registrant's other certifying officer and I have indicated in this annual report whether there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

March 27, 2003

BY: /s/Fred J. Runk  
Fred J. Runk  
Senior Vice President and Treasurer  
(principal financial officer)

## INDEX TO EXHIBITS

### AMERICAN FINANCIAL CORPORATION

<u>Number</u>	<u>Exhibit Description</u>	
3(a)	Amended and Restated Articles of Incorporation, filed as Exhibit 3(a) to AFC's Form 10-K for 1997	(*)
3(b)	Code of Regulations, filed as Exhibit 3(b) to AFC's Form 10-K for 1997.	(*)
4	Instruments defining the rights of security holders.	The rights of holders of Registrant's Preferred Stock are defined in the Articles of Incorporation. Registrant has no outstanding debt issues exceeding 10% of the assets of Registrant and consolidated subsidiaries.
	Management Contracts:	
10(a)	Nonqualified Auxiliary RASP, filed as Exhibit 10(a) to AFC's Form 10-K for 1998.	(*)
10(b)	2002 Annual Bonus Plan, filed as Exhibit 10 to AFC's March 31, 2002 Form 10-Q.	(*)
10(c)	Deferred Compensation Plan, filed as Exhibit 10 to AFG's Registration Statement No. 333-91945 on Form S-8 on December 2, 1999.	(*)
10(d)	Credit Agreement, dated as of November 25, 2002, among American Financial Group, Inc., as Guarantor, AFC Holding Company, as Guarantor, American Financial Corporation, as Borrower, Fleet National Bank, Bank of America, N.A. and KeyBank National Association filed as Exhibit 10 to AFG's Registration Statement No. 333-102556 on Form S-3 on February 4, 2003.	(*)
12	Computation of ratios of earnings to fixed charges.	_____
21	Subsidiaries of the Registrant.	_____
99	Certification of Chief Executive Officer and Chief Financial Officer	_____
(*)	Incorporated herein by reference.	

**AMERICAN FINANCIAL CORPORATION AND SUBSIDIARIES**

**EXHIBIT 12 - COMPUTATION OF RATIOS OF EARNINGS TO FIXED CHARGES  
(Dollars in Thousands)**

	Year Ended December 31,				
	<u>2002</u>	<u>2001</u>	<u>2000</u>	<u>1999</u>	<u>1998</u>
<u>Excluding Interest on Annuities</u>					
Pretax income (loss)	\$149,330	\$ 13,002	(\$ 46,462)	\$231,447	\$209,563
Minority interest in subsidiaries having fixed charges(*)	32,096	31,917	24,491	44,790	45,120
Less undistributed equity in losses of investees	13,830	25,462	142,230	32,156	17,997
Fixed charges:					
Interest expense	47,513	60,605	67,471	65,858	73,868
Debt discount (premium) and expense	414	599	318	(449)	(631)
One-third of rentals	<u>16,483</u>	<u>16,900</u>	<u>13,963</u>	<u>12,226</u>	<u>11,883</u>
<b>EARNINGS</b>	<b><u>\$259,666</u></b>	<b><u>\$148,485</u></b>	<b><u>\$202,011</u></b>	<b><u>\$386,028</u></b>	<b><u>\$357,800</u></b>
Fixed charges:					
Interest expense	\$ 47,513	\$ 60,605	\$ 67,471	\$ 65,858	\$ 73,868
Debt discount (premium) and expense	414	599	318	(449)	(631)
One-third of rentals	16,483	16,900	13,963	12,226	11,883
Pretax preferred dividend requirements of subsidiaries	<u>12,960</u>	<u>17,038</u>	<u>18,399</u>	<u>18,575</u>	<u>19,031</u>
<b>FIXED CHARGES</b>	<b><u>\$ 77,370</u></b>	<b><u>\$ 95,142</u></b>	<b><u>\$100,151</u></b>	<b><u>\$ 96,210</u></b>	<b><u>\$104,151</u></b>
Fixed charges and preferred dividends:					
Fixed charges - per above	\$ 77,370	\$ 95,142	\$100,151	\$ 96,210	\$104,151
Preferred dividends	<u>6,552</u>	<u>7,615</u>	<u>7,961</u>	<u>8,991</u>	<u>9,403</u>
<b>FIXED CHARGES AND PREFERRED DIVIDENDS</b>	<b><u>\$ 83,922</u></b>	<b><u>\$102,757</u></b>	<b><u>\$108,112</u></b>	<b><u>\$105,201</u></b>	<b><u>\$113,554</u></b>
Ratio of Earnings to Fixed Charges	<u>3.36</u>	<u>1.56</u>	<u>2.02</u>	<u>4.01</u>	<u>3.44</u>
Ratio of Earnings to Fixed Charges and Preferred Dividends	<u>3.09</u>	<u>1.45</u>	<u>1.87</u>	<u>3.67</u>	<u>3.15</u>
<u>Including Interest on Annuities</u>					
Earnings - per above	\$259,666	\$148,485	\$202,011	\$386,028	\$357,800
Interest on annuities	<u>300,966</u>	<u>294,654</u>	<u>293,171</u>	<u>262,632</u>	<u>261,666</u>
<b>EARNINGS</b>	<b><u>\$560,632</u></b>	<b><u>\$443,139</u></b>	<b><u>\$495,182</u></b>	<b><u>\$648,660</u></b>	<b><u>\$619,466</u></b>
Fixed charges - per above	\$ 77,370	\$ 95,142	\$100,151	\$ 96,210	\$104,151
Interest on annuities	<u>300,966</u>	<u>294,654</u>	<u>293,171</u>	<u>262,632</u>	<u>261,666</u>
<b>FIXED CHARGES</b>	<b><u>\$378,336</u></b>	<b><u>\$389,796</u></b>	<b><u>\$393,322</u></b>	<b><u>\$358,842</u></b>	<b><u>\$365,817</u></b>
Fixed charges and preferred dividends:					
Fixed charges - per above	\$378,336	\$389,796	\$393,322	\$358,842	\$365,817
Preferred dividends	<u>6,552</u>	<u>7,615</u>	<u>7,961</u>	<u>8,991</u>	<u>9,403</u>
<b>FIXED CHARGES AND PREFERRED DIVIDENDS</b>	<b><u>\$384,888</u></b>	<b><u>\$397,411</u></b>	<b><u>\$401,283</u></b>	<b><u>\$367,833</u></b>	<b><u>\$375,220</u></b>
Ratio of Earnings to Fixed Charges	<u>1.48</u>	<u>1.14</u>	<u>1.26</u>	<u>1.81</u>	<u>1.69</u>
Ratio of Earnings to Fixed Charges and Preferred Dividends	<u>1.46</u>	<u>1.12</u>	<u>1.23</u>	<u>1.76</u>	<u>1.65</u>
Earnings in Excess of Fixed Charges	<u>\$182,296</u>	<u>\$ 53,343</u>	<u>\$101,860</u>	<u>\$289,818</u>	<u>\$253,649</u>
Earnings in Excess of Fixed Charges and Preferred Dividends	<u>\$175,744</u>	<u>\$ 45,728</u>	<u>\$ 93,899</u>	<u>\$280,827</u>	<u>\$244,246</u>

(\*) Amounts include accrued distributions on trust preferred securities.



## AMERICAN FINANCIAL CORPORATION

### EXHIBIT 21 - SUBSIDIARIES OF THE REGISTRANT

The following is a list of subsidiaries of AFC at December 31, 2002. All corporations are subsidiaries of AFC and, if indented, subsidiaries of the company under which they are listed.

Name of Company	Incorporated	Percentage of Ownership
American Money Management Corporation	Ohio	100
American Premier Underwriters, Inc.	Pennsylvania	81
Infinity Property and Casualty Corporation	Ohio	100
Atlanta Casualty Company	Ohio	100
Infinity Insurance Company	Indiana	100
Infinity National Insurance Company	Indiana	100
Infinity Select Insurance Company	Indiana	100
Leader Insurance Company	Ohio	100
Leader Specialty Insurance Company	Indiana	100
TICO Insurance Company	Ohio	100
Windsor Insurance Company	Indiana	100
Regal Insurance Company	Indiana	100
Premier Lease & Loan Services Insurance Agency, Inc.	Washington	100
Premier Lease & Loan Services of Canada, Inc.	Washington	100
Republic Indemnity Company of America	California	100
Republic Indemnity Company of California	California	100
Great American Holding, Inc.	Ohio	100
Great American Security Insurance Company	Ohio	100
Great American Spirit Insurance Company	Indiana	100
Great American Insurance Company	Ohio	100
American Empire Surplus Lines Insurance Company	Delaware	100
American Empire Insurance Company	Ohio	100
Fidelity Excess and Surplus Insurance Company	Ohio	100
Brothers Property Corporation	Ohio	80
Great American Alliance Insurance Company	Ohio	100
Great American Assurance Company	Ohio	100
Great American Contemporary Insurance Company	Ohio	100
Great American Custom Insurance Services, Inc.	Ohio	100
Professional Risk Brokers, Inc.	Illinois	100
Great American E&S Insurance Company	Delaware	100
Great American Fidelity Insurance Company	Delaware	100
Great American Financial Resources, Inc.	Delaware	83
AAG Holding Company, Inc.	Ohio	100
American Annuity Group Capital Trust I	Delaware	100
American Annuity Group Capital Trust II	Delaware	100
Great American Life Insurance Company	Ohio	100
Annuity Investors Life Insurance Company	Ohio	100
Loyal American Life Insurance Company	Ohio	100
Manhattan National Life Insurance Company	Illinois	100
United Teacher Associates Insurance Company	Texas	100
Great American Life Assurance Company of Puerto Rico, Inc.	Puerto Rico	100
Great American Insurance Company of New York	New York	100
Great American Management Services, Inc.	Ohio	100
Great American Protection Insurance Company	Indiana	100
Mid-Continent Casualty Company	Oklahoma	100
Mid-Continent Insurance Company	Oklahoma	100
Oklahoma Surety Company	Oklahoma	100
National Interstate Corporation	Ohio	68
National Interstate Insurance Company	Ohio	100
National Interstate Insurance Company of Hawaii, Inc.	Hawaii	100
Transport Insurance Company	Ohio	100
Worldwide Insurance Company	Ohio	100

The names of certain subsidiaries are omitted, as such subsidiaries in the aggregate would not constitute a significant subsidiary.

**AMERICAN FINANCIAL CORPORATION**

**EXHIBIT 99**

**CERTIFICATION OF CHIEF EXECUTIVE OFFICER AND CHIEF FINANCIAL OFFICER**

**Pursuant to section 906 of the Sarbanes-Oxley Act of 2002**

In connection with the filing with the Securities and Exchange Commission of the Annual Report of American Financial Corporation (the "Company") on Form 10-K for the period ended December 31, 2002 (the "Report"), the undersigned officers of the Company, certify, pursuant to section 906 of the Sarbanes-Oxley Act of 2002, that to the best of their knowledge:

- (1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

March 27, 2003  
Date

BY: s/Carl H. Lindner  
Carl H. Lindner  
Chairman of the Board and  
Chief Executive Officer

March 27, 2003  
Date

BY: s/Fred J. Runk  
Fred J. Runk  
Senior Vice President and Treasurer

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American Financial Corporation 2002 Form 10-K

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