

GREAT AMERICAN FINANCIAL RESOURCES INC
Form 10-Q
May 05, 2005

SECURITIES AND EXCHANGE COMMISSION

Washington, D. C. 20549

FORM 10-Q

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

For the Quarterly Period Ended
March 31, 2005

Commission File
No. 1-11632

Incorporated under
the Laws of Delaware

IRS Employer I.D.
No. 06-1356581

250 East Fifth Street, Cincinnati, Ohio 45202
(513) 333-5300

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

Indicate by check mark whether the Registrant is an accelerated filer. Yes No

As of May 1, 2005, there were 47,018,820 shares of the Registrant's Common Stock outstanding.

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GREAT AMERICAN FINANCIAL RESOURCES, INC.

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Exhibit Index

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| Exhibit 31(a) | Certification of the Chief Executive Officer Pursuant to Section 302(a) of the Sarbanes-Oxley Act of 2002 | E-1 |
| Exhibit 31(b) | Certification of the Chief Financial Officer Pursuant to Section 302(a) of the Sarbanes-Oxley Act of 2002 | E-2 |
| Exhibit 32 | Certification of the Chief Executive Officer and the Chief Financial Officer Pursuant to 18 USC Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 | E-3 |

GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

PART I

FINANCIAL INFORMATION

GREAT AMERICAN FINANCIAL RESOURCES, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEET

(Dollars in millions)

| | March 31, <u>2005</u> | December 31, <u>2004</u> |
|--|--------------------------|-----------------------------|
| Assets | | |
| Investments: | | |
| Fixed maturities: | | |
| Available-for-sale - at market (amortized cost - \$8,575.5 and \$8,383.2) | \$ 8,749.8 | \$ 8,700.1 |
| Trading securities - at market | 283.1 | 292.2 |
| Equity securities - at market (cost - \$152.1 and \$134.1) | 163.2 | 159.2 |
| Mortgage loans on real estate | 22.3 | 22.4 |
| Real estate | 107.6 | 108.8 |
| Policy loans | 250.3 | 250.2 |

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| | | |
|--|-------------------|-------------------|
| Short-term investments | <u>114.6</u> | <u>145.7</u> |
| Total investments | 9,690.9 | 9,678.6 |
| Cash | 13.9 | 24.5 |
| Accrued investment income | 114.4 | 115.6 |
| Unamortized insurance acquisition costs | 883.2 | 841.2 |
| Reinsurance recoverable | 341.8 | 327.6 |
| Other assets | 111.8 | 114.5 |
| Variable annuity assets (separate accounts) | <u>602.8</u> | <u>620.0</u> |
| | <u>\$11,758.8</u> | <u>\$11,722.0</u> |
| Liabilities and Capital | | |
| Annuity benefits accumulated | \$ 8,254.1 | \$ 8,132.1 |
| Unearned revenue | 114.1 | 110.4 |
| Life, accident and health reserves | 1,044.6 | 1,022.0 |
| Notes payable | 300.0 | 300.0 |
| Payable to subsidiary trusts (issuers of preferred securities) | 62.8 | 62.8 |
| Payable to affiliates, net | 120.1 | 115.3 |
| Deferred taxes on unrealized gains | 54.1 | 98.9 |
| Accounts payable, accrued expenses and other liabilities | 204.7 | 191.4 |
| Variable annuity liabilities (separate accounts) | <u>602.8</u> | <u>620.0</u> |
| Total liabilities | 10,757.3 | 10,652.9 |
| Stockholders' Equity: | | |
| Common Stock, \$1 par value | | |
| -100,000,000 shares authorized | | |
| -47,038,407 and 47,062,384 shares outstanding | 47.0 | 47.1 |
| Capital surplus | 406.7 | 407.1 |
| Retained earnings | 441.8 | 424.0 |
| Unrealized gains on marketable securities, net | <u>106.0</u> | <u>190.9</u> |

| | | |
|----------------------------|-------------------|-------------------|
| Total stockholders' equity | <u>1,001.5</u> | <u>1,069.1</u> |
| | <u>\$11,758.8</u> | <u>\$11,722.0</u> |

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GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q
GREAT AMERICAN FINANCIAL RESOURCES, INC. AND SUBSIDIARIES

CONSOLIDATED INCOME STATEMENT

(In millions, except per share amounts)

| | Three months ended | |
|--|--------------------|-------------|
| | <u>March 31,</u> | |
| | <u>2005</u> | <u>2004</u> |
| Revenues: | | |
| Life, accident and health premiums | \$ 92.1 | \$ 90.3 |
| Net investment income | 143.9 | 127.4 |
| Realized gains (losses) on: | | |
| Investments | (0.6) | 8.8 |
| Retirement of subsidiary trust debt | - | (1.3) |
| Other income | <u>25.6</u> | <u>18.5</u> |
| | 261.0 | 243.7 |
| Costs and Expenses: | | |
| Annuity benefits | 80.8 | 72.3 |
| Life, accident and health benefits | 69.0 | 69.3 |
| Insurance acquisition expenses | 35.3 | 30.1 |
| Interest on subsidiary trust obligations | 1.3 | 2.8 |
| Other interest and debt expenses | 5.5 | 5.0 |
| Other expenses | <u>44.0</u> | <u>36.5</u> |

| | | |
|--|----------------|----------------|
| | <u>235.9</u> | <u>216.0</u> |
| Operating earnings before income taxes | 25.1 | 27.7 |
| Provision for income taxes | <u>7.3</u> | <u>8.5</u> |
| Income before accounting change | 17.8 | 19.2 |
| Cumulative effect of accounting change, net of tax | <u>-</u> | <u>(2.2)</u> |
| |) | |
| Net Income | <u>\$ 17.8</u> | <u>\$ 17.0</u> |
| Basic earnings per common share | | |
| : | | |
| Income before accounting change | \$ 0.38 | \$ 0.41 |
| Accounting change | <u>-</u> | <u>(0.05)</u> |
| |) | |
| Net income | <u>\$ 0.38</u> | <u>\$ 0.36</u> |
| Diluted earnings per common share | | |
| : | | |
| Income before accounting change | \$ 0.38 | \$ 0.41 |
| Accounting change | <u>-</u> | <u>(0.05)</u> |
| |) | |
| Net income | <u>\$ 0.38</u> | <u>\$ 0.36</u> |
| Average number of common shares: | | |
| Basic | 47.1 | 47.0 |
| Diluted | 47.3 | 47.3 |

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GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q
 GREAT AMERICAN FINANCIAL RESOURCES, INC. AND SUBSIDIARIES
 CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY
 (In millions)

| | Three months ended <u>March 31,</u> | |
|--------------------------------|--|----------------|
| | <u>2005</u> | <u>2004</u> |
| Common Stock: | | |
| Balance at beginning of period | \$ 47.1 | \$ 47.0 |
| Common Stock issued | - | 0.1 |
| Common Stock retired | <u>(0.1)</u> | <u>-</u> |
|) | | |
| Balance at end of period | <u>\$ 47.0</u> | <u>\$ 47.1</u> |
| Capital Surplus: | | |
| Balance at beginning of period | \$407.1 | \$406.0 |
| Common Stock issued | 0.2 | 1.0 |
| Common Stock retired | <u>(0.6)</u> | <u>-</u> |
|) | | |
| Balance at end of period | <u>\$406.7</u> | <u>\$407.0</u> |
| Retained Earnings: | | |
| Balance at beginning of period | \$424.0 | \$326.9 |
| Net income | <u>17.8</u> | <u>17.0</u> |

| | | |
|--|------------------|----------------|
| Balance at end of period | <u>\$441.8</u> | <u>\$343.9</u> |
| Unrealized Gains, Net: | | |
| Balance at beginning of period | \$190.9 | \$162.6 |
| Change during period | <u>(84.9)</u> | <u>84.0</u> |
| |) | |
| Balance at end of period | <u>\$106.0</u> | <u>\$246.6</u> |
| <hr/> | | |
| Comprehensive Income | | |
| Net income | \$ 17.8 | \$ 17.0 |
| Other comprehensive income (loss) - change in net unrealized gains on marketable securities | <u>(84.9)</u> | <u>84.0</u> |
| |) | |
| Comprehensive income (loss) | <u>(\$ 67.1)</u> | <u>\$101.0</u> |

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GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q
GREAT AMERICAN FINANCIAL RESOURCES, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF CASH FLOWS
(In millions)

| | |
|--------------------|-------------|
| Three months ended | |
| <u>March 31,</u> | |
| <u>2005</u> | <u>2004</u> |

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Cash Flows from Operating Activities:

| | | |
|--|--------------|-------------|
| Net income | \$ 17.8 | \$ 17.0 |
| Adjustments: | | |
| Cumulative effect of accounting change | - | 2.2 |
| Increase in life, accident and health reserves | 22.6 | 17.0 |
| Benefits to annuity policyholders | 80.8 | 72.3 |
| Amortization of insurance acquisition costs | 26.7 | 22.0 |
| Depreciation and amortization | 8.5 | 5.1 |
| Realized (gains) losses on investments | 0.6 | (8.8) |
| Realized losses on retirement of subsidiary trust debt | - | 1.3 |
| Net trading portfolio activity | 4.9 | (23.8) |
| Increase in insurance acquisition costs | (33.8) | (30.8) |
| Increase in reinsurance recoverable | (3.6) | (0.5) |
| Increase in other assets | (0.3) | (4.0) |
| Increase in other liabilities | 8.2 | 2.3 |
| Increase in payable to affiliates, net | 4.8 | 4.8 |
| Other, net | <u>(1.6)</u> | <u>3.0</u> |
| |) | |
| | <u>135.6</u> | <u>79.1</u> |

Cash Flows from Investing Activities:

| | | |
|--|----------------|---------------|
| Purchases of and additional investments in: | | |
| Fixed maturity investments | (946.3) | (956.6) |
| Equity securities | (31.1) | (16.9) |
| Real estate, mortgage loans and other assets | (0.9) | (0.7) |
| Maturities and redemptions of fixed maturity investments | 156.0 | 187.2 |
| Sales of: | | |
| Fixed maturity investments | 584.7 | 708.9 |
| Equity securities | 18.2 | 5.6 |
| Real estate, mortgage loans and other assets | 0.2 | 0.1 |
| Decrease (increase) in policy loans | <u>(0.1)</u> | <u>0.7</u> |
| |) | |
| | <u>(219.3)</u> | <u>(71.7)</u> |
| |) |) |

Cash Flows from Financing Activities:

| | | |
|--|---------|---------|
| Fixed annuity receipts | 266.5 | 152.9 |
| Annuity surrenders, benefits and withdrawals | (224.3) | (159.4) |

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| | | |
|---|----------------|----------------|
| Net transfers (to) from variable annuity assets | 0.3 | (3.7) |
| Additions to notes payable | - | 83.5 |
| Issuance of Common Stock | 0.1 | 1.0 |
| Retirement of Common Stock | (0.6) | - |
| Repurchase of Trust Preferred Securities | <u>-</u> | <u>(93.5)</u> |
| |) | |
| | <u>42.0</u> | <u>(19.2)</u> |
| |) | |
| Net decrease in cash and short-term investments | (41.7) | (11.8) |
| Beginning cash and short-term investments | <u>170.2</u> | <u>164.0</u> |
| Ending cash and short-term investments | <u>\$128.5</u> | <u>\$152.2</u> |

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GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

A. Description of the Company

Great American Financial Resources, Inc. ("GAFRI" or "the Company"), through its subsidiaries, markets fixed and variable annuities, and various forms of supplemental insurance and life products through independent agents, payroll deduction plans, financial institutions and in-home sales.

American Financial Group, Inc. ("AFG") and its subsidiaries owned 82% of GAFRI's Common Stock at May 1, 2005.

• Accounting Policies

Basis of Presentation

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

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

statements.

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

Investments

Fixed maturity securities classified as "available-for-sale" are reported at fair value with unrealized gains and losses reported as a separate component of stockholders' equity. Fixed maturity securities classified as "trading" are reported at fair value with changes in unrealized gains or losses during the period included in investment income. Short-term investments are carried at cost; mortgage loans on real estate are generally carried at amortized cost; and policy loans are carried 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 differences between interest rates of 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 creditworthiness of the borrowers. Variations from anticipated prepayments will affect the life and yield of these securities.

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GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

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

Derivatives

Derivatives included in GAFRI's balance sheet consist primarily of (i) the interest component of certain life reinsurance contracts (included in other liabilities), (ii) interest rate swaps (included in notes payable), (iii) the equity-based component of certain annuity products (included in annuity benefits accumulated) and (iv) related call options (included in other assets) designed to be consistent with the characteristics of the liabilities and used to mitigate the risk embedded in those annuity products. Changes in the fair value of derivatives are included in current earnings.

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

Reinsurance

In the normal course of business, GAFRI's insurance subsidiaries cede reinsurance to other companies under various coinsurance agreements to diversify risk and limit maximum exposure. These transactions may also provide a

source of additional capital and liquidity. GAFRI remains obligated for amounts ceded in the event that the reinsurers do not meet their obligations. GAFRI reviews the financial condition of its reinsurers and monitors the amount of reinsurance it has with each company.

Under these agreements, GAFRI's insurance subsidiaries cede life insurance policies to a third party on a funds withheld basis whereby GAFRI retains the assets (securities) associated with the reinsurance contracts. Interest is credited to the reinsurer based on the actual investment performance (including realized gains and losses) of the retained assets. Under Statement of Financial Accounting Standards ("SFAS") No. 133 Implementation Issue B36 ("B36"), these reinsurance contracts are considered to contain embedded derivatives (that must be marked to market) because the yield on the payables is based on specific blocks of the ceding companies' assets, rather than the overall creditworthiness of the ceding company. GAFRI determined that changes in the fair value of the underlying portfolios of fixed maturity securities is an appropriate measure of the value of the embedded derivative. The Company classifies the securities related to these transactions as "trading." The mark to market on the embedded derivatives offsets the investment income recorded on the mark to market of the related trading portfolios.

Insurance Acquisition Costs and Expenses

Unamortized insurance acquisition costs consist of deferred policy acquisition costs ("DPAC") and the present value of future profits on business in force ("PVFP" or "VOBA") of acquired insurance companies.

Insurance acquisition expenses in the income statement reflect primarily the amortization of DPAC and VOBA. In addition, certain commission costs are expensed as paid and included in insurance acquisition expenses. All other uncapitalized acquisition costs such as marketing and underwriting expenses are included in "Other expenses."

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GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

Deferred Policy Acquisition Costs ("DPAC")

Policy acquisition costs (principally commissions, advertising, underwriting, policy issuance and sales expenses that vary with and are primarily related to the production of new business) are deferred to the extent that such costs are deemed recoverable. Following the adoption of SOP 03-1, DPAC also includes capitalized costs associated with sales inducements offered to fixed annuity policyholders such as enhanced interest rates and premium and persistency bonuses.

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. Expected gross profits consist principally of estimated future investment margin (estimated future net investment income less interest credited on policyholder funds) and surrender, mortality, and other life and variable annuity policy charges, less death and annuitization benefits in excess of account balances and estimated future policy administration expenses.

To the extent that realized gains and losses result in adjustments to the amortization of DPAC related to annuities, such adjustments are reflected as components of realized gains. 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 on marketable securities, net" in the stockholders' 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. Such anticipated premium revenues were estimated using the same assumptions used for computing liabilities for future policy benefits.

Life and health insurance contracts are reviewed periodically using actuarial assumptions revised based on actual and anticipated experience, to determine if there is a potential premium deficiency. If any such deficiency exists, it is recognized by a charge to income and a reduction in unamortized acquisition costs.

Present Value of Future Profits ("PVFP")

Insurance acquisition costs include the PVFP on business in force of acquired insurance companies, which represents the portion of the costs to acquire such companies that is allocated to the value of the right to receive future cash flows from insurance contracts existing at the date of acquisition.

The PVFP is amortized with interest in relation to expected gross profits of the acquired policies for annuities and universal life products and in relation to the premium paying period for traditional life and health insurance products.

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.

Following the adoption of SOP 03-1, reserves for two-tier annuities (annuities with different stated account values depending on whether a policyholder

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GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

annuitizes, dies or surrenders) are now recorded at the lower-tier value plus additional reserves for (i) accrued persistency and premium bonuses and (ii) excess benefits expected to be paid on future deaths and annuitizations ("EDAR") that require payment of the upper-tier value. The liability for EDAR is accrued for and modified using assumptions consistent with those used in determining DPAC and DPAC amortization, except that accruals are in relation to the present value of total expected assessments. Total expected assessments consist principally of estimated future investment margin, surrender, mortality, and other life and variable annuity policy charges, and unearned revenues once they are recognized as income.

Prior to the adoption of the SOP, reserves for two-tier annuities were generally recorded at the lower-tier value plus an EDAR reserve.

Reserves for traditional single-tier fixed annuities are generally recorded at the stated annuitization value.

Unearned Revenue

The liability for unearned revenue relating to certain policy charges representing compensation for future services is recognized as income using the same assumptions and estimated gross profits used to amortize DPAC.

Life, Accident and Health Reserves

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

The liability for future policy benefits for interest sensitive life and universal life policies is equal to the sum of the accumulated fund balances under such policies.

Variable Annuity Assets and Liabilities

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

Variable annuity contracts contain a guaranteed minimum death benefit ("GMDB") to be paid if the policyholder dies before the annuity payout period commences. In periods of declining equity markets, the GMDB may exceed the value of the policyholder's account. A GMDB liability is established for future excess death benefits using assumptions together with a range of reasonably possible scenarios for investment fund performance that are consistent with DPAC capitalization and amortization assumptions. Prior to the adoption of SOP 03-1, death benefits in excess of the variable annuity account balances were expensed when paid.

Life, Accident and Health Premiums and Benefits

For traditional life, accident and health products, premiums are recognized as revenue when legally collectible from policyholders. Policy reserves have been established in a manner that allocates policy benefits and expenses on a basis consistent with the recognition of related premiums and generally results in the recognition of profits over the premium paying period of the policies.

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GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

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. Surrender benefits reduce the account value. Death benefits are expensed when incurred, net of the account value.

Payable to Subsidiary Trust (Issuers of Preferred Securities)

GAFRI has formed wholly-owned subsidiary trusts that issued preferred securities and, in turn, purchased a like amount of subordinated debt from their parent company. Interest and principal payments from the parent fund the respective trust obligations. GAFRI does not consolidate these subsidiary trusts because they are "variable interest entities" in which GAFRI is not considered to be the primary beneficiary under revised Financial Interpretation No. 46. Accordingly, the subordinated debt due to the trusts is shown as a liability in the Balance Sheet.

Income Taxes

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GAFRI and Great American Life Insurance Company ("GALIC") have separate tax allocation agreements with American Financial Group, ("AFG"), which designate how tax payments are shared by members of the tax group. In general, both companies compute taxes on a separate return basis. GALIC is obligated to make payments to (or receive benefits from) AFG based on taxable income without regard to temporary differences. If GALIC's taxable income (computed on a statutory accounting basis) exceeds a current period net operating loss of GAFRI, the taxes payable or receivable by GALIC associated with the excess are payable to or receivable from AFG. If the AFG tax group utilizes any of GAFRI's net operating losses or deductions that originated prior to GAFRI's entering AFG's consolidated tax group, AFG will pay to GAFRI an amount equal to the benefit received. The tax allocation agreements with AFG have not impacted the recognition of income tax expense and income tax payable in GAFRI's financial statements.

Deferred income tax assets and liabilities are determined based on differences between financial reporting and tax basis and are measured using enacted tax rates. The Company recognizes deferred tax assets if it is more likely than not that a benefit will be realized. Current and deferred tax assets and liabilities of companies in AFG's consolidated tax group are aggregated with other amounts receivable from or payable to affiliates.

Stock-Based Compensation

As permitted under SFAS No. 123, "Accounting for Stock-Based Compensation," GAFRI accounts for stock options and other stock-based compensation plans using the intrinsic value based method prescribed by Accounting Principles Board Opinion ("APB") No. 25, "Accounting for Stock Issued to Employees." Under GAFRI's stock option plans, options are granted at exercise prices equal to the fair value of the shares at the dates of grant. No compensation expense is recognized for stock option grants.

The following table illustrates the effect on net income (in millions) and earnings per share had compensation cost been recognized and determined based on the fair values at grant dates consistent with the method prescribed by SFAS No. 123.

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GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

For SFAS No. 123 purposes, the "fair value" of \$5.28 per option granted in the first quarter of 2005 and \$4.62 for the first quarter of 2004 was calculated using the Black-Scholes option pricing model and the following assumptions: dividend yield of less than 1%; expected volatility of 20%; risk-free interest rate of 4%; and expected option life of 7.5 years. There is no single reliable method to determine the actual value of options at grant date. Accordingly, actual value of the option grants may be higher or lower than the SFAS No. 123 "fair value."

Three months ended

March 31,

2005

2004

| | | |
|--|---------------|---------------|
| Net income, as reported | \$17.8 | \$17.0 |
| Pro forma stock option expense, net of tax | <u>(0.5)</u> | <u>(0.2)</u> |
| |) |) |
| Adjusted net income | <u>\$17.3</u> | <u>\$16.8</u> |
| Earnings per share (as reported): | | |
| Basic | \$0.38 | \$0.36 |
| Diluted | \$0.38 | \$0.36 |
| Earnings per share (adjusted): | | |
| Basic | \$0.37 | \$0.36 |
| Diluted | \$0.37 | \$0.36 |

In December 2004, the Financial Accounting Standards Board ("FASB") issued SFAS No. 123(R), "Share-Based Payment." SFAS 123(R) revises SFAS 123 and eliminates the use of the intrinsic value method prescribed by APB 25. Under SFAS 123(R), companies must recognize compensation expense for all new share-based awards (including employee stock options), and the nonvested portions of prior awards, based on their fair value at the date of grant. GAFRI expects to implement the new standard on January 1, 2006, on a prospective basis. After that date, all share-based grants will be recognized as compensation expense over their respective vesting periods. While GAFRI currently uses the Black-Scholes pricing model to measure the fair value of stock options for purposes of disclosing pro forma earnings, the use of other models will also be permitted. GAFRI has not yet determined which model it will use to measure the fair value of future stock option grants.

Benefit Plans

GAFRI provides retirement benefits to qualified employees of participating companies through the GAFRI Retirement and Savings Plan, a defined contribution plan. GAFRI makes all contributions to the retirement fund portion of the Plan (at the discretion of the GAFRI Board of Directors) 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. Matching contributions to the savings fund are also invested in accordance with participant elections, while Company contributions to the retirement fund have been invested primarily in GAFRI Common Stock. Company contributions are expensed in the year for which they are declared.

GAFRI and certain of its subsidiaries provide certain benefits to eligible retirees. The projected future cost of providing these benefits is expensed over the period the employees earn such benefits.

Earnings Per Share

Basic earnings per share is calculated using the weighted-average number of shares of common stock outstanding during the period. The calculation of diluted earnings per share includes the following dilutive effect of common stock options: first quarter of 2005 - 0.2 million shares and first quarter of 2004 - 0.3 million shares.

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 annuity receipts, benefits and withdrawals and obtaining resources from owners and providing them with a return on their investments. All other activities are considered "operating." Short-term investments having original maturities of

three months or less when purchased are considered to be cash equivalents for purposes of the financial statements.

C. Acquisition

In May 2004, GAFRI acquired the fixed annuity block of National Health Insurance Company ("NHIC"). At the date of acquisition, the block consisted of approximately 33,000 policies with GAAP reserves of approximately \$765 million.

D. Segments of Operations

GAFRI's life and annuity operations include fixed and variable annuity products as well as investments in real estate operations. GAFRI's annuity products are sold through managing general agents and independent agents to employees of primary and secondary educational institutions, hospitals and in the non-qualified markets. Traditional term and universal life insurance products had been marketed through national marketing organizations. In the second quarter of 2004, GAFRI suspended new sales of these life insurance products due to inadequate volume and returns. The Company will continue to service its in-force block of these policies. The Company continues to sell life products through its supplemental insurance operations and GA Life of Puerto Rico (see below). GAFRI is engaged in a variety of real estate operations including hotels and marinas. The seasonal nature of the Company's hotel operations and the discretionary sales of assets cause the quarterly results not to be indicative of results for longer periods of time.

GAFRI's supplemental insurance businesses (United Teacher Associates Insurance Company ("UTA") and Loyal American Life Insurance Company) offer a variety of limited benefit policies to supplement primary health insurance and other insurance coverage. UTA offers its products through independent agents.

GA Life of Puerto Rico ("GAPR") sells in-home life and supplemental health products through a network of company-employed agents. It also sells other life products through independent agents. Sales in Puerto Rico accounted for approximately 20% of GAFRI's life, accident and health premiums in the first quarter of 2005 and 2004, respectively.

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GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

Corporate and other consists primarily of GAFRI (parent) and AAG Holding (intermediate holding company). The following table shows GAFRI's revenues and operating profit by significant business segment (in millions):

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| | Three months ended | |
|---|--------------------|----------------|
| | <u>March 31,</u> | |
| | <u>2005</u> | <u>2004</u> |
| <u>Revenues</u> | | |
| Fixed annuity operations | \$127.6 | \$109.6 |
| Variable annuity operations | 5.9 | 5.8 |
| Life operations | 19.6 | 20.3 |
| Real estate operations | <u>11.9</u> | <u>6.1</u> |
| | | |
| Total life and annuity operations | 165.0 | 141.8 |
| | | |
| Supplemental insurance operations | 75.6 | 72.7 |
| GA Life of Puerto Rico | 21.4 | 20.2 |
| Corporate and other | <u>(0.4)</u> | <u>1.5</u> |
| | | |
| Total operating revenues | 261.6 | 236.2 |
| | | |
| Realized gains (losses) | <u>(0.6)</u> | <u>7.5</u> |
| | | |
| Total revenues per income statement | <u>\$261.0</u> | <u>\$243.7</u> |
| | | |
| <u>Operating profit - pretax</u> | | |
| Fixed annuity operations | \$ 25.0 | \$ 24.1 |
| Variable annuity operations | 0.8 | 0.3 |
| Life operations | (1.8) | (2.6) |
| Real estate operations - operating cash flow | 2.5 | 0.4 |
| Real estate operations - depreciation and other | <u>(3.0)</u> | <u>(1.6)</u> |
| | | |
| Total life and annuity operations | 23.5 | 20.6 |
| | | |
| Supplemental insurance operations | 6.8 | 4.6 |
| GA Life of Puerto Rico | 3.8 | 3.3 |
| Corporate and other | <u>(8.4)</u> | <u>(8.3)</u> |

| | | |
|--|----------------|----------------|
| |) |) |
| Pretax earnings from operations | 25.7 | 20.2 |
| Realized gains (losses) | <u>(0.6)</u> | <u>7.5</u> |
| |) | |
| Total pretax earnings per income statement | <u>\$ 25.1</u> | <u>\$ 27.7</u> |

E. Unamortized Insurance Acquisition Costs

Unamortized insurance acquisition costs consisted of the following (in millions):

| | March 31, <u>2005</u> | December 31, <u>2004</u> |
|---|--------------------------|-----------------------------|
| Deferred policy acquisition costs ("DPAC") | \$841.0 | \$828.0 |
| Unrealized DPAC adjustment* | (29.3) | (59.5) |
| Present value of future profits acquired ("PVFP") | <u>71.5</u> | <u>72.7</u> |
| | <u>\$883.2</u> | <u>\$841.2</u> |

*Reflects the change in DPAC assuming the unrealized gains on securities had actually been realized. (See Note B)

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GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

Included in DPAC at March 31, 2005, are unamortized sales inducements of \$66.8 million. As a result of adopting SOP 03-1 as of January 1, 2004, unamortized insurance acquisition costs increased by \$50 million due to required balance sheet reclassifications. Included in PVFP at March 31, 2005 is \$15.8 million relating to the May 2004 acquisition of the fixed annuity business of NHIC. The PVFP amounts in the table above are net of \$76.9 million and \$73.2 million of accumulated amortization at March 31, 2005 and December 31, 2004, respectively. Amortization of the PVFP was \$3.7 million in the first quarter of 2005 compared to \$1.6 million in the first quarter of 2004.

F. Notes Payable

Notes payable consisted of the following (in millions):

| | March 31, <u>2005</u> | December 31, <u>2004</u> |
|---|--------------------------|-----------------------------|
| Direct obligations of GAFRI | \$ 1.2 | \$ 1.2 |
| Obligations of AAG Holding (guaranteed by GAFRI): | | |
| 7-1/2% Senior Debentures due 2033 | 112.5 | 112.5 |
| 6-7/8% Senior Notes due 2008 | 100.0 | 100.0 |
| 7-1/4% Senior Debentures due 2034 | <u>86.3</u> | <u>86.3</u> |
| Total | <u>\$300.0</u> | <u>\$300.0</u> |

In August 2004, AAG Holding replaced its existing bank credit agreement with a \$150 million, unsecured, four-year credit facility. In April 2005, this credit facility was increased to \$165 million. Amounts borrowed will bear interest at rates ranging from 1% to 2% over LIBOR based on GAFRI's credit rating. Loans under this agreement will mature on August 28, 2008, (or February 26, 2008, if the Company's senior notes have not been effectively retired). At April 30, 2005, there were no borrowings outstanding under the agreement.

GAFRI has entered into interest rate swaps which effectively convert its 6-7/8% Senior Notes to a floating rate of 3-month LIBOR plus 2.9% (effective rate of approximately 6% at March 31, 2005). The swaps realign GAFRI's mix of floating and fixed rate debt.

In January 2004, the Company issued \$86.3 million of 7-1/4%, 30-year Senior Debentures, using the proceeds to redeem all of its \$65.0 million principal amount of 9-1/4% trust preferred securities at face value and to repurchase a portion of its outstanding 8-7/8% preferred securities.

At March 31, 2005, scheduled principal payments on debt for the remainder of 2005 and the subsequent five years were as follows (in millions):

| <u>2005</u> | <u>2006</u> | <u>2007</u> | <u>2008</u> | <u>2009</u> | <u>2010</u> |
|-------------|-------------|-------------|-------------|-------------|-------------|
| \$0.2 | \$0.2 | \$0.1 | \$100.1 | \$0.1 | \$0.1 |

GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

G. Payable to Subsidiary Trusts (Issuers of Preferred Securities)

The preferred securities supported by the payable to subsidiary trusts consisted of the following:

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| Date of Issuance | Issue (Maturity Date) | Amount Outstanding | | Optional Redemption Dates |
|------------------|-----------------------|--------------------|--------------|---------------------------|
| | | 3/31/05 | 12/31/04 | |
| March 1997 | 8.875% Pfd (2027) | \$42,800,000 | \$42,800,000 | On or after 3/1/2007 |
| May 2003 | 7.35% Pfd (2033) | 20,000,000 | 20,000,000 | On or after 5/15/2008 |

GAFRI effectively provides an unconditional guarantee of the trusts' obligations. In the first quarter of 2004, GAFRI redeemed all \$65.0 million principal amount of its 9-1/4% trust preferred securities at face value and repurchased \$27.2 million of its 8-7/8% preferred securities for \$28.5 million in cash, recognizing a pretax charge of \$1.3 million.

H. Stockholders' Equity

At March 31, 2005, there were 7.5 million shares of GAFRI Common Stock reserved for issuance under GAFRI's stock option plans for employees, agents and directors. Under these plans, the exercise price of each option equals the market price of GAFRI Common Stock at the date of grant. Options generally become exercisable at the rate of 20% per year commencing one year after grant. All options expire ten years after the date of grant.

The change in net unrealized gains on marketable securities for the three months

ended March 31 included the following (in millions):

| | 2005 | | | 2004 | | |
|--|------------------|---------------|-----------------|----------------|-----------------|---------------|
| | Pretax | Taxes | Net | Pretax | Taxes | Net |
| Unrealized holding gains on securities arising during the period | (\$130.3) | \$44.9 | (\$85.4) | \$137.1 | (\$47.4) | \$89.7 |
| Realized (gains) losses on securities | <u>0.6</u> | <u>(0.1)</u> | <u>0.5</u> | <u>(8.8)</u> | <u>3.1</u> | <u>(5.7)</u> |
| |) | |) | |) | |
| Change in net unrealized gains on marketable securities | <u>(\$129.7)</u> | <u>\$44.8</u> | <u>(\$84.9)</u> | <u>\$128.3</u> | <u>(\$44.3)</u> | <u>\$84.0</u> |

The Company is authorized to issue 25,000,000 shares of Preferred Stock, par value \$1.00 per share.

I. Income Taxes

GAFRI is currently evaluating the impact of new U.S. tax legislation, the American Jobs Creation Act of 2004, which was signed into law on October 22, 2004. The new law allows a deduction of 85% of repatriated qualified foreign earnings in calendar year 2005.

GAFRI's wholly owned subsidiary, GAPR, is currently analyzing the impact of remitting qualified foreign earnings under this provision. As a result of deferred taxes previously accrued on these earnings, GAFRI anticipates there will be no additional income tax expense upon the repatriation. Due to the current uncertainty, no impact has been reflected in the current financial statements or accompanying footnotes.

J. Contingencies

There have been no significant changes to the matters discussed and referred to in Note M "Contingencies" of GAFRI's Annual Report on Form 10-K for 2004.

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GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

K. Additional Information

Statutory Information

Insurance companies are required to file financial statements with state insurance regulatory authorities prepared on an accounting basis prescribed or permitted by such authorities (statutory basis). Certain statutory amounts for GALIC, GAFRI's primary insurance subsidiary, were as follows (in millions):

| | March 31, <u>2005</u> | December 31, <u>2004</u> |
|-------------------------------|------------------------------------|-----------------------------|
| Capital and surplus | \$580.4 | \$577.9 |
| Asset valuation reserve | 70.4 | 69.9 |
| Interest maintenance reserve | 14.2 | 19.0 |
| | <u>Three months ended March 31</u> | |
| | <u>2005</u> | <u>2004</u> |
| Pretax income from operations | \$16.9 | \$21.8 |
| Net income | 13.2 | 16.7 |

Dividends that can be paid by GAFRI's insurance subsidiaries without prior approval of regulatory authorities are subject to restrictions relating to capital and surplus and statutory net income. Based on these restrictions at December 31, 2004, GALIC and GAFRI may pay dividends of \$81 million and \$42.4 million, respectively, in 2005 without prior approval. GALIC and GAFRI paid no dividends in the first quarter of 2005.

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For statutory purposes, the acquisition of the fixed annuity block of business of NHIC was recorded on April 1, 2004 as a reinsurance transaction under which NHIC paid GAFRI a negative ceding commission of \$38 million to assume the block of business.

Variable Annuities

At March 31, 2005 the aggregate guaranteed minimum death benefit value (assuming every policyholder died on those dates) exceeded the market value of the underlying variable annuities by \$114 million, compared to \$106 million at December 31, 2004. This benefit is on all of GAFRI's variable annuity policies. Death benefits paid in excess of the variable annuity account balances were \$0.2 million and \$0.4 million in the first quarter of 2005 and 2004, respectively.

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GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

Condensed Consolidating Information

GAFRI has guaranteed all of the outstanding debt of AAG Holding. Condensed consolidating financial statements for GAFRI are as follows:

CONDENSED CONSOLIDATING BALANCE SHEET

(In millions)

| | AAG | ALL | CONS | | |
|---|------------------|------------------|-------------------|--------------------|-------------------|
| | | OTHER | | | |
| <u>MARCH 31, 2005</u> | <u>GAFRI</u> | <u>HOLDING</u> | <u>SUBS</u> | <u>ENTRIES</u> | <u>CONS</u> |
| Assets | | | | | |
| Cash and investments | \$ 1.9 | \$ 0.3 | \$ 9,702.6 | \$ - | \$ 9,704.8 |
| Investment in subsidiaries | 949.9 | 1,293.4 | 11.0 | (2,254.3) | - |
| Notes receivable from subs | 104.3 | - | - | (104.3) | - |
| Unamortized insurance acquisition costs | - | - | 883.2 | - | 883.2 |
| Other assets | 20.2 | 9.0 | 494.9 | 43.9 | 568.0 |
| Variable annuity assets (separate accounts) | <u>-</u> | <u>-</u> | <u>602.8</u> | <u>-</u> | <u>602.8</u> |
| | <u>\$1,076.3</u> | <u>\$1,302.7</u> | <u>\$11,694.5</u> | <u>(\$2,314.7)</u> | <u>\$11,758.8</u> |
| Liabilities and Capital | | | | | |
| Insurance liabilities | \$ - | \$ - | \$ 9,417.9 | (\$ 5.1) | \$ 9,412.8 |
| Notes payable to GAFRI | - | 102.4 | 1.9 | (104.3) | - |
| Other notes payable | 1.2 | 298.8 | - | - | 300.0 |

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| | | | | | |
|---|------------------|------------------|-------------------|--------------------|-------------------|
| Payable to subsidiary trusts | - | 97.9 | - | (35.1) | 62.8 |
| Other liabilities | 73.6 | 15.7 | 291.1 | (1.5) | 378.9 |
| Variable annuity liabilities (separate accounts) | <u>-</u> | <u>-</u> | <u>602.8</u> | <u>-</u> | <u>602.8</u> |
| | 74.8 | 514.8 | 10,313.7 | (146.0) | 10,757.3 |
| Total stockholders' equity | <u>1,001.5</u> | <u>787.9</u> | <u>1,380.8</u> | <u>(2,168.7)</u> | <u>1,001.5</u> |
| | | |) | | |
| | <u>\$1,076.3</u> | <u>\$1,302.7</u> | <u>\$11,694.5</u> | <u>(\$2,314.7)</u> | <u>\$11,758.8</u> |

DECEMBER 31, 2004

Assets

| | | | | | |
|--|------------------|------------------|-------------------|--------------------|-------------------|
| Cash and investments | \$ 1.0 | \$ - | \$ 9,702.2 | (\$ 0.1) | \$ 9,703.1 |
| Investment in subsidiaries | 1,020.2 | 1,354.4 | 11.0 | (2,385.6) | - |
| Notes receivable from subs | 104.3 | - | - | (104.3) | - |
| Unamortized insurance acquisition costs | - | - | 841.2 | - | 841.2 |
| Other assets | 18.5 | 8.5 | 490.4 | 40.3 | 557.7 |
| Variable annuity assets (separate accounts) | <u>-</u> | <u>-</u> | <u>620.0</u> | <u>-</u> | <u>620.0</u> |
| | <u>\$1,144.0</u> | <u>\$1,362.9</u> | <u>\$11,664.8</u> | <u>(\$2,449.7)</u> | <u>\$11,722.0</u> |

Liabilities and Capital

| | | | | | |
|---|----------------|--------------|----------------|------------------|----------------|
| Insurance liabilities | \$ - | \$ - | \$ 9,269.8 | (\$ 5.3) | \$ 9,264.5 |
| Notes payable to GAFRI | - | 102.4 | 1.9 | (104.3) | - |
| Other notes payable | 1.2 | 298.8 | - | - | 300.0 |
| Payable to subsidiary trusts | - | 97.9 | - | (35.1) | 62.8 |
| Other liabilities | 73.7 | 5.1 | 331.0 | (4.2) | 405.6 |
| Variable annuity liabilities (separate accounts) | <u>-</u> | <u>-</u> | <u>620.0</u> | <u>-</u> | <u>620.0</u> |
| | 74.9 | 504.2 | 10,222.7 | (148.9) | 10,652.9 |
| Total stockholders' equity | <u>1,069.1</u> | <u>858.7</u> | <u>1,442.1</u> | <u>(2,300.8)</u> | <u>1,069.1</u> |

)

| | | | | |
|------------------|------------------|-------------------|----------------------|-------------------|
| <u>\$1,144.0</u> | <u>\$1,362.9</u> | <u>\$11,664.8</u> | (<u>\$2,449.7</u>) | <u>\$11,722.0</u> |
|------------------|------------------|-------------------|----------------------|-------------------|

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GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued
CONDENSED CONSOLIDATING INCOME STATEMENT

(In millions)

| FOR THE THREE MONTHS ENDED | AAG | | ALL OTHER | CONS | |
|---|--------------|----------------|--------------|----------------|--------------|
| <u>MARCH 31, 2005</u> | <u>GAFRI</u> | <u>HOLDING</u> | <u>SUBS</u> | <u>ENTRIES</u> | <u>CONS</u> |
| Revenues | | | | | |
| : | | | | | |
| Life, accident and health premiums | \$ - | \$ - | \$ 92.1 | \$ - | \$ 92.1 |
| Net investment income and other revenue | 5.3 | - | 166.5 | (2.9) | 168.9 |
| Equity in earnings of subsidiaries | <u>22.4</u> | <u>30.2</u> | <u>-</u> | <u>(52.6)</u> | <u>-</u> |
| | 27.7 | 30.2 | 258.6 | (55.5) | 261.0 |
| | | |) | | |
| Costs and Expenses: | | | | | |
| Insurance benefits and expenses | - | - | 185.1 | - | 185.1 |
| Interest and debt expenses | - | 10.0 | - | (3.2) | 6.8 |
| Other expenses | <u>2.6</u> | <u>1.4</u> | <u>39.9</u> | <u>0.1</u> | <u>44.0</u> |
| | <u>2.6</u> | <u>11.4</u> | <u>225.0</u> | <u>(3.1)</u> | <u>235.9</u> |
| | | |) | | |
| Earnings before income taxes | 25.1 | 18.8 | 33.6 | (52.4) | 25.1 |
| Provision for income taxes | <u>7.3</u> | <u>6.4</u> | <u>10.1</u> | <u>(16.5)</u> | <u>7.3</u> |
| | | |) | | |

| | | | | | |
|------------|---------------|---------------|----------------|------------------|----------------|
| Net income | <u>\$17.8</u> | <u>\$12.4</u> | <u>\$ 23.5</u> | <u>(\$ 35.9)</u> | <u>\$ 17.8</u> |
|------------|---------------|---------------|----------------|------------------|----------------|

FOR THE THREE MONTHS ENDED
MARCH 31, 2004

Revenues

| | | | | | |
|---|-------------|-------------|----------|---------------|----------|
| : | | | | | |
| Life, accident and health premiums | \$ - | \$ - | \$ 90.3 | \$ - | \$ 90.3 |
| Net investment income and other revenue | 4.6 | - | 152.2 | (3.4) | 153.4 |
| Equity in earnings of subsidiaries | <u>24.8</u> | <u>33.9</u> | <u>-</u> | <u>(58.7)</u> | <u>-</u> |
| | | |) | | |
| | 29.4 | 33.9 | 242.5 | (62.1) | 243.7 |

Costs and Expenses:

| | | | | | |
|---------------------------------|------------|------------|-------------|----------|-------------|
| Insurance benefits and expenses | - | - | 171.7 | - | 171.7 |
| Interest and debt expenses | - | 10.8 | - | (3.0) | 7.8 |
| Other expenses | <u>1.7</u> | <u>1.6</u> | <u>33.2</u> | <u>-</u> | <u>36.5</u> |

| | | | | | |
|--|------------|-------------|--------------|--------------|--------------|
| | <u>1.7</u> | <u>12.4</u> | <u>204.9</u> | <u>(3.0)</u> | <u>216.0</u> |
| | | |) | | |

| | | | | | |
|------------------------------|------------|------------|-------------|---------------|------------|
| Earnings before income taxes | 27.7 | 21.5 | 37.6 | (59.1) | 27.7 |
| Provision for income taxes | <u>8.5</u> | <u>7.2</u> | <u>11.7</u> | <u>(18.9)</u> | <u>8.5</u> |

| | | | | | |
|---------------------------------|--------------|----------|--------------|------------|--------------|
| | | |) | | |
| Income before accounting change | 19.2 | 14.3 | 25.9 | (40.2) | 19.2 |
| Accounting change, net | <u>(2.2)</u> | <u>-</u> | <u>(2.2)</u> | <u>2.2</u> | <u>(2.2)</u> |

| | | | | | |
|------------|----------------|----------------|----------------|-----------------|----------------|
| | | |) | | |
| Net income | <u>\$ 17.0</u> | <u>\$ 14.3</u> | <u>\$ 23.7</u> | <u>(\$38.0)</u> | <u>\$ 17.0</u> |

GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued
CONDENSED CONSOLIDATING STATEMENT OF CASH FLOWS

(In millions)

| FOR THE THREE MONTHS ENDED | AAG | | ALL | CONS | |
|---|--------------|----------------|--------------|----------------|--------------|
| | | HOLDING | OTHER | ENTRIES | CONS |
| <u>MARCH 31, 2005</u> | <u>GAFRI</u> | <u>HOLDING</u> | <u>SUBS</u> | <u>ENTRIES</u> | <u>CONS</u> |
| Cash Flows from Operating Activities: | | | | | |
| Net income | \$17.8 | \$12.4 | \$ 23.5 | (\$35.9) | \$ 17.8 |
| Adjustments: | | | | | |
| Equity in net earnings of subsidiaries and affiliates | (16.1) | (20.0) | - | 36.1 | - |
| Increase in life, accident and health reserves | - | - | 22.6 | - | 22.6 |
| Benefits to annuity policyholders | - | - | 80.8 | - | 80.8 |
| Amortization of insurance acquisition costs | - | - | 26.7 | - | 26.7 |
| Depreciation and amortization | - | 0.4 | 8.1 | - | 8.5 |
| Realized losses on investments | - | - | 0.6 | - | 0.6 |
| Net trading portfolio activity | - | - | 4.9 | - | 4.9 |
| Increase in insurance acquisition costs | - | - | (33.8) | - | (33.8) |
| Increase in reinsurance recoverable | - | - | (3.6) | - | (3.6) |
| Decrease (increase) in other assets | (2.0) | (0.5) | 2.2 | - | (0.3) |
| Increase (decrease) in other liabilities | (1.1) | (0.5) | 9.8 | - | 8.2 |
| Increase (decrease) in payable to affiliates, net | 0.9 | 11.1 | (7.2) | - | 4.8 |
| Capital contribution from parent (to subsidiary) | (14.7) | 14.7 | - | - | - |
| Dividends from subsidiaries(to parent) | 16.6 | (16.6) | - | - | - |
| Other, net | <u>-</u> | <u>(0.7)</u> | <u>(0.7)</u> | <u>(0.2)</u> | <u>(1.6)</u> |
| |) |) |) |) | |
| | <u>1.4</u> | <u>0.3</u> | <u>133.9</u> | <u>-</u> | <u>135.6</u> |

Cash Flows from Investing Activities:

| | | | | | |
|--|----------|----------|----------------|----------|----------------|
| Purchases of investments and other assets | - | - | (978.3) | - | (978.3) |
| Maturities and redemptions of fixed maturity investments | - | - | 156.0 | - | 156.0 |
| Sales of investments and other assets | - | - | 603.1 | - | 603.1 |
| Increase in policy loans | <u>-</u> | <u>-</u> | <u>(0.1)</u> | <u>-</u> | <u>(0.1)</u> |
| | |) | |) | |
| | <u>-</u> | <u>-</u> | <u>(219.3)</u> | <u>-</u> | <u>(219.3)</u> |
| | |) | |) | |

Cash Flows from Financing Activities:

| | | | | | |
|--|--------------|----------|-------------|----------|--------------|
| Fixed annuity receipts | - | - | 266.5 | - | 266.5 |
| Annuity surrenders, benefits and withdrawals | - | - | (224.3) | - | (224.3) |
| Net transfers from variable annuity assets | - | - | 0.3 | - | 0.3 |
| Issuance of Common Stock | 0.1 | - | - | - | 0.1 |
| Retirement of Common Stock | <u>(0.6)</u> | <u>-</u> | <u>-</u> | <u>-</u> | <u>(0.6)</u> |
| | |) | |) | |
| | <u>(0.5)</u> | <u>-</u> | <u>42.5</u> | <u>-</u> | <u>42.0</u> |
| | |) | |) | |

Net increase (decrease) in cash and short-term investments

| | | | | | |
|--|------------|----------|--------------|----------|--------------|
| Net increase (decrease) in cash and short-term investments | 0.9 | 0.3 | (42.9) | - | (41.7) |
| Beginning cash and short-term investments | <u>1.0</u> | <u>-</u> | <u>169.2</u> | <u>-</u> | <u>170.2</u> |

| | | | | | |
|--|---------------|---------------|----------------|-------------|----------------|
| Ending cash and short-term investments | <u>\$ 1.9</u> | <u>\$ 0.3</u> | <u>\$126.3</u> | <u>\$ -</u> | <u>\$128.5</u> |
|--|---------------|---------------|----------------|-------------|----------------|

GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued
 CONDENSED CONSOLIDATING STATEMENT OF CASH FLOWS

(In millions)

| FOR THE THREE MONTHS ENDED | | AAG | ALL | CONS | |
|--|--------------|--------------|-------------|------------|-------------|
| | | HOLDING | OTHER | ENTRIES | |
| <u>MARCH 31, 2004</u> | <u>GAFRI</u> | | <u>SUBS</u> | | <u>CONS</u> |
| Cash Flows from Operating Activities: | | | | | |
| Net income | \$ 17.0 | \$14.3 | \$ 23.7 | (\$38.0) | \$ 17.0 |
| Adjustments: | | | | | |
| Cumulative effect of accounting change | 2.2 | - | 2.2 | (2.2) | 2.2 |
| Equity in net earnings of subsidiaries and affiliates | (15.2) | (22.6) | - | 37.8 | - |
| Increase in life, accident and health reserves | - | - | 17.0 | - | 17.0 |
| Benefits to annuity policyholders | - | - | 72.3 | - | 72.3 |
| Amortization of insurance acquisition costs | - | - | 22.0 | - | 22.0 |
| Depreciation and amortization | - | 0.7 | 4.4 | - | 5.1 |
| Realized gains on investments | (0.3) | - | (8.5) | - | (8.8) |
| Realized losses on retirement of subsidiary trust debt | 1.0 | - | - | 0.3 | 1.3 |
| Net trading portfolio activity | - | - | (23.8) | - | (23.8) |
| Increase in insurance acquisition costs | - | - | (30.8) | - | (30.8) |
| Increase in reinsurance recoverable | - | - | (0.5) | - | (0.5) |
| Decrease (increase) in other assets | 0.1 | - | (4.1) | - | (4.0) |
| Increase (decrease) in other liabilities | (2.7) | - | 5.0 | - | 2.3 |
| Increase in payable to affiliates, net | 0.8 | - | 4.0 | - | 4.8 |
| Capital contribution from parent (to subsidiary) | (90.3) | 90.3 | - | - | - |
| Dividends from subsidiaries (to parent) | 114.2 | (91.2) | (23.0) | - | - |
| Other, net | <u>(2.4)</u> | <u>0.1</u> | <u>3.2</u> | <u>2.1</u> | <u>3.0</u> |
| |) | | | | |
| | <u>24.4</u> | <u>(8.4)</u> | <u>63.1</u> | <u>-</u> | <u>79.1</u> |
| |) | | | | |
| Cash Flows from Investing Activities: | | | | | |
| Purchases of investments and other assets | (23.2) | - | (979.5) | 28.5 | (974.2) |
| Maturities and redemptions of fixed maturity investments | - | - | 187.2 | - | 187.2 |
| Sales of investments and other assets | 1.0 | - | 723.6 | (10.0) | 714.6 |
| Decrease in policy loans | <u>-</u> | <u>-</u> | <u>0.7</u> | <u>-</u> | <u>0.7</u> |

| | | | | | |
|--|---------------|---------------|----------------|---------------|----------------|
| | <u>(22.2)</u> | <u>-</u> | <u>(68.0)</u> | <u>18.5</u> | <u>(71.7)</u> |
| |) |) |) |) |) |
| Cash Flows from Financing Activities: | | | | | |
| Fixed annuity receipts | - | - | 152.9 | - | 152.9 |
| Annuity surrenders, benefits and withdrawals | - | - | (159.4) | - | (159.4) |
| Net transfers to variable annuity assets | - | - | (3.7) | - | (3.7) |
| Additions to notes payable | - | 83.5 | - | - | 83.5 |
| Issuance of Common Stock | 1.0 | - | - | - | 1.0 |
| Repurchase of Trust Preferred Securities | <u>-</u> | <u>(75.0)</u> | <u>-</u> | <u>(18.5)</u> | <u>(93.5)</u> |
| |) |) |) |) |) |
| | <u>1.0</u> | <u>8.5</u> | <u>(10.2)</u> | <u>(18.5)</u> | <u>(19.2)</u> |
| |) |) |) |) |) |
| Net increase (decrease) in cash and short-term investments | 3.2 | 0.1 | (15.1) | - | (11.8) |
| Beginning cash and short-term investments | <u>0.4</u> | <u>-</u> | <u>163.6</u> | <u>-</u> | <u>164.0</u> |
| Ending cash and short-term investments | <u>\$ 3.6</u> | <u>\$ 0.1</u> | <u>\$148.5</u> | <u>\$ -</u> | <u>\$152.2</u> |

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GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

ITEM 2

Management's Discussion and Analysis

of Financial Condition and Results of Operations

Index to MD&A

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FORWARD-LOOKING STATEMENTS

The Private Securities Litigation Reform Act of 1995 provides a safe harbor for forward-looking statements. Some of the forward-looking statements can be identified by the use of 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 relate to: expectations concerning market and other conditions and their effect on future premiums, revenues, earning and investment activities; recoverability of asset values; mortality and the adequacy of reserves for environmental pollution.

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;
- trends in mortality and morbidity;
- regulatory actions;
- changes in regulatory and legal environments;
- tax law changes;
- changes in laws governing retirement savings vehicles;
- availability of reinsurance and ability of reinsurers to pay their obligations;
- competitive pressures; and
- changes in debt and claims paying ratings.

Forward-looking statements included in this Form 10-Q are made only as of the date of this report and under Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934; we do not have any obligation to update any forward-looking statement to reflect subsequent events or circumstances.

GENERAL

Great American Financial Resources, Inc. ("GAFRI" or "the Company") and its subsidiary, AAG Holding Company, Inc., are organized as holding companies with nearly all of their operations being conducted by their subsidiaries. These companies, however, have continuing expenditures for administrative expenses, corporate services and for the payment of interest and principal on borrowings and stockholder dividends.

OVERVIEW

Financial Condition

Over the last several years, GAFRI has significantly strengthened its capital and liquidity. Stockholders' equity (excluding unrealized gains) has grown from \$671.9 million at January 1, 2003 to \$895.5 million at March 31, 2005. Over the same period, GAFRI's ratio of debt to total capital has decreased from 36.3% to 28.7%. In addition, the adjusted capital and surplus of GAFRI's insurance subsidiaries increased from \$508 million to \$698 million during the same period.

Results of Operations

Through the operations of its insurance subsidiaries, GAFRI is engaged in the sale of retirement annuities and various forms of supplemental insurance and life products.

GAFRI's net income for the first quarter of 2005 was \$17.8 million (\$0.38 per diluted share) compared to \$17.0 million (\$0.36 per diluted share) for the same period in 2004. The increase reflects improved results in each of the Company's lines of business.

CRITICAL ACCOUNTING POLICIES

Significant accounting policies are described in Note B to the financial statements. The preparation of financial statements requires management to make estimates and assumptions that can have a significant effect on amounts reported in the financial statements. As more information becomes known, these estimates and assumptions could change and thus impact amounts reported in the future.

Management believes that the following items are the areas where the degree of judgment required to determine amounts recorded in the financial statements make the accounting policies critical:

- The recoverability of unamortized insurance acquisition costs;
- The establishment of insurance reserves;
- The determination of "other than temporary" impairments on investments; and
- Environmental reserves of GAFRI's former manufacturing operations.

For further discussion of these policies, see "Critical Accounting Policies" in GAFRI's 2004 Form 10-K.

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GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

Management's Discussion and Analysis

of Financial Condition and Results of Operations - Continued

LIQUIDITY AND CAPITAL RESOURCES

Ratios

GAFRI's consolidated debt to capital ratio is shown below (dollars in millions). For purposes of this calculation, consolidated debt includes notes payable and payable to subsidiary trusts; capital represents the sum of consolidated debt and stockholders' equity (excluding unrealized gains on fixed maturity securities).

| | March 31, | <u>December 31,</u> | |
|------------------------------|----------------|---------------------|----------------|
| | <u>2005</u> | <u>2004</u> | <u>2003</u> |
| Consolidated Debt | \$ 363 | \$ 363 | \$ 369 |
| Stockholders' Equity | <u>903</u> | <u>895</u> | <u>805</u> |
| Total Capital | <u>\$1,266</u> | <u>\$1,258</u> | <u>\$1,174</u> |
| Consolidated Debt to Capital | 28.7% | 28.9% | 31.4% |

The National Association of Insurance Commissioners' ("NAIC") risk-based capital ("RBC") formula determines the amount of capital that an insurance company needs to ensure that it has an acceptable expectation of not becoming financially impaired. At March 31, 2005, the capital ratio of GAFRI's principal insurance subsidiary was 6.5 times its authorized control level RBC.

Sources and Uses of Funds

Parent Holding Company Liquidity

To pay interest and principal on borrowings and other holding company costs, GAFRI (parent) and AAG Holding use primarily capital distributions and other payments from their insurance subsidiaries, (Great American Life Insurance Company ("GALIC") and GA Life of Puerto Rico ("GAPR")), bank borrowings and cash and investments on hand. Capital distributions from GAFRI's insurance subsidiaries are subject to regulatory restrictions relating to statutory surplus and earnings. The maximum amount of dividends payable by GALIC and GAPR in 2005 without prior regulatory approval is \$81 million and \$42.4 million, respectively. GALIC and GAPR paid no dividends in the first quarter of 2005.

In August 2004, the Company replaced its existing credit agreement with a \$150 million four-year credit facility. In April 2005, this credit facility was increased to \$165 million. Amounts borrowed bear interest at rates ranging from 1% to 2% over LIBOR based on GAFRI's credit rating. There were no borrowings outstanding at April 30, 2005.

In January 2004, GAFRI raised approximately \$84 million through the issuance of 7-1/4% Senior Debentures. The majority of the proceeds were used to retire trust preferred securities having a higher effective interest rate. Under a

currently effective shelf registration, GAFRI and AAG Holding can issue approximately \$250 million in additional equity or debt securities. All debentures issued by GAFRI are rated investment grade by three nationally recognized rating agencies.

GAFRI believes that it has sufficient resources to meet its liquidity requirements.

Subsidiary Liquidity

GAFRI believes its insurance subsidiaries maintain sufficient liquidity to pay anticipated claims and benefits and operating expenses, as well as meet commitments in the event of unforeseen events such as unusually high annuity withdrawals, reserve deficiencies, inadequate premium rates or reinsurer insolvencies.

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GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

Management's Discussion and Analysis

of Financial Condition and Results of Operations - Continued

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

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

In recent years, the Company has entered into several reinsurance transactions in connection with certain of its life and supplemental insurance operations. These transactions provided additional capital and liquidity and were entered into in the normal course of business in order to exit certain lines, fund an acquisition and transfer risk. The Company may enter into additional reinsurance transactions in the future.

Independent Ratings

The Company's principal insurance subsidiaries are rated by A.M. Best, Fitch and Standard & Poor's. Management believes that the ratings assigned by independent insurance rating agencies are important because agents, potential policyholders and school districts often use a company's rating as an initial screening device in considering annuity products. Management believes that (i) a rating in the "A" category by A.M. Best is necessary to successfully market tax-deferred annuities to public education employees and other 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 entities also compete in markets other than the sale of tax-deferred annuities. Ratings are an important

competitive factor; management believes that these entities can successfully compete in these markets with their respective ratings.

GAFRI's operations could be materially and adversely affected by ratings downgrades. In connection with recent reviews by independent rating agencies, management indicated that it intends to maintain lower ratios of debt to capital than it has in recent years and 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 that could adversely affect capital levels include (i) an extended period of low interest rates and a resulting significant narrowing of annuity "spread" (the difference between earnings received by the Company on its investments less the amount credited to policyholders' annuity accounts); (ii) investment impairments; (iii) a sustained decrease in the stock market; (iv) adverse mortality or morbidity; and (v) higher than planned dividends paid due to liquidity needs by GAFRI and AAG Holding.

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GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

Management's Discussion and Analysis

of Financial Condition and Results of Operations - Continued

Following are the Company's insurance ratings as of March 31, 2005:

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

*GALIC is rated A3 (good financial security) by Moody's.

All of the above ratings carry a "stable" outlook. In evaluating a company, independent rating agencies review such factors as the company's: (i) capital adequacy; (ii) profitability; (iii) leverage and liquidity; (iv) book of business; (v) quality and estimated market value of assets; (vi) adequacy of policy reserves; (vii) experience and competency of management; and (viii) operating profile.

Investments

At March 31, 2005, GAFRI's investment portfolio contained \$8.7 billion in "Fixed maturities" classified as available-for-sale, which are carried at market value with unrealized gains and losses reported as a separate component of stockholders' equity on an after-tax basis. At March 31, 2005, GAFRI had pretax net unrealized gains of \$174 million on fixed maturities and \$11 million on equity securities.

GAFRI invests primarily in fixed income investments that, including loans and short-term investments, comprised 97% of its investment portfolio at March 31, 2005. GAFRI generally invests in securities having intermediate-term

maturities with an objective of optimizing interest yields while maintaining an appropriate relationship of maturities between GAFRI's assets and expected liabilities.

The NAIC assigns quality ratings to publicly traded as well as privately placed securities. At March 31, 2005, 94% of GAFRI's fixed maturity portfolio was comprised of investment grade bonds (NAIC rating of "1" or "2"). Management believes that a high quality investment portfolio is more likely to generate a stable and predictable investment return.

At March 31, 2005, GAFRI's mortgage-backed securities ("MBSs") portfolio represented approximately 30% of its investments. MBS portfolios 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 the lower current rates. Due to the significant decline in the general level of interest rates in recent years, GAFRI has experienced an increase in the level of prepayments on its MBS portfolio; these prepayments have not been reinvested at interest rates comparable to the rates earned on the prepaid MBSs. Partly as a result of this, the overall yield on GAFRI's fixed maturity portfolio dropped from approximately 6.2% at year-end 2003 to 6.0% at March 31, 2005.

More than 95% of GAFRI's MBSs are rated "AAA" with substantially all being investment grade quality. The market in which these securities trade is highly liquid. Aside from interest rate risk referred to above, GAFRI does not believe a material risk (relative to earnings or liquidity) is inherent in holding such investments.

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GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

Management's Discussion and Analysis

of Financial Condition and Results of Operations - Continued

Summarized information for the unrealized gains and losses recorded in GAFRI's balance sheet at March 31, 2005, is shown in the following table (dollars in millions). Approximately \$154 million of available-for-sale "Fixed Maturities" and \$7 million of "Equity Securities" had no unrealized gains or losses at March 31, 2005.

| <u>Available-for-sale Fixed Maturities</u> | Securities with Unrealized <u>Gains</u> | Securities with Unrealized <u>Losses</u> |
|--|--|---|
| Market value of securities | \$5,503 | \$3,093 |
| Amortized cost of securities | \$5,273 | \$3,149 |
| Gross unrealized gain (loss) | \$ 230 | (\$ 56) |
| Market value as % of amortized cost | 104% | 98% |
| Number of security positions | 1,116 | 381 |
| Number individually exceeding \$2 million gain or loss | 5 | - |
| Concentration of gains (losses) by type or industry (exceeding 5% of unrealized): | | |
| Banks, savings and credit institutions | \$ 36.5 | (\$ 2.5) |
| Gas and electric services | 32.9 | (2.2) |

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| | | |
|---|------|--------|
| Mortgage-backed securities | 20.2 | (29.0) |
| U.S. Government and government agencies | 12.8 | (2.8) |
| Percentage rated investment grade | 92% | 97% |

Equity Securities

| | | |
|------------------------------|-------|--------|
| Market value of securities | \$ 87 | \$ 69 |
| Cost of securities | \$ 73 | \$ 72 |
| Gross unrealized gain (loss) | \$ 14 | \$ (3) |
| Market value as % of cost | 119% | 96% |

The table below sets forth the scheduled maturities of GAFRI's available-for-sale fixed maturity securities at March 31, 2005, 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 <u>Gains</u> | Securities with Unrealized <u>Losses</u> |
|------------------------------------|--|---|
| * | * | * |
| One year or less | 3% | 1% |
| After one year through five years | 20 | 4 |
| After five years through ten years | 43 | 29 |
| After ten years | <u>17</u> | <u>10</u> |
| | 83 | 44 |
| Mortgage-backed securities | <u>17</u> | <u>56</u> |
| | <u>100</u> | <u>100</u> |
| | % | % |

*Excludes \$154 million of fixed maturities with no unrealized gains or losses.

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GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

Management's Discussion and Analysis

of Financial Condition and Results of Operations - Continued

GAFRI realized aggregate losses of \$4.3 million during the first quarter of 2005 on \$111.2 million in sales of fixed maturity securities (4 issues/issuers) that had individual unrealized losses greater than \$500,000 at December 31, 2004. The market value of one of the securities increased \$389,000 from December 31 to the date of sale. The market

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value of the other three securities decreased an aggregate of \$652,000 from December 31 to date of sale.

Although GAFRI 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. None of the securities were sold out of a necessity to raise cash. GAFRI has the ability and intent to hold securities with unrealized losses at March 31, 2005, for a period of time sufficient to allow for a recovery in market value.

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

| <u>Fixed Maturities at March 31, 2005</u> | <u>Aggregate Market Value</u> | <u>Aggregate Unrealized Gain (Loss)</u> | <u>Market Value as % of Cost Basis</u> |
|--|---------------------------------------|---|--|
| Securities with unrealized gains: | | | |
| Exceeding \$500,000 (123 issues): | \$1,491 | \$108 | 107.8% |
| Less than \$500,000 (993 issues): | <u>4,012</u> | <u>122</u> | 103.1% |
| | <u>\$5,503</u> | <u>\$230</u> | 104.4% |
| Securities with unrealized losses: | | | |
| Exceeding \$500,000 (25 issues): | \$ 557 | (\$ 19) | 96.7% |
| Less than \$500,000 (356 issues): | <u>2,536</u> | <u>(37)</u> | 98.6% |
| | <u>\$3,093</u> | <u>(\$ 56)</u> | 98.2% |
| | | | |
| <u>Equity Securities at March 31, 2005</u> | | | |
| Securities with unrealized gains: | | | |
| Exceeding \$500,000 (9 issues): | \$ 52 | \$12 | 130.0% |
| Less than \$500,000 (18 issues): | <u>35</u> | <u>2</u> | 106.1% |
| | <u>\$ 87</u> | <u>\$14</u> | 119.2% |
| Securities with unrealized losses: | | | |
| | \$ 38 | (\$1) | 97.4% |

Exceeding \$500,000 (1 issue):

31 (2) 93.9%

Less than \$500,000 (13 issues):

)
\$ 69 (\$3) 95.8%

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GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

Management's Discussion and Analysis

of Financial Condition and Results of Operations - Continued

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

| <u>Fixed Maturities with Unrealized Losses at March 31, 2005</u> | <u>Aggregate Market Value</u> | <u>Aggregate Unrealized Gain(Loss)</u> | <u>Market Value as % of Cost Basis</u> |
|--|---------------------------------------|--|--|
| Investment grade with losses for: | | | |
| One year or less (318 issues) | \$2,736 | (\$41) | 98.5% |
| Greater than one year (25 issues) | <u>252</u> | <u>(11)</u> | 95.8% |
| |) | | |
| | <u>\$2,988</u> | <u>(\$52)</u> | 98.3% |
| Non-investment grade with losses for: | | | |
| One year or less (26 issues) | \$ 77 | (\$ 2) | 97.5% |
| Greater than one year (12 issues) | <u>28</u> | <u>(2)</u> | 93.3% |
| |) | | |

| | | | |
|--|---------------|---------------|-------|
| | <u>\$ 105</u> | <u>(\$ 4)</u> | 96.3% |
|--|---------------|---------------|-------|

Equity Securities with Unrealized

Losses at March 31, 2005

| | | | |
|----------------------------------|--------------|---------------|-------|
| One year or less (14 issues) | \$ 69 | (\$ 3) | 95.8% |
| Greater than one year (0 issues) | <u>—</u> | <u>—</u> | - |
| | <u>\$ 69</u> | <u>(\$ 3)</u> | 95.8% |

When a decline in the value of a specific investment is considered to be "other than temporary," a provision for impairment is charged to earnings (accounted for as a realized loss) and the cost basis of that investment is reduced. The determination of whether unrealized losses are "other than temporary" requires judgment based on subjective as well as objective factors. A listing of factors considered and resources used is contained in the discussion of "Investments" under Management's Discussion and Analysis in GAFRI's 2004 Form 10-K.

Based on its analysis, management believes that (i) GAFRI will recover its cost basis in the securities with unrealized losses and (ii) GAFRI 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 GAFRI's liquidity.

GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

Management's Discussion and Analysis

of Financial Condition and Results of Operations - Continued

RESULTS OF OPERATIONS

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General

As shown in Footnote D - "Segments of Operations", operating earnings for the first quarter of 2005 reflects improved operating profit in each of the Company's lines of business compared to the respective 2004 period. The \$2.6 million decrease in operating earnings for the first quarter of 2005 compared to the same period in 2004 reflects realized gains of \$7.5 million in the first quarter of 2004 compared to realized losses of (\$0.6) million in 2005.

Retirement Products

The following table summarizes GAFRI's statutory premiums for its retirement annuities (in millions).

| | Three months ended <u>March 31,</u> | |
|--|--|--------------|
| <u>Annuity Premiums</u> | <u>2005</u> | <u>2004</u> |
| Cincinnati Insurance Operations: | | |
| Single premium fixed rate annuities | \$190 | \$103 |
| Flexible premium fixed rate annuities | 44 | 39 |
| Single premium variable annuities | 9 | 9 |
| Flexible premium variable annuities | <u>17</u> | <u>19</u> |
| Subtotal Cincinnati Insurance Operations | 260 | 170 |
| UTA and GAPR fixed rate annuities | <u>6</u> | <u>7</u> |
| Total annuity premiums | <u>\$266</u> | <u>\$177</u> |

The increase in GAFRI's single premium annuities includes approximately \$100 million of fixed annuity premiums from policyholders of an unaffiliated company in rehabilitation who chose to transfer their funds to GAFRI.

Life, Accident and Health Premiums and Benefits

The following table summarizes GAFRI's life, accident and health premiums and benefits as shown in the Consolidated Income Statement (in millions).

| | Three months ended <u>March 31,</u> | |
|-----------------|--|-------------|
| <u>Premiums</u> | <u>2005</u> | <u>2004</u> |

| | | |
|-----------------------------------|-------------|-------------|
| Supplemental insurance operations | \$64 | \$62 |
| GA Life of Puerto Rico | 18 | 17 |
| Cincinnati life operations | <u>10</u> | <u>11</u> |
| | <u>\$92</u> | <u>\$90</u> |

Benefits

| | | |
|-----------------------------------|-------------|-------------|
| Supplemental insurance operations | \$48 | \$47 |
| GA Life of Puerto Rico | 9 | 9 |
| Cincinnati life operations | <u>12</u> | <u>13</u> |
| | <u>\$69</u> | <u>\$69</u> |

Beginning in the second quarter of 2004, GALIC's life division stopped issuing life insurance policies due to inadequate volume and returns. GAFRI will continue to service and accept renewal premiums on its in-force block of these policies. The Company will also continue to sell life products through its supplemental insurance operations and GA Life of Puerto Rico.

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GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

Management's Discussion and Analysis

of Financial Condition and Results of Operations - Continued

Net Investment Income

Net investment income increased \$16.5 million (13%) in the first quarter of 2005, compared to the same period of 2004. An increase in average invested assets of approximately \$1.1 billion (13%), due primarily to the acquisition of the NHIC block of annuities in May 2004, was partially offset by a lower yield on GAFRI's investment portfolio.

The yield on GAFRI's fixed maturity portfolio was approximately 6.0% at March 31, 2005 compared to approximately 6.2% at year-end 2003. See "Management's Discussion and Analysis - Investments."

Realized Gains (Losses)

Investments

Realized gains (losses) on investments included provisions for other than temporary impairment on securities still held as follows: first quarter of 2005 and 2004 - \$1.7 million and \$2.6 million, respectively.

Retirement of Subsidiary Trust Debt

Loss on retirement of subsidiary trust debt reflects pretax losses on repurchases of \$27.2 million principal amount of the Company's 8-7/8% trust preferred securities in the first quarter of 2004.

Other Income

Other income increased \$7.1 million (38%) in the first quarter of 2005 compared to the same period in 2004 reflecting (i) increased real estate revenues due to the acquisition of a new property in July 2004; (ii) increased surrender fee income on GAFRI's fixed annuity operations (including the NHIC block acquired in May 2004); and (iii) higher fees earned on GAFRI's variable annuity business due to higher average variable annuity asset balances.

Real Estate Operations

GAFRI is engaged in a variety of real estate operations including hotels and marinas. Revenues and expenses of these operations are included in GAFRI's Consolidated Income Statement as shown below (in millions). The increase in real estate revenues and expenses is due primarily to the acquisition of a new property in July 2004.

| | Three months ended | |
|------------------------|--------------------|-------------|
| | <u>March 31,</u> | |
| | <u>2005</u> | <u>2004</u> |
| Other income | \$11.9 | \$6.1 |
| Other expenses: | | |
| Operating expenses | 9.4 | 5.7 |
| Depreciation and other | 3.0 | 1.6 |

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GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

Management's Discussion and Analysis

of Financial Condition and Results of Operations - Continued

Annuity Benefits

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

Historically, management has been able to react to changes in market interest rates and maintain a desired interest rate

spread. Management believes that significant changes in projected investment yields could result in charges (or credits) to earnings in the period an increase in annuity reserves, the projections are modified.

Annuity benefits increased \$8.5 million in the first quarter of 2005 compared to the same period in 2004 reflecting an increase in annuity reserves primarily as a result of the acquisition of a block of business in May 2004.

Insurance Acquisition Expenses

Insurance acquisition expenses includes amortization of DPAC as well as a portion of commissions on sales of insurance products. Insurance acquisition expenses also include amortization of the present value of future profits of businesses acquired.

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

Interest on Subsidiary Trust Obligations

The decrease in interest on subsidiary trust obligations in the first quarter of 2005 compared to the same period in 2004 reflects the Company's March 2004 redemption of \$65 million principal amount of its 9-1/4% TOPrS and the first quarter 2004 repurchases of \$27.2 million principal amount of its 8-7/8% preferred securities.

Other Interest and Debt Expenses

The increase in other interest and debt expenses in the first quarter of 2005 compared to the same period in 2004 reflects the first quarter 2004 issuance of 7-1/4% Senior Debentures.

Other Expenses

Other expenses increased \$7.5 million (21%) in the first quarter of 2005 compared to the same period in 2004 reflects an increase in expenses from real estate operations due to the acquisition of a new property in July 2004.

Income Taxes

The provision for income taxes presented reflects the effects of non-taxable foreign operations.

Cumulative Effect of Accounting Change

In January 2004, GAFRI recorded an after-tax charge of \$2.2 million resulting from the implementation of SOP 03-1. The most significant effect to GAFRI is a change in accounting for assets and liabilities related to two-tier annuities and persistency bonuses. As a result of adopting the SOP, unamortized insurance acquisition costs increased by \$50 million and annuity benefits accumulated increased by \$54 million.

Item 3

Quantitative and Qualitative Disclosure of Market Risk

As of March 31, 2005, there were no material changes to the information provided in Item 7A - "Quantitative and Qualitative Disclosure about Market Risk" in GAFRI's 2004 Form 10-K.

Item 4

Controls and Procedures

GAFRI's management, with participation from its Chief Executive Officer and Chief Financial Officer, has evaluated GAFRI's disclosure controls and procedures (as defined in Exchange Act Rule 13a-15(e)) as of March 31, 2005. Based on that evaluation, GAFRI's CEO and CFO concluded that these disclosure controls and procedures were effective.

During the first quarter of 2005, there have been no changes in GAFRI's internal controls over financial reporting that have materially affected, or are reasonably likely to materially affect, GAFRI's internal controls over financial reporting. In the quarter ended March 31, 2005, the Company did complete conversions of the following two software systems:

- ◆ Medicare supplement claims processing; and
- ◆ General ledger and accounts payable.

In addition, payroll processing migrated from an outside service provider to in-house processing on an existing system. These changes were part of the Company's ongoing process of upgrading its software to expand the functionality of its systems. However, the related business processes and procedures did not materially change and, accordingly, management does not believe such changes are likely to materially affect GAFRI's internal controls over financial reporting.

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GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

PART II

OTHER INFORMATION

Item 2

Unregistered Sales of Equity Securities and Use of Proceeds

GAFRI made the following purchases of its \$1 par value common stock during the first quarter:

| <u>Period</u> | <u>Total Number of Shares Purchased</u> | <u>Average Price Paid Per Share</u> | <u>Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs</u> | <u>Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs(a)</u> |
|---------------|---|-------------------------------------|---|--|
| <u>2005</u> | | | | |
| January | - | - | - | - |
| February | - | - | - | - |
| March | 31,700 | \$16.82 | 31,700 | 1,706,674 |

(a) In April 2005, GAFRI's Board of Directors increased the authorization for share repurchases by 1.5 million shares. The Company is now authorized to repurchase up to 1.7 million shares.

Item 6

Exhibits

Exhibits:

Number Exhibit Description

31(a)

Certification of the Chief Executive Officer pursuant to Section 302(a) of the Sarbanes-Oxley Act of 2002.

31(b) Certification of the Chief Financial Officer pursuant to Section 302(a) of the Sarbanes-Oxley Act of 2002.

32 Certification of the Chief Executive Officer and Chief Financial Officer pursuant to 18 USC Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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Signature

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Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned duly authorized.

GREAT AMERICAN FINANCIAL RESOURCES, INC.

May 6, 2005

BY: /s/Christopher P. Miliano
Christopher P. Miliano
Chief Financial Officer

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