HANOVER INSURANCE GROUP, INC.
Form 10-Q
November 09, 2006
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q

(Mark One)

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended September 30, 2006

or

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from __________ to __________

Commission File Number: 1-13754

THE HANOVER INSURANCE GROUP, INC.

(Exact name of registrant as specified in its charter)

Delaware	04-3263626
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

440 Lincoln Street, Worcester, Massachusetts 01653
(Address of principal executive offices) (Zip Code)
(508) 855-1000

(Registrant s telephone number, including area code)

(Former name, former address and former fiscal year, if changed since last report)
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 (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer x Accelerated filer ¨ Non-accelerated filer ¨

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

APPLICABLE ONLY TO ISSUERS INVOLVED IN BANKRUPTCY

PROCEEDINGS DURING THE PRECEDING FIVE YEARS:

Indicate by check mark whether the registrant has filed all documents and reports required to be filed by Section 12, 13 or 15(d) of the Securities Exchange Act of 1934 subsequent to the distribution of securities under a plan confirmed by a court. Yes ¨ No ¨

APPLICABLE ONLY TO CORPORATE ISSUERS:

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date: 51,005,156 shares of common stock outstanding, as of November 1, 2006.

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PART I - FINANCIAL INFORMATION

ITEM 1 - FINANCIAL STATEMENTS

THE HANOVER INSURANCE GROUP, INC.

CONSOLIDATED STATEMENTS OF INCOME

	(Unaudited) Quarter Ended September 30,		(Unaudited) Nine Months Ended September 30,	
(In millions, except per share data)	**2006**	**2005**	**2006**	**2005**
REVENUES				
Premiums	**$ 568.2**	$ 525.7	**$ 1,682.4**	$ 1,650.3
Fees and other income	**22.6**	22.2	**58.8**	60.8
Net investment income	**78.3**	79.4	**237.8**	238.0
Net realized investment gains	**2.1**	1.9	**10.6**	18.1
Total revenues	**671.2**	629.2	**1,989.6**	1,967.2
BENEFITS, LOSSES AND EXPENSES				
Policy benefits, claims, losses and loss adjustment expenses	**399.5**	566.9	**1,114.8**	1,340.9
Policy acquisition expenses	**121.7**	116.5	**352.8**	347.9
Other operating expenses	**106.7**	86.6	**315.0**	290.5
Total benefits, losses and expenses	**627.9**	770.0	**1,782.6**	1,979.3
Income (loss) from continuing operations before federal income taxes	**43.3**	(140.8)	**207.0**	(12.1)
Federal income tax expense (benefit):				
Current	**(4.5)**	(0.8)	**18.3**	5.2
Deferred	**19.3**	(34.6)	**46.5**	(9.4)
Total federal income tax expense (benefit)	**14.8**	(35.4)	**64.8**	(4.2)
Income (loss) from continuing operations	**28.5**	(105.4)	**142.2**	(7.9)
Discontinued operations (See Note 3):				
Income from operations of discontinued variable life insurance and annuity business (net of income tax benefit of $3.5 and $14.1 for the quarter and nine months ended September 30, 2005)	**-**	17.6	**-**	38.6
Loss on disposal of variable life insurance and annuity business (net of income tax (expense) benefit of $(2.5) and $7.0 for the quarters ended September 30, 2006 and 2005, respectively, and $5.3 and $7.0 for the nine months ended September 30, 2006 and 2005, respectively	**(2.9)**	(474.6)	**(25.8)**	(474.6)
Gain on sale of Financial Profiles, Inc. (net of income tax expense of $1.2 for the quarter and nine months ended September 30, 2006)	**7.8**	-	**7.8**	-
Income before cumulative effect of change in accounting principle	**33.4**	(562.4)	**124.2**	(443.9)
Cumulative effect of change in accounting principle (net of income tax expense of $0.3)	**-**	-	**0.6**	-
Net income (loss)	**$ 33.4**	$ (562.4)	**$ 124.8**	$ (443.9)
PER SHARE DATA				
Basic				
Income (loss) from continuing operations	**$ 0.56**	$ (1.97)	**$ 2.75**	$ (0.15)
Discontinued operations:				

Income from operations of discontinued variable life insurance and annuity business (net of income tax benefit of $0.07 and $0.26 for the quarter and nine months ended September 30, 2005)		**-**		0.33		**-**		0.72
Loss on disposal of variable life insurance and annuity business (net of income tax (expense) benefit of $(0.05) and $0.13 for the quarters ended September 30, 2006 and 2005, respectively, and $0.10 and $0.13 for the nine months ended September 30, 2006 and 2005, respectively)		**(0.05)**		(8.87)		**(0.49)**		(8.88)
Gain on sale of Financial Profiles, Inc. (net of income tax expense of $0.02 for the quarter and nine months ended September 30, 2006)		**0.15**		-		**0.15**		-
Income (loss) before cumulative effect of change in accounting principle		**0.66**		(10.51)		**2.41**		(8.31)
Cumulative effect of change in accounting principle		**-**		-		**0.01**		-
Net income (loss) per share	**$**	**0.66**	$	(10.51)	**$**	**2.42**	$	(8.31)
Weighted average shares outstanding		**50.9**		53.5		**51.7**		53.4
<u>Diluted</u>								
Income (loss) from continuing operations	**$**	**0.56**	$	(1.97)	**$**	**2.73**	$	(0.15)
Discontinued operations:								
Income from operations of discontinued variable life insurance and annuity business (net of income tax benefit of $0.07 and $0.26 for the quarter and nine months ended September 30, 2005)		**-**		0.33		**-**		0.72
Loss on disposal of variable life insurance and annuity business (net of income tax (expense) benefit of $(0.05) and $0.13 for the quarters ended September 30, 2006 and 2005, respectively, and $0.10 and $0.13 for the nine months ended September 30, 2006 and 2005, respectively)		**(0.06)**		(8.87)		**(0.49)**		(8.88)
Gain on sale of Financial Profiles, Inc. (net of income tax expense of $0.02 for the quarter and nine months ended September 30, 2006)		**0.15**		-		**0.14**		-
Income (loss) before cumulative effect of change in accounting principle		**0.65**		(10.51)		**2.38**		(8.31)
Cumulative effect of change in accounting principle		**-**		-		**0.01**		-
Net income (loss) per share	**$**	**0.65**	$	(10.51)	**$**	**2.39**	$	(8.31)
Weighted average shares outstanding		**51.3**		53.5		**52.2**		53.4

The accompanying notes are an integral part of these consolidated financial statements.

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THE HANOVER INSURANCE GROUP, INC.

CONSOLIDATED BALANCE SHEETS

(In millions, except per share data)		(Unaudited) September 30, 2006		December 31, 2005
ASSETS				
Investments:				
Fixed maturities at fair value (amortized cost of $5,498.4 and $5,685.9)	**$**	**5,474.9**	$	5,708.2
Equity securities at fair value (cost of $12.1 and $13.0)		**17.3**		18.0
Mortgage loans		**59.4**		99.6
Policy loans		**127.2**		139.9
Other long-term investments		**40.5**		42.6
Total investments		**5,719.3**		6,008.3
Cash and cash equivalents		**391.9**		701.5
Accrued investment income		**72.6**		76.5
Premiums, accounts and notes receivable, net		**606.9**		493.2
Reinsurance receivable on paid and unpaid losses, benefits and unearned premiums		**1,391.7**		1,617.3
Deferred policy acquisition costs		**237.9**		209.0
Deferred federal income taxes		**432.5**		465.3
Goodwill		**121.4**		128.2
Other assets		**345.6**		362.8
Separate account assets		**524.2**		571.9
Total assets	**$**	**9,844.0**	$	10,634.0
LIABILITIES				
Policy liabilities and accruals:				
Future policy benefits	**$**	**1,281.5**	$	1,336.1
Outstanding claims, losses and loss adjustment expenses		**3,279.9**		3,551.6
Unearned premiums		**1,141.6**		1,011.3
Contractholder deposit funds and other policy liabilities		**203.2**		254.7
Total policy liabilities and accruals		**5,906.2**		6,153.7
Expenses and taxes payable		**898.2**		1,062.0
Reinsurance premiums payable		**60.4**		92.0
Trust instruments supported by funding obligations		**36.9**		294.3
Long-term debt		**508.8**		508.8
Separate account liabilities		**524.2**		571.9
Total liabilities		**7,934.7**		8,682.7
Commitments and contingencies (Note 12)				
SHAREHOLDERS EQUITY				
Preferred stock, $0.01 par value, 20.0 million shares authorized, none issued		**-**		-
Common stock, $0.01 par value, 300.0 million shares authorized, 60.5 million shares issued		**0.6**		0.6
Additional paid-in capital		**1,809.0**		1,785.1
Accumulated other comprehensive loss		**(87.5)**		(59.5)
Retained earnings		**685.4**		589.8
Treasury stock at cost (9.6 million and 6.8 million shares)		**(498.2)**		(364.7)

Total shareholders equity		**1,909.3**		1,951.3
Total liabilities and shareholders equity	**$**	**9,844.0**	$	10,634.0

The accompanying notes are an integral part of these consolidated financial statements.

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THE HANOVER INSURANCE GROUP, INC.

CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY

	(Unaudited)	
	Nine Months Ended	
	September 30,	
(In millions)	**2006**	**2005**
PREFERRED STOCK		
Balance at beginning and end of period	**$ -**	$ -
COMMON STOCK		
Balance at beginning and end of period	**0.6**	0.6
ADDITIONAL PAID-IN CAPITAL		
Balance at beginning of period	**1,785.1**	1,782.1
Tax benefit from exercise of stock options and other	**7.1**	2.4
Employee and director stock-based awards	**16.8**	(0.2)
Balance at end of period	**1,809.0**	1,784.3
ACCUMULATED OTHER COMPREHENSIVE LOSS		
NET UNREALIZED (DEPRECIATION) APPRECIATION ON INVESTMENTS AND DERIVATIVE INSTRUMENTS:		
Balance at beginning of period	**9.9**	87.1
Depreciation during the period:		
Net depreciation on available-for-sale securities and derivative instruments	**(33.3)**	(59.1)
Benefit for deferred federal income taxes	**5.3**	20.7
	(28.0)	(38.4)
Balance at end of period	**(18.1)**	48.7
MINIMUM PENSION LIABILITY:		
Balance at beginning and end of period	**(69.4)**	(84.1)
Total accumulated other comprehensive loss	**(87.5)**	(35.4)
RETAINED EARNINGS		
Balance at beginning of period	**589.8**	943.4
Net income (loss)	**124.8**	(443.9)
Treasury stock issued for less than cost	**(29.2)**	(13.3)
Balance at end of period	**685.4**	486.2
TREASURY STOCK		
Balance at beginning of period	**(364.7)**	(389.6)
Shares purchased at cost	**(200.1)**	-
Net shares reissued at cost under employee stock-based compensation plans	**66.6**	21.6
Balance at end of period	**(498.2)**	(368.0)

Total shareholders equity	**$**	**1,909.3**	$	1,867.7

The accompanying notes are an integral part of these consolidated financial statements.

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THE HANOVER INSURANCE GROUP, INC.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

	(Unaudited)		(Unaudited)	
	Quarter Ended		Nine Months Ended	
	September 30,		September 30,	
(In millions)	**2006**	**2005**	**2006**	**2005**
Net income (loss)	**$ 33.4**	$ (562.4)	**$ 124.8**	$ (443.9)
Other comprehensive income (loss):				
Available-for-sale securities:				
Net appreciation (depreciation) during the period	**95.5**	(104.8)	**(34.6)**	(135.1)
Benefit for deferred federal income taxes	**5.0**	36.7	**5.7**	47.3
Total available-for-sale securities	**100.5**	(68.1)	**(28.9)**	(87.8)
Derivative instruments:				
Net (depreciation) appreciation during the period	**(0.1)**	1.7	**1.3**	76.0
Benefit (provision) for deferred federal income taxes	**0.1**	(0.6)	**(0.4)**	(26.6)
Total derivative instruments	**-**	1.1	**0.9**	49.4
Other comprehensive income (loss)	**100.5**	(67.0)	**(28.0)**	(38.4)
Comprehensive income (loss)	**$ 133.9**	$ (629.4)	**$ 96.8**	$ (482.3)

The accompanying notes are an integral part of these consolidated financial statements.

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THE HANOVER INSURANCE GROUP, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In millions)	(Unaudited) Nine Months Ended September 30, 2006	2005
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income (loss)	**$ 124.8**	$ (443.9)
Adjustments to reconcile net income (loss) to net cash (used in) provided by operating activities:		
Loss on disposal of variable life insurance and annuity business	**25.8**	474.6
Gain on sale of Financial Profiles, Inc.	**(7.8)**	-
Net realized investment gains	**(10.6)**	(24.2)
Net amortization and depreciation	**16.3**	24.8
Stock-based compensation expense	**13.0**	-
Interest credited to contractholder deposit funds and trust instruments supported by funding obligations	**6.0**	17.8
Deferred federal income taxes	**42.3**	(19.4)
Change in deferred acquisition costs	**(29.7)**	107.4
Change in premiums and notes receivable, net of reinsurance premiums payable	**(130.9)**	2.4
Change in accrued investment income	**3.9**	18.1
Change in policy liabilities and accruals, net	**(212.1)**	320.9
Change in reinsurance receivable	**225.6**	(227.7)
Change in expenses and taxes payable	**(99.0)**	(62.2)
Other, net	**(14.0)**	(17.9)
Net cash (used in) provided by operating activities	**(46.4)**	170.7
CASH FLOWS FROM INVESTING ACTIVITIES		
Proceeds from disposals and maturities of available-for-sale fixed maturities	**1,105.8**	1,729.1
Proceeds from disposals of equity securities and other investments	**18.8**	24.8
Proceeds from mortgages sold, matured or collected	**40.2**	13.1
Proceeds from collections of installment finance and notes receivable	**259.3**	240.7
Proceeds from sale of variable life insurance and annuity business	**27.3**	-
Proceeds from sale of Financial Profiles, Inc.	**17.9**	-
Purchase of available-for-sale fixed maturities	**(923.5)**	(1,209.6)
Purchase of equity securities and other investments	**(5.8)**	(5.9)
Capital expenditures	**(6.0)**	(5.1)
Net payments related to margin deposits on derivative instruments	**(28.3)**	(37.2)
Disbursements to fund installment finance and notes receivable	**(273.7)**	(231.9)
Net cash provided by investing activities	**232.0**	518.0
CASH FLOWS FROM FINANCING ACTIVITIES		
Withdrawals from contractholder deposit funds	**(25.8)**	(1.7)
Withdrawals from trust instruments supported by funding obligations	**(253.1)**	(647.2)
Exercise of options	**37.8**	7.6
Proceeds from excess tax benefits related to share-based payments	**7.1**	-
Change in collateral related to securities lending program	**(61.1)**	27.3
Treasury stock purchased at cost	**(200.1)**	-
Net cash used in financing activities	**(495.2)**	(614.0)
Net change in cash and cash equivalents	**(309.6)**	74.7
Net change in cash held by discontinued operations	**-**	(19.2)

Cash and cash equivalents, beginning of period		**701.5**		376.9
Cash and cash equivalents, end of period	**$**	**391.9**	$	432.4

The accompanying notes are an integral part of these consolidated financial statements.

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THE HANOVER INSURANCE GROUP, INC.

NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS

1. Basis of Presentation and Principles of Consolidation

The accompanying unaudited consolidated financial statements of The Hanover Insurance Group, Inc. (THG or the Company) have been prepared in accordance with generally accepted accounting principles for interim financial information and with the requirements of Form 10-Q.

The interim consolidated financial statements of THG include the accounts of The Hanover Insurance Company (Hanover Insurance) and Citizens Insurance Company of America (Citizens), THG s principal property and casualty companies; First Allmerica Financial Life Insurance Company (FAFLIC), THG s life insurance and annuity subsidiary; and certain other insurance and non-insurance subsidiaries. These legal entities conduct their operations through several business segments discussed in Note 9. All significant intercompany accounts and transactions have been eliminated. The Company s results of operations also include the accounts of Allmerica Financial Life Insurance and Annuity Company (AFLIAC) through December 30, 2005. As further described in Note 3 - Sale of Variable Life Insurance and Annuity Business, on December 30, 2005, the Company sold, as part of a stock purchase agreement, its run-off variable life insurance and annuity business.

The accompanying interim consolidated financial statements reflect, in the opinion of the Company s management, all adjustments necessary for a fair presentation of the financial position and results of operations. The results of operations for the nine months ended September 30, 2006 are not necessarily indicative of the results to be expected for the full year. These financial statements should be read in conjunction with the Company s 2005 Annual Report on Form 10-K filed with the Securities and Exchange Commission.

The preparation of financial statements in conformity with generally accepted accounting principles requires the Company to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amount of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Certain prior period amounts have been reclassified to conform to the current year presentation.

2. New Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 158, *Employers Accounting for Defined Benefit Pension and Other Postretirement Plans an amendment of FASB statements No. 87, 88, 106, and 132(R)* (Statement No. 158). This statement requires an employer to recognize the funded status of its benefit plans in its statement of financial position and to recognize changes in that funded status through comprehensive income in the year in which they occur. The funded status of the plans should be measured as the difference between the fair value of plan assets and the benefit obligation. This statement also requires the recognition, as a component of other comprehensive income, net of taxes, of the gains or losses and prior service costs or credits that arise during the period but are not recognized as a component of net periodic benefit cost pursuant to Statement of Financial Accounting Standards No. 87, *Employers Accounting for Pensions* (Statement No. 87) or Statement of Financial Accounting Standards No. 106, *Employers Accounting for Postretirement Benefits Other Than Pensions* (Statement No. 106). Amounts recognized in accumulated other comprehensive income shall continue to be subsequently recognized as components of net periodic benefit cost pursuant to the recognition and amortization requirements of Statement No. 87 and Statement No. 106. In addition, the statement requires an employer to measure the funded status of its plans as of the date of its year-end statement of financial position. The statement also provides for enhanced disclosures which include, among other items, the estimated amount of actuarial gains or losses, prior services costs or credits, and transition assets or obligations that are included in accumulated other comprehensive income to be recognized as components of net periodic benefit cost in the next fiscal year. The effective date for a company to recognize the funded status of its plans and the related disclosure requirements is its fiscal year ending after December 15, 2006. Based on assessments of plan data available, the Company believes that the effect of adopting Statement No. 158 will not be material to its statement of financial position. The effective date for changing a company s measurement date for plan assets and benefit obligations to coincide with the date of its statement of financial position will be the fiscal year ending after December 15, 2008. Retrospective application of this statement is not permitted. The Company currently measures its funded status as of December 31.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, Fair Value Measurements (Statement No. 157). This statement creates a common definition of fair value to be used throughout generally accepted accounting principles. Statement No. 157 will apply whenever another standard requires or permits assets or liabilities to be measured at fair value, with certain exceptions. The standard establishes a hierarchy for determining fair value which emphasizes

the use of observable market data whenever available. The statement also requires expanded disclosures which include the extent to which assets and liabilities are measured at fair value, the methods and assumptions used to measure fair value and the effect of fair value measures on earnings. Statement No. 157 is effective for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. The difference between the carrying amounts and fair values of those financial instruments held at the date this statement is initially applied should be recognized as a cumulative effect adjustment to the opening balance of retained earnings for the fiscal year in which this statement is initially applied. The Company is currently assessing the effect of adopting Statement No. 157.

In June 2006, the FASB issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109* (FIN 48). The interpretation requires companies to recognize the tax benefits of uncertain tax positions only where the position is more likely than not to be sustained upon examination by tax authorities. The amount recognized would be the amount that represents the largest amount of tax benefit that is greater than 50% likely of being ultimately realized. A liability would be recognized for any benefit claimed, or expected to be claimed, in a tax return in excess of the benefit recorded in the financial statements, along with any interest and penalty on the excess. FIN 48 will require, among other items, a tabular reconciliation of the change during the reporting period, in the aggregate unrecognized tax benefits claimed or expected to be claimed in tax returns and disclosure relating to accrued interest and penalties for unrecognized tax benefits. Additional disclosure will also be required for those uncertain tax positions where it is reasonably possible that the estimate of the tax benefit will change significantly in the next twelve months. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company is currently assessing the effect of adopting FIN 48.

In February 2006, the FASB issued Statement of Financial Accounting Standards No. 155, *Accounting for Certain Hybrid Financial Instruments an amendment of FASB Statements No. 133 and 140* (Statement No. 155). This Statement amends Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities* (Statement No. 133) and Statement of Financial Accounting Standards No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities a replacement of FASB Statement No. 125.* Statement No. 155, among other things, permits fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation, adds clarity regarding interest-only strips and principal-only strips that are not subject to the requirements of Statement No. 133, and requires companies to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments containing an embedded derivative that requires bifurcation. Statement No. 155 is effective for all financial instruments acquired or issued after the beginning of an entity s first fiscal year that begins after September 15, 2006. Since early adoption is permitted, the Company adopted Statement No. 155 on January 1, 2006 with no material impact to its financial statements.

In September 2005, the American Institute of Certified Public Accountants (AICPA) issued Statement of Position 05-1, *Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection with Modifications or Exchanges of Insurance Contracts* (SOP 05-1). SOP 05-1 provides guidance on accounting by insurance companies for deferred acquisition costs on internal replacements of insurance and investment contracts other than those described in Statement of Financial Accounting Standards No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*. This statement is effective for internal replacements occurring in fiscal years beginning after December 15, 2006. The Company is currently assessing the effect of adopting SOP 05-1.

In May 2005, the FASB issued Statement of Financial Accounting Standards No. 154, *Accounting Changes and Error Corrections a replacement of APB Opinion No. 20 and FASB Statement No. 3* (Statement No. 154). Statement No. 154 replaces Accounting Principles Board Opinion No. 20, *Accounting Changes* (APB Opinion No. 20), and Statement of Financial Accounting Standards No. 3, *Reporting Accounting Changes in Interim Financial Statements*. This statement establishes, unless impracticable, retrospective application as the required method for all voluntary changes in accounting principle in the absence of specific transition provisions for the newly adopted accounting principle. Statement No. 154 requires companies to retrospectively apply the effect of the change to all prior periods practicable, and the financial statements for all periods presented shall be adjusted to reflect the change. Similarly, an error in the financial statements of a prior period that is discovered subsequent to their issuance shall be reported as a prior-period adjustment, and the financial statements for each period presented shall be adjusted to reflect the correction. This statement also provides guidance for determining whether retrospective application of a change in accounting principle is impracticable and the necessary disclosures once that determination has been made. Additionally, changes in methods of depreciation, amortization or depletion of long-lived, non-financial assets must be accounted for as a change in accounting estimate. The statement also requires certain disclosures in the period in which a change in accounting principle or correction of an error is made. Statement No. 154 is effective for changes and correction of errors made in fiscal years beginning after December 15, 2005.

In December 2004, the FASB issued Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment* (Statement No. 123(R)). This statement requires companies to measure and recognize the cost of employee services received in

exchange for an award of equity instruments based on the grant-date fair value. Statement No. 123(R) replaces Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation* (Statement No. 123), and supersedes Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* (APB Opinion No. 25). The Company has adopted Statement No. 123(R) effective January 1, 2006 using the modified prospective transition method. Prior to the adoption of Statement No. 123(R), the Company accounted for its stock-based compensation in accordance with APB Opinion No. 25; therefore, the Company had not previously recognized compensation expense for employee stock options in net income because the exercise price equaled the market value of the underlying common stock on the grant date. Upon adoption of Statement No. 123(R), the Company began recognizing expense related to employee stock options and modified its expense calculation associated with restricted shares and restricted share units. (See Note 11 Stock-Based Compensation Plans.) The cumulative effect adjustment of adopting Statement No. 123(R), net of tax, was a benefit of $0.6 million.

3. Sale of Variable Life Insurance and Annuity Business

On December 30, 2005, the Company sold all of the outstanding shares of capital stock of AFLIAC, a life insurance subsidiary representing approximately 95% of the Company s run-off variable life insurance and annuity business to The Goldman Sachs Group, Inc. (Goldman Sachs). The transaction also included the reinsurance of 100% of the variable business of FAFLIC. In connection with these transactions, Allmerica Investment Trust (AIT) agreed to transfer certain assets and liabilities of its funds to certain Goldman Sachs Variable Insurance Trust managed funds through a fund reorganization transaction. Finally, the Company agreed to sell to Goldman Sachs all of the outstanding shares of capital stock of Allmerica Financial Investment Management Service, Inc. (AFIMS), its investment advisory subsidiary, concurrently with the consummation of a fund reorganization transaction. The fund reorganization transaction was consummated on January 9, 2006.

Total proceeds from the sale were $318.8 million, of which $46.7 million was deferred and expected to be paid over a three year period, with 50% being received in 2006 and 25% in each of the following two years. As of September 30, 2006, the Company had received proceeds from Goldman Sachs totaling $272.1 million. As of September 30, 2005, prior to the closing, total proceeds from the sale were estimated at $292.4 million, of which $27.6 million would be deferred.

In connection with the sale, the Massachusetts Division of Insurance approved a cash dividend of $48.6 million from FAFLIC, including an $8.6 million ceding commission received related to the reinsurance of 100% of the variable business of FAFLIC, and for the distribution of other non-insurance subsidiaries, from which the holding company received $15.4 million of additional funds. These funds were paid to the holding company in the first quarter of 2006.

The Company and Goldman Sachs have made various representations, warranties and covenants in the Stock Purchase Agreement entered into in connection with the transaction. The Company has agreed to indemnify Goldman Sachs for the breaches of the Company s representations, warranties and covenants. THG has also agreed to indemnify Goldman Sachs for certain litigation, regulatory matters and other liabilities relating to the pre-closing activities of the business that was sold.

The Company determined that the disposal of AFLIAC should be reflected as a discontinued operation in accordance with Statement of Financial Accounting Standards No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* (Statement No. 144). As such, the Company recognized a loss of $474.6 million related to this transaction as of September 30, 2005, primarily from a change in certain actuarial assumptions related to the deferred acquisition cost and deferred sales inducement asset. This was adjusted on December 30, 2005, the closing date, to reflect the actual purchase price paid by Goldman Sachs and the book value of AFLIAC on that date. The Company adjusted its loss on the sale of AFLIAC to a loss of $444.4 million at December 30, 2005. The loss is presented in the Consolidated Statements of Income as Loss on Disposal of Variable Life Insurance and Annuity Business, a component of Discontinued Operations.

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The following table summarizes the components of the estimated loss on the disposal of our variable life insurance and annuity business as of September 30, 2005 and December 31, 2005:

		(unaudited)	
(In millions)		September 30, 2005	December 31, 2005
Proceeds from Goldman Sachs	(1)	$ 292.4	$ 318.8
Less:			
Carrying value of AFLIAC	(2)	(726.0)	(719.3)
Estimated transaction costs	(3)	(11.0)	(10.5)
Deferred gain on FAFLIC coinsurance	(4)	(8.6)	(8.6)
Liability for certain legal indemnities	(5)	(13.0)	(13.0)
Hedge results	(6)	(8.4)	(27.9)
THG tax benefit	(7)	-	10.0
Realized gain on securities related to AFLIAC		-	6.1
Net loss		$ (474.6)	$ (444.4)

(1) Proceeds from Goldman Sachs include deferred payments of $27.6 million and $46.7 million as of September 30, 2005 and December 31, 2005, respectively, to be received over three years.

(2) Shareholder s equity of the AFLIAC variable life insurance and annuity business at December 31, 2005 (estimated as of September 30, 2005), prior to the impact of the sale transaction.

(3) Transaction costs include investment banker, vendor contract licensing, legal and other professional fees.

(4) Included in the proceeds from Goldman Sachs is the FAFLIC variable business coinsurance ceding commission of $8.6 million. Upon closing of the FAFLIC coinsurance agreement, this gain was deferred and is being amortized over the remaining life of the policies in accordance with Statement of Financial Accounting Standards No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts.*

(5) Estimated liability to Goldman Sachs for certain contractual indemnities of AFLIAC related to the agreement recorded under FASB Interpretation No. 45, *Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* (FIN 45).

(6) A hedging program was implemented on August 23, 2005 to reduce the volatility in the sales price calculation from the effect of equity market movements through the date of the closing.

(7) At December 30, 2005, THG, the holding company, recognized a tax benefit primarily due to realized losses generated by the AFLIAC sale.

In the first nine months of 2006, THG incurred additional losses of $25.8 million, net of taxes, related to the sale, of which $2.9 million was recorded in the third quarter. Included in the $25.8 million after-tax loss was a $15.0 million expense related to the existing provision for the Company s estimated potential liability for certain contractual indemnities to Goldman Sachs relating to the pre-sale activities of the business

sold recorded under FIN 45. This additional provision relates to preliminary estimated expenses, reimbursements, penalties and other costs of remediating certain pre-closing processing errors relating to tax reporting to certain policyholders and others in connection with distributions under a subset of the Company s former variable annuity business. The estimate is based on, among other items, the Company s review of affected policies, mathematical extrapolations derived from such review, and management s preliminary view of possible settlement ranges with the Internal Revenue Service and affected policyholders. Although the Company believes its FIN 45 liability for legal and regulatory matter indemnities is appropriate, including with respect to this matter, such estimates are inherently uncertain and there can be no assurance that these estimates will not materially increase in the future.

Also included in the loss for the quarter and nine months ended September 30, 2006 was $2.9 million and $10.8 million, respectively, related to after-tax net costs incurred for severance, transition services, conversion activities and other litigation matters. The Company has agreed to provide transition services until the earlier of eighteen months from the December 30, 2005 closing or when the operations of AFLIAC, and the FAFLIC business to be reinsured, can be transferred to Goldman Sachs. These services include policy and claims processing, accounting and reporting, and other administrative services. In the third quarter and first nine months of 2006, the Company earned pre-tax revenues of $4.1 million and $13.4 million, respectively, and incurred pre-tax costs relating to transition services of $8.2 million and $29.7 million, respectively. This transition period is currently expected to extend into the fourth quarter of 2006.

In accordance with Statement No. 144, the Company has reclassified prior year results of operations related to the discontinued variable life insurance and annuity business from its operations, to discontinued operations. These results, including the related

tax effect, are reflected in the Consolidated Statements of Income as Income from Operations of Discontinued Variable Life Insurance and Annuity Business. For the quarter and nine months ended September 30, 2005, total revenues were $80.8 million and $261.2 million, respectively, and income before federal income taxes were $14.1 million and $24.5 million, respectively.

4. Significant Transactions

On August 31, 2006, the Company sold all of the outstanding shares of Financial Profiles, Inc., a wholly-owned subsidiary, to Emerging Information Systems Incorporated. Financial Profiles, Inc. was originally acquired by the Company in 1998 in connection with the Company s then-ongoing life insurance and annuity operations. The Company received pre-tax proceeds of $21.5 million from the transaction and recognized an after-tax gain of $7.8 million during the third quarter of 2006.

On December 28, 2005, the Company s Board of Directors authorized a share repurchase program of up to $200 million. As of May 3, 2006, the Company completed its repurchases under this program, having repurchased 4.0 million shares at an aggregate cost of $200 million.

5. Federal Income Taxes

Federal income tax expense for the nine months ended September 30, 2006 and 2005 has been computed using estimated effective tax rates. These rates are revised, if necessary, at the end of each successive interim period to reflect the current estimates of the annual effective tax rates.

In the third quarter of 2006, the Company generated a tax gain of $12.1 million from the sale of Financial Profiles, Inc. This tax gain was used to offset capital loss carryforwards and reduced the Company s valuation allowance by $4.1 million. The reduction in the valuation allowance was recorded in the Consolidated Statements of Income as an increase in Gain on Sale of Financial Profiles, Inc., a component of Discontinued Operations.

During the nine months ended September 30, 2005, the Company reflected a $12.9 million benefit representing a reduction in federal income tax reserves for prior years, resulting from ongoing Internal Revenue Service audits. Of this amount, $10.6 million was reflected in Income from Operations of Discontinued Variable Life Insurance and Annuity Business on the Company s Consolidated Statements of Income and the remaining $2.3 million was recorded in the Company s federal income tax expense.

The Company s Accumulated Other Comprehensive Loss included the additional minimum pension liability and net unrealized investment losses of $124.8 million as of September 30, 2006. These unrealized losses resulted in a net deferred tax asset of $43.7 million. The Company recorded a valuation allowance related to the unrealized losses associated with the Company s investment portfolio of $6.4 million in the first nine months of 2006, as it is the Company s opinion that it is more likely than not that this asset will not be fully realized. The Company recorded this valuation allowance as an adjustment to Accumulated Other Comprehensive Loss, in the Shareholders Equity section of the Consolidated Balance Sheets. At September 30, 2006 and December 31, 2005, the Company s deferred tax asset valuation allowance was $167.6 million and $165.3 million, respectively.

6. Pension and Other Postretirement Benefit Plans

Prior to 2005, THG provided retirement benefits to substantially all of its employees under defined benefit pension plans based on a cash balance formula. In addition, certain transition group employees who had met specified age and service requirements as of December 31, 1994, were eligible for a grandfathered benefit based on service and compensation. As of January 1, 2005, the defined benefit pension plans were frozen; therefore, no further cash balance allocations have been credited for plan years beginning on or after January 1, 2005. Additionally, the grandfathered benefits were frozen at January 1, 2005 levels with an annual transition pension adjustment. Additional unfunded pension plans and postretirement plans provide certain benefits to a portion of full-time employees, former agents, retirees and their dependents.

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The components of net periodic pension cost for pension and other postretirement benefit plans are as follows:

	(Unaudited)			
	Quarter Ended September 30,			
(In millions)	**2006**	**2005**	**2006**	**2005**
	Pension Benefits		Postretirement Benefits	
Service cost benefits earned during the period	**$ -**	$ -	**$ 0.4**	$ 0.1
Interest cost	**7.3**	7.6	**1.3**	0.8
Expected return on plan assets	**(6.8)**	(6.5)	**-**	-
Recognized net actuarial loss	**3.0**	4.4	**0.4**	0.1
Amortization of transition asset	**(0.4)**	(0.4)	**-**	-
Amortization of prior service cost	**-**	0.1	**(0.9)**	(1.4)
Net periodic benefit cost (benefit)	**$ 3.1**	$ 5.2	**$ 1.2**	$ (0.4)

	(Unaudited)			
	Nine Months Ended September 30,			
	2006	**2005**	**2006**	**2005**
	Pension Benefits		Postretirement Benefits	
Service cost benefits earned during the period	**$ -**	$ -	**$ 0.7**	$ 0.3
Interest cost	**22.0**	22.9	**3.2**	2.4
Expected return on plan assets	**(20.6)**	(19.5)	**-**	-
Recognized net actuarial loss	**9.3**	13.1	**0.7**	0.3
Amortization of transition asset	**(1.1)**	(1.0)	**-**	-
Amortization of prior service cost	**0.2**	0.4	**(3.8)**	(4.1)
Net periodic benefit cost (benefit)	**$ 9.8**	$ 15.9	**$ 0.8**	$ (1.1)

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7. Closed Block

Summarized financial information of the Closed Block is as follows for the periods indicated:

	(Unaudited)	
	September 30,	December 31,
(In millions)	2006	2005
Assets		
Fixed maturities at fair value (amortized cost of $514.6 and $514.5)	**$ 515.7**	$ 520.7
Mortgage loans	**24.3**	25.2
Policy loans	**127.2**	135.8
Cash and cash equivalents	**0.4**	4.4
Accrued investment income	**11.0**	11.5
Deferred policy acquisition costs	**3.0**	3.4
Deferred federal income taxes	**2.0**	3.9
Other assets	**1.3**	2.2
Total assets	**$ 684.9**	$ 707.1
Liabilities		
Policy liabilities and accruals	**$ 693.3**	$ 707.1
Policyholder dividends	**17.9**	34.4
Other liabilities	**2.6**	2.2
Total liabilities	**$ 713.8**	$ 743.7
Excess of Closed Block liabilities over assets designated to the Closed Block	**$ 28.9**	$ 36.6
Amounts included in accumulated other comprehensive income:		
Net unrealized investment gains (losses), net of deferred federal income tax (expense) benefit of $(0.1) and $1.8	**-**	(3.4)
Maximum future earnings to be recognized from Closed Block assets and liabilities	**$ 28.9**	$ 33.2

	(Unaudited)		(Unaudited)	
	Quarter Ended		Nine Months Ended	
	September 30,		September 30,	
(In millions)	2006	2005	2006	2005
Revenues				
Premiums	**$ 5.5**	$ 5.7	**$ 29.0**	$ 30.2
Net investment income	**9.7**	10.4	**29.8**	31.0
Net realized investment gains (losses)	**-**	3.8	**(0.9)**	5.2
Total revenues	**15.2**	19.9	**57.9**	66.4
Benefits and expenses				
Policy benefits	**12.7**	17.2	**51.3**	59.0
Policy acquisition expenses	**0.3**	0.3	**0.7**	0.8

Other operating expenses		**0.1**		0.1		**-**	0.1
Total benefits and expenses		**13.1**		17.6		**52.0**	59.9
Contribution from the Closed Block	**$**	**2.1**	$	2.3	**$**	**5.9**	$ 6.5

Many expenses related to Closed Block operations are charged to operations outside the Closed Block; accordingly, the contribution from the Closed Block does not represent the actual profitability of the Closed Block operations. Operating costs and expenses outside of the Closed Block are, therefore, disproportionate to the business outside the Closed Block.

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8. Other Comprehensive Income

The following table provides a reconciliation of gross unrealized gains (losses) to the net balance shown in the Consolidated Statements of Comprehensive Income.

(In millions)	(Unaudited) Quarter Ended September 30, 2006	2005	(Unaudited) Nine Months Ended September 30, 2006	2005
Unrealized appreciation (depreciation) on available-for-sale securities:				
Unrealized holding gains (losses) arising during period, net of income tax benefit of $4.3 and $38.9 for the quarters ended September 30, 2006 and 2005 and $2.1 and $42.0 for the nine months ended September 30, 2006 and 2005	**$ 101.9**	$ (72.0)	**$ (22.2)**	$ (77.9)
Less: reclassification adjustment for gains (losses) included in net income, net of income tax (expense) benefit of $(0.7) and $2.2 for the quarters ended September 30, 2006 and 2005 and $(3.6) and $(5.3) for the nine months ended September 30, 2006 and 2005	**1.4**	(3.9)	**6.7**	9.9
Total available-for-sale securities	**100.5**	(68.1)	**(28.9)**	(87.8)
Unrealized appreciation on derivative instruments:				
Unrealized holding gains (losses) arising during period, net of income tax benefit (expense) of $2.3 for the quarter ended September 30, 2005 and $(8.2) and $17.4 for the nine months ended September 30, 2006 and 2005	**0.2**	(4.1)	**15.3**	(32.2)
Less: reclassification adjustment for gains (losses) included in net income, net of income tax (expense) benefit of $(0.1) and $2.9 for the quarters ended September 30, 2006 and 2005 and $(7.8) and $44.0 for the nine months ended September 30, 2006 and 2005	**0.2**	(5.2)	**14.4**	(81.6)
Total derivative instruments	**-**	1.1	**0.9**	49.4
Other comprehensive income (loss)	**$ 100.5**	$ (67.0)	**$ (28.0)**	$ (38.4)

9. Segment Information

The Company s business includes insurance products and services in two broad areas: Property and Casualty and Life Companies. Within these broad areas, the Company conducts business principally in four operating segments. These segments are Personal Lines, Commercial Lines, Other Property and Casualty, and Life Companies. In accordance with Statement of Financial Accounting Standards No. 131, *Disclosures About Segments of an Enterprise and Related Information* (Statement No. 131), the separate financial information of each segment is presented consistent with the way results are regularly evaluated by the chief operating decision maker in deciding how to allocate resources and in assessing performance. A summary of the Company s reportable segments is included below.

The Property and Casualty group manages its operations principally through three segments: Personal Lines, Commercial Lines and Other Property and Casualty. Personal Lines includes such property and casualty coverages as personal automobile, homeowners and other personal policies, while Commercial Lines includes such property and casualty coverages as commercial multiple peril, commercial automobile, workers compensation, and other commercial policies, such as bonds and inland marine. In addition, the Other Property and Casualty segment consists of: AMGRO, Inc. (AMGRO), the Company s premium financing business; Opus Investment Management, Inc. (Opus), which markets investment management services to institutions, pension funds and other organizations; earnings on holding company assets; as well as voluntary pools in which the Company has not actively participated since 1995.

As a result of the sale of the Company s variable life insurance and annuity business, the Life Companies segment, which is in run-off, now consists primarily of a block of traditional life insurance products (principally the Closed Block), guaranteed investment contract (GIC) business and certain group retirement products, as well as certain non-insurance subsidiaries. Assets

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and liabilities related to the reinsured variable life insurance and annuity business, as well as the discontinued group life and health business, including group life and health voluntary pools, are also reflected in this segment.

The Company reports interest expense related to its corporate debt separately from the earnings of its operating segments. Corporate debt consists of the Company s junior subordinated debentures and its senior debentures.

Management evaluates the results of the aforementioned segments on a pre-tax basis. Segment income excludes certain items, which are included in net income, such as federal income taxes and net realized investment gains and losses, including certain gains or losses on derivative instruments, because fluctuations in these gains and losses are determined by interest rates, financial markets and the timing of sales. Also, segment income excludes net gains and losses on disposals of businesses, discontinued operations, restructuring costs, extraordinary items, the cumulative effect of accounting changes and certain other items. While these items may be significant components in understanding and assessing the Company s financial performance, management believes that the presentation of segment income enhances understanding of the Company s results of operations by highlighting net income attributable to the core operations of the business. However, segment income should not be construed as a substitute for net income determined in accordance with generally accepted accounting principles.

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Summarized below is financial information with respect to business segments:

	(Unaudited) Quarter Ended September 30,		(Unaudited) Nine Months Ended September 30,	
(In millions)	**2006**	**2005**	**2006**	**2005**
Segment revenues:				
Property and Casualty:				
Personal Lines	**$ 383.2**	$ 361.8	**$ 1,129.1**	$ 1,133.3
Commercial Lines	**239.6**	216.8	**705.7**	658.5
Other Property and Casualty	**16.6**	7.3	**35.2**	21.4
Total Property and Casualty	**639.4**	585.9	**1,870.0**	1,813.2
Life Companies	**31.2**	41.9	**113.5**	141.3
Intersegment revenues	**(1.8)**	(2.1)	**(5.1)**	(6.7)
Total segment revenues	**668.8**	625.7	**1,978.4**	1,947.8
Adjustments to segment revenues:				
Net realized investment gains	**2.1**	1.9	**10.6**	18.1
Other income	**0.3**	1.6	**0.6**	1.3
Total revenues	**$ 671.2**	$ 629.2	**$ 1,989.6**	$ 1,967.2
Segment income before federal income taxes:				
Property and Casualty:				
Personal Lines:				
GAAP underwriting profit (loss)	**$ 6.0**	$ (57.0)	**$ 49.1**	$ (15.4)
Net investment income	**26.7**	25.6	**80.1**	75.7
Other	**2.3**	3.6	**8.5**	8.5
Personal Lines segment income (loss)	**35.0**	(27.8)	**137.7**	68.8
Commercial Lines:				
GAAP underwriting loss	**(19.5)**	(127.6)	**(4.5)**	(127.7)
Net investment income	**26.0**	25.3	**78.3**	74.8
Other	**1.2**	1.3	**3.1**	3.4
Commercial Lines segment income (loss)	**7.7**	(101.0)	**76.9**	(49.5)
Other Property and Casualty:				
GAAP underwriting loss	**(0.2)**	(1.4)	**(1.4)**	(2.0)
Net investment income	**3.2**	1.3	**10.0**	3.9
Other	**7.1**	1.2	**7.5**	3.0
Other Property and Casualty segment income	**10.1**	1.1	**16.1**	4.9
Total Property and Casualty	**52.8**	(127.7)	**230.7**	24.2
Life Companies	**(1.1)**	(0.9)	**(4.0)**	(17.7)
Interest on corporate debt	**(10.0)**	(10.0)	**(29.9)**	(29.9)
Segment income (loss) before federal income taxes	**41.7**	(138.6)	**196.8**	(23.4)
Adjustments to segment income:				
Net realized investment gains (losses), net of deferred acquisition cost amortization	**2.0**	(2.0)	**11.4**	12.9
Gains (losses) on derivative instruments	**0.1**	0.2	**0.2**	(0.3)
Restructuring costs	**(0.5)**	(0.4)	**(1.4)**	(1.3)

Income (loss) from continuing operations before federal income taxes	**$**	**43.3**	$	(140.8)	**$**	**207.0**	$	(12.1)

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	Identifiable Assets (Unaudited)		Deferred Acquisition Costs (Unaudited)	
	September 30,	December 31,	September 30,	December 31,
(In millions)	2006	2005	2006	2005
Property and Casualty (1)	**$ 6,958.8**	$ 7,220.2	**$ 232.5**	$ 201.9
Life Companies (2)	**2,885.2**	3,478.0	**5.4**	7.1
Intersegment eliminations (3)	**-**	(64.2)	**-**	-
Total	**$ 9,844.0**	$ 10,634.0	**$ 237.9**	$ 209.0

(1) The Company reviews assets based on the total Property and Casualty Group and does not allocate between the Personal Lines, Commercial Lines and Other Property and Casualty segments.
(2) Includes assets related to the Company s discontinued group life and health operations.
(3) The 2005 balance reflects a $64.0 million dividend from FAFLIC and other Life Companies non-insurance subsidiaries to the holding company, which was paid during the first quarter of 2006.

Discontinued Operations Group Life and Health

During 1999, the Company exited its group life and health insurance business, consisting of its Employee Benefit Services (EBS) business, its Affinity Group Underwriters business and its accident and health assumed reinsurance pool business. Prior to 1999, these businesses comprised substantially all of the former Corporate Risk Management Services segment. Accordingly, the operating results of the discontinued segment have been reported in accordance with Accounting Principles Board Opinion No. 30, Reporting the Results of Operations Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions (APB Opinion No. 30). In 1999, the Company recorded a $30.5 million loss, net of taxes, on the disposal of this segment, consisting of after-tax losses from the run-off of the group life and health business of approximately $46.9 million, partially offset by net proceeds from the sale of the EBS business of approximately $16.4 million. Subsequent to the measurement date of June 30, 1999, approximately $25.1 million of the aforementioned $46.9 million loss has been generated from the operations of the discontinued business and net proceeds of $12.5 million were received from the sale of the EBS business.

As permitted by APB Opinion No. 30, the Consolidated Balance Sheets have not been segregated between continuing and discontinued operations. At September 30, 2006 and December 31, 2005, the discontinued segment had assets of approximately $352.1 million and $369.9 million, respectively, consisting primarily of invested assets and reinsurance recoverables, and liabilities of approximately $425.1 million and $441.9 million, respectively, consisting primarily of policy liabilities.

10. Earnings Per Share

The following table provides share information used in the calculation of the Company s basic and diluted earnings per share.

	(Unaudited) Quarter Ended September 30,		(Unaudited) Nine Months Ended September 30,	
(In millions, except per share data)	2006	2005	2006	2005
Basic shares used in the calculation of earnings per share	**50.9**	53.5	**51.7**	53.4
Dilutive effect of employee stock options and non-vested grants (1)	**0.4**	-	**0.5**	-
Diluted shares used in calculation of earnings per share	**51.3**	53.5	**52.2**	53.4

Per share effect of dilutive securities on income from continuing operations	**$**	**-**	$	-	**$**	**(0.02)**	$	-
Per share effect of dilutive securities on net income	**$**	**(0.01)**	$	-	**$**	**(0.03)**	$	-

(1) Excludes 0.6 million and 0.5 million shares due to antidilution for the quarter and nine months ended September 30, 2005.

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Options to purchase 1.2 and 1.1 million shares of common stock were outstanding during the quarter and nine months ended September 30, 2006, respectively, and options to purchase 2.3 and 4.1 million shares of common stock were outstanding during the quarter and nine months ended September 30, 2005, respectively, but were not included in the computation of diluted earnings per share because the estimated proceeds from their exercise was greater than the average market price of the common shares for these periods and, therefore, the effect would be antidilutive.

11. Stock-Based Compensation Plans

On May 16, 2006, the shareholders approved the adoption of The Hanover Insurance Group, Inc. 2006 Long-Term Incentive Plan (the Plan). Key employees, directors and certain consultants of the Company and its subsidiaries are eligible for awards pursuant to the Plan, which is administered by the Compensation Committee of the Board of Directors (the Committee) of the Company. Under the Plan, awards may be granted in the form of non-qualified or incentive stock options, stock appreciation rights, performance awards, restricted stock, unrestricted stock, stock units, or any other award that is convertible into or otherwise based on the Company s stock, subject to certain limits. The Plan authorizes the issuance of 3,000,000 new shares that may be used for awards. In addition, shares of stock underlying any award granted and outstanding under the Company s Amended Long-Term Stock Incentive Plan (the 1996 Plan) as of the adoption date of the Plan that are forfeited or cancelled, or expire or terminate, after the adoption date without the issuance of stock become available for future grants under the Plan. As of September 30, 2006, there were 3,110,997 shares available for grants under the Plan. The Company utilizes shares of stock held in the treasury account for option exercises and other awards granted under both plans.

Prior to January 1, 2006, the Company applied the provisions of APB Opinion No. 25 in accounting for its stock-based compensation plans. Under APB Opinion No. 25, the Company did not recognize compensation expense related to employee stock options because the exercise price of its options equaled the fair market value of the underlying stock on the date of grant. Effective January 1, 2006, the Company adopted Statement No. 123(R) which requires the Company to recognize the fair value of compensation costs for all share-based payments, including employee stock options, in the financial statements. The Company adopted Statement No. 123(R) using the modified prospective transition method. Under this method, the Company will not restate its prior financial statements, but will recognize compensation cost for all share-based awards granted, modified or settled after January 1, 2006, as well as any awards that were granted prior to January 1, 2006 for which the requisite service period had not been provided as of the implementation date, (i.e., unvested awards). Unvested awards are to be expensed consistent with the valuation used in previous disclosures of the pro-forma effect of Statement No. 123. The cumulative effect adjustment recognized in the first quarter of 2006 relating to the adoption of Statement No. 123(R), was a benefit of $0.6 million, net of tax.

Compensation cost recorded pursuant to Statement No. 123(R) for the quarter and nine months ended September 30, 2006 was $4.4 million and $13.0 million, respectively. The related tax benefit for the quarter and nine months ended September 30, 2006 was $1.5 million and $4.5 million, respectively. For the quarter and nine months ended September 30, 2005, compensation cost of $0.1 million and $0.4 million, respectively, was recognized in accordance with APB Opinion No. 25. The related tax benefits for the quarter and nine months ended September 30, 2005 was $0.1 million and $0.2 million, respectively.

The following table shows the additional costs and related per share effect for the quarter and nine months ended September 30, 2006, reflected in our Consolidated Statements of Income as a result of implementing Statement No. 123(R). Also shown is the impact on the Consolidated Statements of Cash Flows to cash flows from operating activities and financing activities as a result of implementing Statement No. 123(R).

	(Unaudited) Quarter Ended September 30, 2006		**(Unaudited) Nine Months Ended September 30, 2006**	
(In millions, except per share data)	**Results**	**Earnings Per Share (Basic and Diluted)**	**Results**	**Earnings Per Share (Basic and Diluted)**
Income from continuing operations before federal income tax	**$ (2.1)**	**$ (0.04)**	**$ (5.0)**	**$ (0.10)**
Income from continuing operations	**(1.4)**	**(0.03)**	**(3.3)**	**(0.06)**
Cumulative effect of change in accounting principle	**-**	**-**	**0.6**	**0.01**
Net income	**$ (1.4)**	**$ (0.03)**	**$ (2.7)**	**$ (0.05)**

Cash flows:				
Operating activities	**$ (0.1)**	**NA**	**$ (7.1)**	**NA**
Financing activities	**0.1**	**NA**	**7.1**	**NA**

NA not applicable

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The following table illustrates the effect on net loss and net loss per share if the Company had applied the fair value recognition provisions of Statement No. 123, to stock-based compensation in 2005:

(In millions, except per share data)	(Unaudited) Quarter Ended September 30, 2005	(Unaudited) Nine Months Ended September 30, 2005
Net loss, as reported	$ (562.4)	$ (443.9)
Stock-based compensation expense included in reported net income, net of taxes	-	0.2
Total stock-based compensation expense determined under fair value based method for all awards, net of taxes	(2.1)	(5.9)
Net loss, after effect of Statement No. 123	$ (564.5)	$ (449.6)
Earnings per share:		
Basic and diluted - as reported	$ (10.51)	$ (8.31)
Basic and diluted - after effect of Statement No. 123	$ (10.54)	$ (8.42)

Stock Options

Under the Plan (or the 1996 Plan, as applicable), options may be granted to eligible employees, directors or consultants at an exercise price equal to the market price of the Company s common stock on the date of grant. Option shares may be exercised subject to the terms prescribed by the Committee at the time of grant. Options granted in 2005 and 2006 vest over three years with a 25% vesting rate in the first two years and a 50% vesting rate in the final year. Options must be exercised not later than ten years from the date of grant. When participants retire, their shares generally become fully vested and must be exercised within three years from the date of retirement. Information on the Company s stock option plans is summarized below.

	(Unaudited)			
	Nine Months Ended September 30, 2006			
(In whole shares, dollars in millions, except per share data)	**Shares**	**Weighted Average Exercise Price**	**Aggregate Intrinsic Value**	**Weighted Average Remaining Contractual Life (years)**
Outstanding, beginning of period	**5,745,106**	**$ 38.45**		
Granted	**138,702**	**45.61**		
Exercised	**1,215,897**	**31.12**		
Forfeited or cancelled	**391,001**	**43.88**		
Outstanding, end of period	**4,276,910**	**$ 40.26**	**$ 28.9**	**6.1**
Exercisable, end of period	**2,870,256**	**$ 41.75**	**$ 18.4**	**5.1**

The following table summarizes information for stock options exercised during the periods indicated.

	(Unaudited)	(Unaudited)

(In millions)	**Quarter Ended September 30, 2006**	**2005**	**Nine Months Ended September 30, 2006**	**2005**
Intrinsic value of options exercised	**$ 0.5**	$ 4.0	**$ 20.6**	$ 6.9
Cash received for options exercised	**0.8**	5.2	**37.8**	7.6
Excess tax benefits realized from options exercised	**0.1**	-	**7.1**	-

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The fair value of each option is estimated on the date of grant or date of conversion using the Black-Scholes option pricing model. For all options granted through September 30, 2006, the exercise price equaled the market price on the grant date. Compensation cost related to options is based upon the grant date fair value and expensed on a straight-line basis over the service period for each separately vesting portion of the option as if the option was, in substance, multiple awards.

Upon the adoption of Statement No. 123(R), the compensation cost associated with options granted to employees who are eligible for retirement is recognized immediately. Compensation cost for options granted to employees who are near retirement eligibility is recognized over the period from the grant date to the retirement eligibility date, if that period is shorter than the stated vesting period.

The weighted average grant date fair value of options granted during the nine months ended September 30, 2006 and 2005 was $13.73 and $11.54, respectively. The following significant assumptions were used to determine the fair value for options granted.

	(Unaudited)		(Unaudited)	
	Quarter Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Dividend yield	**0.6%**	0.6% to 0.8%	**0.5% to 0.6%**	0.6% to 0.8%
Expected volatility	**25.04% to 30.43%**	31.06% to 33.97%	**25.04% to 32.93%**	31.06% to 34.97%
Risk-free interest rate	**4.7% to 5.1%**	3.8% to 4.2%	**4.6% to 5.1%**	3.3% to 4.2%
Expected term, in years	**2.5 to 5.0**	2.5 to 5.0	**2.5 to 5.0**	2.5 to 5.0

The expected dividend yield is based on the Company s most recent dividend payout. Expected volatility is based on the Company s historical daily stock price volatility. The risk-free rate for periods within the contractual life of the option is based on the U.S. Treasury yield curve in effect at the time of grant. The expected term of options granted represents the period of time that options are expected to be outstanding and is derived using historical exercise, forfeit and cancellation behavior, along with certain other factors expected to differ from historical data.

The fair value of shares vested during the quarters ended September 30, 2006 and 2005 was $1.5 million and $0.7 million, respectively, and the fair value of shares vested during the nine months ended September 30, 2006 and 2005 was $15.2 million and $18.7 million, respectively. Unrecognized compensation expense of $5.3 million related to unvested stock options at September 30, 2006 will be recognized over the next 1.3 years (weighted average period).

Restricted Stock

Stock grants may be awarded to eligible employees at a price established by the Committee (which may be zero). Under the Plan, the Company may award shares of restricted stock, as well as shares of unrestricted stock. Restricted stock grants may vest based upon performance criteria or continued employment and be in the form of shares or units. Vesting periods are established by the Committee. Stock grants under the 1996 Plan which vest based on performance, vest over a minimum one year period. Stock grants under the 1996 Plan which vest based on continued employment, vest at the end of a minimum of three consecutive years of employment.

In 2006, the Company has granted performance based restricted share units to certain employees, using two vesting schedules. The first group vests after two years of continued employment and the achievement of specific individual performance goals. The second group vests upon the Company s achieving certain corporate goals at the end of the second year, with a vesting period of 50% after two years of continued service from the date of grant and the balance after an additional year of continued service. The Company also granted shares of restricted stock to eligible employees, which vest after three years of continued service.

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The following table summarizes information about employee nonvested stock and performance based restricted share units:

	(Unaudited)			
	Nine Months Ended September 30, 2006			
(In whole shares, dollars in millions, except per share data)	**Shares**	**Weighted Average Grant Date Fair Value**	**Aggregate Intrinsic Value**	**Weighted Average Remaining Contractual Life (years)**
Restricted Stock:				
Restricted, beginning of period	**43,652**	**$ 35.02**		
Granted	**8,203**	**45.16**		
Forfeited	**4,000**	**28.80**		
Restricted, end of period	**47,855**	**$ 37.93**	**$ 0.3**	**1.6**
Performance based restricted stock units:				
Outstanding, beginning of period (1)	**245,294**	**$ 36.23**		
Granted (1)	**319,143**	**46.31**		
Forfeited	**32,063**	**38.20**		
Outstanding, end of period (1)	**532,374**	**$ 42.16**	**$ 1.9**	**1.3**

(1) Performance based restricted stock units are based upon the achievement of the performance metric at 100%. These units have the potential to range from 0% to 175% of the shares disclosed, which varies based on grant year and individual participation level.

Compensation cost associated with both restricted stock and restricted stock units is calculated based upon grant date fair value, which is determined using current market prices.

As of September 30, 2006, there was $12.6 million of total unrecognized compensation cost related to unvested restricted stock and performance based restricted stock units. The cost is expected to be recognized over a weighted-average period of 1.5 years.

There were no restricted shares that vested during the third quarter or first nine months of 2006 or the third quarter or first nine months of 2005.

12. Commitments and Contingencies

Regulatory and Industry Developments

Unfavorable economic conditions, or other factors such as catastrophic losses, may contribute to an increase in the number of insurance companies that are under regulatory supervision. This may result in an increase in mandatory assessments by state guaranty funds, or voluntary payments by solvent insurance companies to cover losses to policyholders of insolvent or rehabilitated companies. Mandatory assessments, which are subject to statutory limits, can be partially recovered through a reduction in future premium taxes in some states. The Company is not able to reasonably estimate the potential impact of any such future assessments or voluntary payments.

From time to time, the Company is involved in investigations and proceedings by governmental and self-regulatory agencies, which currently include investigations relating to market timing in sub-accounts of variable annuity and life products, and inquiries relating to tax reporting calculations to policyholders and others in connection with distributions under a subset of variable annuity contracts in this business. In the Company s opinion, based on the advice of legal counsel, the ultimate resolution of such proceedings will not have a material effect on the Company s consolidated financial position, although they could have a material effect on the results of operations for a particular quarter or annual period.

Litigation

On July 24, 2002, an action captioned American National Bank and Trust Company of Chicago, as Trustee f/b/o Emerald Investments Limited Partnership, and Emerald Investments Limited Partnership v. Allmerica Financial Life Insurance and Annuity Company was commenced in the United States District Court for the Northern District of Illinois, Eastern Division. In 1999, plaintiffs purchased two variable annuity contracts with initial premiums aggregating $5 million. Plaintiffs, who AFLIAC subsequently identified as engaging in frequent transfers of significant sums between sub-accounts that in the Company s opinion constituted market timing , were subject to restrictions upon such trading that AFLIAC imposed in December 2001. Plaintiffs

allege that such restrictions constituted a breach of the terms of the annuity contracts. In December 2003, the court granted partial summary judgment to the plaintiffs, holding that at least certain restrictions imposed on their trading activities violated the terms of the annuity contracts.

On May 19, 2004, plaintiffs filed a Brief Statement of Damages in which, without quantifying their damage claim, they outlined a claim for (i) amounts totaling $150,000 for surrender charges imposed on the partial surrender by plaintiffs of the annuity contracts, (ii) loss of trading profits they expected over the remaining term of each annuity contract, and (iii) lost trading profits resulting from AFLIAC s alleged refusal to process five specific transfers in 2002 because of trading restrictions imposed on market timers. With respect to the lost profits, plaintiffs claim that pursuant to their trading strategy of transferring money from money market accounts to international equity accounts and back again to money market accounts, they have been able to consistently obtain relatively risk free returns of between 35% and 40% annually. Plaintiffs claim that they would have been able to continue to maintain such returns on the account values of their annuity contracts over the remaining terms of the annuity contracts (which are based in part on the lives of the named annuitants). The aggregate account value of plaintiffs annuities was approximately $12.8 million in December 2001. On February 1, 2006, the Court issued a ruling which, as confirmed by the Court at a status conference on April 12, 2006, precludes plaintiffs from claiming any damages accruing beyond July 31, 2004.

The Company continues to vigorously defend this matter, and regards plaintiffs claims for lost trading profits as being speculative and, in any case, subject to an obligation to mitigate damages. Further, in the Company s view, these purported lost profits would not have been earned because of various actions taken by the investment management industry and regulators, to deter or eliminate market timing, including the implementation of fair value pricing.

The monetary damages sought by plaintiffs, if awarded, could have a material adverse effect on the Company s financial position. Although AFLIAC was sold to Goldman Sachs on December 30, 2005, the Company has agreed to indemnify AFLIAC and Goldman Sachs with respect to this litigation. However, in the Company s judgment, the outcome is not expected to be material to the Company s financial position, although it could have a material effect on the results of operations for a particular quarter or annual period. A trial date for the damage phase of the litigation has been set for December 2006.

The Company has been named a defendant in various other legal proceedings arising in the normal course of business, including one other suit which, like the Emerald case described above, challenges the Company s imposition of certain restrictions on trading funds invested in separate accounts. Such matters also include class actions and other litigation in the southeast United States, particularly Louisiana and Mississippi, relating to the scope of insurance coverage under homeowners and commercial property policies of losses due to flooding, civil authority actions, loss of landscaping and business interruption, as well as factual disputes as to the underlying causes of certain losses.

Residual Markets

The Company is required to participate in residual markets in various states. The results of the residual markets are not subject to the predictability associated with the Company s own managed business, and are significant to the workers compensation line of business, the homeowners line of business and both the personal and commercial automobile lines of business.

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PART I

ITEM 2

MANAGEMENT S DISCUSSION AND ANALYSIS OF

FINANCIAL CONDITION AND RESULTS OF OPERATIONS

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Introduction

The following Management s Discussion and Analysis of Financial Condition and Results of Operations is intended to assist readers in understanding the interim consolidated results of operations and financial condition of The Hanover Insurance Group, Inc. and subsidiaries (THG) and should be read in conjunction with the interim Consolidated Financial Statements and related footnotes included elsewhere in this Quarterly Report on Form 10-Q and the Management s Discussion and Analysis of Financial Condition and Results of Operations contained in our 2005 Annual Report on Form 10-K filed with the Securities and Exchange Commission.

Our results of operations include the accounts of The Hanover Insurance Company (Hanover Insurance) and Citizens Insurance Company of America (Citizens), our principal property and casualty companies; First Allmerica Financial Life Insurance Company (FAFLIC), our life insurance and annuity company; and certain other insurance and non-insurance subsidiaries. Our results of operations also include the accounts of Allmerica Financial Life Insurance and Annuity Company (AFLIAC) through December 30, 2005. On December 30, 2005, we completed the sale of AFLIAC to The Goldman Sachs Group, Inc. and its subsidiaries (Goldman Sachs). In addition, we have reinsured 100% of the variable life insurance and annuity business of FAFLIC. The results of AFLIAC s variable life insurance and annuity operations are reported as discontinued operations.

Executive Overview

As a result of the sale of the variable life insurance and annuity business in December 2005, the property and casualty business constitutes our primary ongoing operations. During the remainder of 2006, we plan to continue to execute our strategies for profitably growing both our personal lines and commercial lines of business.

In our personal lines business, we are focused on making investments that are intended to help us maintain profitability, build a distinctive position in the market and continue to provide us with profitable growth opportunities. We plan to maintain our focus on the expansion of our distribution capabilities by actively seeking to write more business with our best agents, and to develop new relationships with agents in the states where we conduct business. At the same time, we are making significant investments to strengthen our product offerings. We continued to introduce *Connections Auto*, our multivariate auto product, to additional states in 2006. It is now available in all seventeen states that we had planned to be in for 2006. Additionally, we released an upgrade to our homeowners product in September 2006 which is expected to enhance our agents ease of doing business and decrease quote times. We expect to introduce further homeowners product enhancements in several states during the first half of 2007. In the first nine months of 2006, we generated growth in written premium, primarily due to the introduction of the *Connections Auto* product and the appointment of new agents in several states in 2005 and in 2006.

During the fourth quarter of 2006, we will continue to focus on growing our commercial lines business. We will continue to develop our product portfolio and specialty lines expertise in commercial lines as we target small and first-tier middle markets, which encompass clients whose annual premiums are generally below $200,000, through mid-sized agents. We continue to expand our business owner s policy to accommodate a broader spectrum of risks, and continue to enhance our inland marine, bond and umbrella programs, which on average are expected to offer higher margins over time and enable us to deliver a more complete product portfolio to our agents and policyholders in our target markets. In the first nine months of 2006, we have experienced strong growth in both our inland marine and bond businesses, as well as solid growth in our more traditional products.

In the third quarter of 2005, the property and casualty industry was significantly and adversely affected by the damage caused by Hurricane Katrina. This catastrophe placed unprecedented demands on both the industry and Hanover Insurance, one of our primary property and casualty companies. During the third quarter of 2005, the estimated impact of this catastrophe, on a gross, pre-tax basis, was $527 million. The estimated impact, net of reinsurance, of this catastrophe was approximately $215 million on a pre-tax basis, or $140 million on an after-tax basis. Recent trends in claims activity observed over the past several months led us to re-evaluate and increase our estimate of Hurricane Katrina loss and loss adjustment expense (LAE) reserves. During the third quarter of 2006, we increased our Hurricane Katrina gross reserves by approximately $62 million on a pre-tax basis. Our increase in this reserve, net of reinsurance, totaled $52 million on a pre-tax basis, or $34 million on an after-tax basis. This, together with other adjustments to Hurricane Katrina reserves in previous quarters, results in an inception-to-date gross impact from this event of approximately $621 million on a pre-tax basis. Our net of reinsurance impact from this catastrophe was approximately $298 million on a pre-tax basis, or approximately $194 million on an after-tax basis.

Excluding the impact of Hurricane Katrina, our property and casualty group s earnings would have increased during the first nine months of 2006 as compared to the prior year due primarily to improved loss performance in both Commercial Lines and Personal Lines. The improved earnings were driven by increased favorable development of prior years reserves and improved current accident year results, primarily in Commercial Lines, as well as lower non-Katrina related catastrophe losses. Partially offsetting these improved earnings was an increase in underwriting and loss adjustment expenses.

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Description of Operating Segments

Our business includes insurance products and services in two areas: Property and Casualty and Life Companies. Within these broad areas, we conduct business principally in four operating segments. These segments are Personal Lines, Commercial Lines, Other Property and Casualty, and Life Companies. We present the separate financial information of each segment consistent with the manner in which our chief operating decision maker evaluates results in deciding how to allocate resources and in assessing performance.

The Property and Casualty group manages its operations principally through three segments: Personal Lines, Commercial Lines and Other Property and Casualty. Personal Lines includes such property and casualty coverages as personal automobile, homeowners and other personal policies, while Commercial Lines includes such property and casualty coverages as commercial multiple peril, commercial automobile, workers compensation and other commercial policies, such as bonds and inland marine business. In addition, the Other Property and Casualty segment consists of: Amgro, Inc. (AMGRO), our premium financing business; Opus Investment Management, Inc. (Opus), which markets investment management services to institutions, pension funds and other organizations; and earnings on holding company assets, as well as voluntary pools business in which we have not actively participated since 1995.

As a result of the aforementioned sale of our variable life insurance and annuity business, our Life Companies segment, which is in run-off, consists primarily of a block of traditional life insurance products (principally the Closed Block), our guaranteed investment contract (GIC) business and certain group retirement products, as well as certain non-insurance subsidiaries. Assets and liabilities related to our reinsured variable life insurance and annuity business, as well as our discontinued group life and health business, including group life and health voluntary pools, are reflected in this segment.

We report interest expense related to our corporate debt separately from the earnings of our operating segments. Corporate debt consists of our junior subordinated debentures and our senior debentures.

Results of Operations

Our consolidated net income includes the results of our four operating segments (segment income) which we evaluate on a pre-tax basis and our interest expense on corporate debt. In addition, segment income excludes certain items which we believe are not indicative of our core operations. The income of our segments excludes items such as federal income taxes and net realized investment gains and losses, including net gains or losses on certain derivative instruments, because fluctuations in these gains and losses are determined by interest rates, financial markets and the timing of sales. Also, segment income excludes net gains and losses on disposals of businesses, discontinued operations, restructuring costs, extraordinary items, the cumulative effect of accounting changes and certain other items. Although the items excluded from segment income may be significant components in understanding and assessing our financial performance, we believe segment income enhances an investor s understanding of our results of operations by highlighting net income attributable to the core operations of the business. However, segment income should not be construed as a substitute for net income determined in accordance with generally accepted accounting principles (GAAP).

Our consolidated net income for the third quarter of 2006 was $33.4 million compared to a net loss of $562.4 million for the same period in 2005. Consolidated net income for the first nine months was $124.8 million, compared to a net loss of $443.9 million for the same period in 2005. The increase in earnings for both the quarter and nine months is primarily the result of the absence in 2006 of the $474.6 million loss representing the estimated loss on disposal of our variable life insurance and annuity business recorded in 2005, as well as an increase in segment results from our property and casualty business. This improvement in property and casualty segment results primarily reflects lower after-tax catastrophe losses in 2006. We experienced unusually high catastrophe losses in 2005 from Hurricane Katrina, and to a lesser extent, Hurricane Rita.

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The following table reflects segment income as determined in accordance with Statement of Financial Accounting Standards No. 131, *Disclosures about Segments of an Enterprise and Related Information,* and a reconciliation of total segment income to consolidated net income.

(In millions)	Quarter Ended September 30, 2006	Quarter Ended September 30, 2005	Nine Months Ended September 30, 2006	Nine Months Ended September 30, 2005
Segment income (loss) before federal income taxes:				
Property and Casualty				
Personal Lines	**$ 35.0**	$ (27.8)	**$ 137.7**	$ 68.8
Commercial Lines	**7.7**	(101.0)	**76.9**	(49.5)
Other Property and Casualty	**10.1**	1.1	**16.1**	4.9
Total Property and Casualty	**52.8**	(127.7)	**230.7**	24.2
Life Companies	**(1.1)**	(0.9)	**(4.0)**	(17.7)
Interest expense on corporate debt	**(10.0)**	(10.0)	**(29.9)**	(29.9)
Total segment income (loss) before federal income taxes	**41.7**	(138.6)	**196.8**	(23.4)
Federal income tax (expense) benefit on segment income	**(14.1)**	29.6	**(61.3)**	0.3
Change in prior year tax reserves	**-**	-	**-**	2.3
Net realized investment gains (losses), net of deferred acquisition cost and amortization	**2.0**	(2.0)	**11.4**	12.9
Gains (losses) on derivative instruments	**0.1**	0.2	**0.2**	(0.3)
Restructuring costs	**(0.5)**	(0.4)	**(1.4)**	(1.3)
Federal income tax (expense) benefit on non-segment items	**(0.7)**	5.8	**(3.5)**	1.6
Income (loss) from continuing operations, net of taxes	**28.5**	(105.4)	**142.2**	(7.9)
Discontinued operations:				
Income from discontinued variable life insurance and annuity business, net of taxes	**-**	17.6	**-**	38.6
Loss from disposal of variable life insurance and annuity business, net of taxes	**(2.9)**	(474.6)	**(25.8)**	(474.6)
Gain on sale of Financial Profiles, Inc., net of taxes	**7.8**	-	**7.8**	-
Income (loss) before cumulative effect of change in accounting principle	**33.4**	(562.4)	**124.2**	(443.9)
Cumulative effect of change in accounting principle, net of taxes	**-**	-	**0.6**	-
Net income (loss)	**$ 33.4**	$ (562.4)	**$ 124.8**	$ (443.9)

Segment Income

Quarter Ended September 30, 2006 Compared to Quarter Ended September 30, 2005

Property and Casualty segment income increased $180.5 million, to $52.8 million, in the third quarter of 2006, compared to a loss of $127.7 million in the third quarter of 2005. Catastrophe related activity decreased $181.3 million, from $245.5 million in the third quarter of 2005 to $64.2 million in the same period of 2006. In the third quarter of 2005, we experienced significant catastrophe related activity primarily due to Hurricane Katrina, and to a lesser extent, Hurricane Rita. In the third quarter of 2006, we increased our catastrophe reserves for Hurricane Katrina. Segment income was also positively affected by a litigation settlement which resulted in a $7.0 million benefit for the third quarter of 2006. Excluding the impact of all catastrophe related activity and the litigation settlement, segment income would have decreased $7.8 million as compared to 2005. Segment income was negatively affected by increased underwriting and LAE expenses of $34.6 million, primarily attributable to an increase in variable compensation costs, investments in technology, an unusually large premium tax refund for Michigan in 2005, increased expenses in our claims operation and the impact of the new accounting for stock-based compensation in 2006. These items were partially offset by an increase of $15.8 million of favorable development on prior years loss and LAE reserves, as well as by improved current

accident year underwriting results, primarily due to earned premium growth and favorable loss performance in our bond and inland marine lines of business.

Our federal tax expense on segment income was $14.1 million for the third quarter of 2006, compared to a tax benefit of $29.6 million for the same period in 2005. This increase in expense is primarily due to the improvement in earnings from our property and casualty segment.

Nine Months Ended September 30, 2006 Compared to Nine Months Ended September 30, 2005

Property and Casualty segment income increased $206.5 million, to $230.7 million, for the nine months ended September 30, 2006, compared to $24.2 million in the same period in 2005. Catastrophe related activity decreased $173.8 million, from $264.8 million in 2005 to $91.0 million in 2006. In the nine months ended September 30, 2005, we experienced significant catastrophe related activity primarily due to Hurricane Katrina, and to a lesser extent, Hurricane Rita. For the nine months ended September 30, 2006, we increased our catastrophe reserves for Hurricane Katrina. In addition, segment income was positively affected by the aforementioned $7.0 million litigation settlement. Excluding the impact of catastrophe related activity and the litigation settlement, segment income would have increased $25.7 million as compared to 2005. Segment income was positively affected by an increase of $38.3 million of favorable development on prior years loss and LAE reserves, as well as by improved current accident year underwriting results in both our Commercial and Personal lines of business. Net investment income increased by $14.0 million, primarily due to improved operational cash flows in the first nine months of 2006. These items were partially offset by increased underwriting and LAE expenses of $69.2 million, primarily attributable to an increase in variable compensation costs, higher expenses in our claims operation, investments in technology, the impact of the new accounting for stock-based compensation in 2006 and higher expenses in support of our bond and inland marine business. In addition, there was an increase in the proportion of the corporate overhead expenses assigned to the Property and Casualty group as a result of the disposal of the variable life insurance and annuity business in December 2005.

Life Companies segment loss was $4.0 million in the nine months ended September 30, 2006 compared to a loss of $17.7 million in the same period of 2005. This improvement was primarily the result of lower expenses due to the run-off of our continuing life business and the absence, in 2006, of a $4.0 million provision for an SEC investigation related to market timing recognized in the second quarter of 2005.

Our federal income tax expense on segment income was $61.3 million for the first nine months of 2006 compared to a benefit of $0.3 million for the same period of 2005. The increase in tax expense is primarily the result of an increase in segment income in our Property and Casualty business.

Other Items

Net realized gains on investments were $2.0 million in the third quarter of 2006, compared to a loss of $2.0 million for the same period in 2005. Net realized gains on investments for the first nine months of 2006 and 2005 were $11.4 million and $12.9 million, respectively, primarily due to gains recognized from the sale of fixed maturities, partially offset by impairments of fixed maturities.

In December 2005, we sold our variable life insurance and annuity business. In accordance with Statement of Financial Accounting Standards No. 144, *Accounting for Impairment on Disposal of Long-Lived Assets* (Statement No. 144), we have reflected the 2005 results of AFLIAC variable life insurance and annuity business as a discontinued operation. As such, we have restated prior year balances related to this business as discontinued operations. We recognized income of $17.6 million and $38.6 million from discontinued operations in the third quarter and first nine months of 2005, respectively. Included in these amounts is $10.6 million of a $12.9 million federal income tax settlement. The remaining $2.3 million is reflected as a change in prior years tax reserves within continuing operations. Also, for the third quarter and nine months ended September 30, 2005, we recognized a $474.6 million loss representing the estimated loss on our variable life insurance and annuity business (See Life Companies Discontinued Operations for further discussion of this business).

Additionally, we recorded losses of $2.9 million and $25.8 million in the third quarter and first nine months of 2006, respectively, related to these discontinued operations. The losses in the third quarter primarily related to costs associated with the transition of this business to Goldman Sachs. The losses in the first nine months related to both a $15.0 million increase to the existing provision for our estimated potential liability for certain contractual indemnities to Goldman Sachs relating to the pre-sale activities of the business sold, as well as a $10.8 million loss related to costs associated with the transition of this business to Goldman Sachs (see Life Companies for further information). The additional $15.0 million provision was recorded under FASB Interpretation No. 45, *Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* (FIN 45). This additional provision relates to preliminary estimated expenses, reimbursements, penalties and other costs of remediating certain pre-closing processing errors relating to tax reporting to certain policyholders and others in connection with distributions under a subset of our former variable annuity business.

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On August 31, 2006, we sold all of the outstanding shares of Financial Profiles, Inc., a wholly-owned subsidiary, to Emerging Information Systems Incorporated and recognized a $7.8 million after-tax gain on the sale during the third quarter of 2006 (see Significant Transactions).

Effective January 1, 2006, we adopted Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment* (Statement No. 123(R)), which resulted in a benefit of $0.6 million. This adjustment was the result of remeasuring the value of certain stock-based awards at grant-date fair value that had previously been measured at intrinsic value.

Net income includes the following items by segment:

	Quarter Ended September 30, 2006				
	Property and Casualty				
	Personal Lines	Commercial Lines	Other Property and Casualty (2)	Life Companies	Total
Net realized investment gains (1)	**$ 0.6**	**$ 1.0**	**$ -**	**$ 0.4**	**$ 2.0**
Gains on derivative instruments	**-**	**-**	**-**	**0.1**	**0.1**
Restructuring costs	**-**	**-**	**-**	**(0.5)**	**(0.5)**
Loss on disposal of variable life insurance and annuity business, net of taxes	**-**	**-**	**-**	**(2.9)**	**(2.9)**
Gain on sale of Financial Profiles, Inc., net of taxes	**-**	**-**	**-**	**7.8**	**7.8**

	Quarter Ended September 30, 2005				
	Property and Casualty				
	Personal Lines	Commercial Lines	Other Property and Casualty (2)	Life Companies	Total
Net realized investment (losses) gains (1)	$ (0.3)	$ (0.3)	$ 0.1	$ (1.5)	$ (2.0)
Gains on derivative instruments	-	-	-	0.2	0.2
Restructuring costs	-	-	-	(0.4)	(0.4)
Income from discontinued variable life insurance and annuity business, net of taxes	-	-	-	17.6	17.6
Loss on disposal of variable life insurance and annuity business, net of taxes	-	-	-	(474.6)	(474.6)

	Nine Months Ended September 30, 2006				
	Property and Casualty				
	Personal Lines	Commercial Lines	Other Property and Casualty (2)	Life Companies	Total
Net realized investment gains (losses) (1)	**$ 5.3**	**$ 5.7**	**$ 3.7**	**$ (3.3)**	**$ 11.4**
Gains on derivative instruments	**-**	**-**	**-**	**0.2**	**0.2**
Restructuring costs	**-**	**-**	**-**	**(1.4)**	**(1.4)**
Loss on disposal of variable life insurance and annuity business, net of taxes	**-**	**-**	**-**	**(25.8)**	**(25.8)**
Gain on sale of Financial Profiles, Inc., net of taxes	**-**	**-**	**-**	**7.8**	**7.8**
Cumulative effect of change in accounting principle, net of taxes	**0.2**	**0.3**	**-**	**0.1**	**0.6**

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	Nine Months Ended September 30, 2005				
	Property and Casualty				
	Personal Lines	Commercial Lines	Other Property and Casualty (2)	Life Companies	Total
Change in prior years tax reserves	$ -	$ -	$ -	$ 2.3	$ 2.3
Net realized investment (losses) gains (1)	(0.8)	(1.0)	0.8	13.9	12.9
Losses on derivative instruments	-	-	-	(0.3)	(0.3)
Restructuring costs	-	-	-	(1.3)	(1.3)
Income from discontinued variable life insurance and annuity business, net of taxes	-	-	-	38.6	38.6
Loss on disposal of variable life insurance and annuity business, net of taxes	-	-	-	(474.6)	(474.6)

(1) We manage investment assets for our property and casualty business based on the requirements of the entire property and casualty group. We allocate the investment income, expenses and realized gains (losses) to our Personal Lines, Commercial Lines and Other Property and Casualty segments based on actuarial information related to the underlying business.

(2) Includes corporate eliminations.

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Segment Results

The following is our discussion and analysis of our results of operations by business segment. The segment results are presented before taxes and other items which we believe are not indicative of core operations, including realized gains and losses.

Property and Casualty

The following table summarizes the results of operations for the Property and Casualty group:

(In millions)	Quarter Ended September 30, 2006	Quarter Ended September 30, 2005	Nine Months Ended September 30, 2006	Nine Months Ended September 30, 2005
Segment revenues				
Net premiums written	**$ 602.9**	$ 542.0	**$ 1,775.3**	$ 1,647.9
Net premiums earned	**$ 562.6**	$ 519.7	**$ 1,652.9**	$ 1,619.7
Net investment income	**55.9**	52.2	**168.4**	154.4
Other income	**20.9**	14.0	**48.7**	39.1
Total segment revenues	**639.4**	585.9	**1,870.0**	1,813.2
Losses and operating expenses				
Losses and loss adjustment expenses	**380.2**	541.3	**1,044.6**	1,256.5
Policy acquisition expenses	**121.5**	115.1	**352.1**	342.7
Other operating expenses	**84.9**	57.2	**242.6**	189.8
Total losses and operating expenses	**586.6**	713.6	**1,639.3**	1,789.0
Segment income (loss)	**$ 52.8**	$ (127.7)	**$ 230.7**	$ 24.2

Quarter Ended September 30, 2006 Compared to Quarter Ended September 30, 2005

The following table summarizes the impact of catastrophes on results for the quarters ended September 30, 2006 and 2005:

(In millions)	Quarter Ended September 30, 2006	Quarter Ended September 30, 2005
Hurricane Katrina:		
Losses	**$ 43.7**	$ 184.1
LAE	**8.4**	3.6
Reinstatement premiums	**-**	27.0
Total impact of Katrina	**52.1**	214.7
Other	**12.1**	30.8
Total catastrophes	**$ 64.2**	$ 245.5

Property and Casualty segment income increased $180.5 million, to $52.8 million, in the third quarter of 2006, compared to a loss of $127.7 million in the third quarter of 2005. Catastrophe related activity decreased $181.3 million, from $245.5 million in the third quarter of 2005 to $64.2 million in the same period of 2006. In the third quarter of 2005, we experienced significant catastrophe related activity due primarily to Hurricane Katrina, and to a lesser extent, Hurricane Rita. In the third quarter of 2006, we increased our catastrophe reserves for Hurricane Katrina. In addition, segment income was positively affected by a litigation settlement related to Opus Investment Management, Inc., which resulted in a $7.0 million benefit for the third quarter of 2006. Excluding the impact of all catastrophe related activity and the litigation settlement, our Property and Casualty group s segment income would have decreased $7.8 million as compared to 2005. Segment income was negatively affected by increased underwriting and LAE expenses of $34.6 million, primarily attributable to increased variable compensation costs, investments in technology, an unusually large premium tax refund for Michigan in 2005, increased expenses in our claims operation and the impact of the new accounting for stock-based compensation in 2006. These items were partially offset by an increase of $15.8 million of favorable development on prior years loss and LAE reserves excluding Hurricane Katrina activity, to $39.2 million in the third quarter of 2006, from $23.4 million in the same period of 2005. Also positively affecting segment income was improved current accident year underwriting results of an estimated $8 million, primarily due to earned premium growth and favorable loss performance in our bond and inland marine lines of business.

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Underwriting Results

The following table summarizes GAAP net premiums written and GAAP loss, LAE, expense and combined ratios for the Personal Lines and Commercial Lines segments. These items are not meaningful for our Other Property and Casualty segment.

	Quarter Ended September 30,					
	2006			2005		
(In millions, except ratios)	GAAP Net Premiums Written	GAAP Loss Ratios (1), (2)	Catastrophe loss ratios (3)	GAAP Net Premiums Written(4)	GAAP Loss Ratios (1), (2)	Catastrophe loss ratios (3)
Personal Lines:						
Personal automobile	**$ 253.7**	**55.6**	**0.4**	$ 241.2	58.2	1.6
Homeowners	**118.8**	**56.1**	**14.2**	102.3	133.2	88.9
Other personal	**10.7**	**46.4**	**12.1**	10.0	56.2	7.9
Total Personal Lines	**383.2**	**55.4**	**4.7**	353.5	77.9	24.8
Commercial Lines:						
Workers compensation	**27.2**	**48.9**	**N/M**	28.1	77.4	N/M
Commercial automobile	**48.7**	**40.7**	**1.4**	49.3	48.1	N/M
Commercial multiple peril	**86.2**	**73.4**	**38.7**	72.3	212.4	166.8
Other commercial	**57.6**	**40.3**	**11.5**	38.8	45.2	11.9
Total Commercial Lines	**219.7**	**54.8**	**18.7**	188.5	119.8	70.4
Total	**$ 602.9**	**55.2**	**9.9**	$ 542.0	93.4	41.4

	2006			2005		
	GAAP LAE Ratios	GAAP Expense Ratios	GAAP Combined Ratios (5)	GAAP LAE Ratios	GAAP Expense Ratios	GAAP Combined Ratios (5)
Personal Lines	**12.6**	**30.4**	**98.4**	10.7	28.5	117.1
Commercial Lines	**12.0**	**42.4**	**109.2**	10.9	37.1	167.8
Total	**12.3**	**34.9**	**102.4**	10.8	31.6	135.8

(1) GAAP loss ratio is a common industry measurement of the results of property and casualty insurance underwriting. This ratio reflects incurred claims compared to premiums earned. Our GAAP loss ratios include catastrophe losses.

(2) Includes policyholders dividends.

(3) Catastrophe loss ratio reflects incurred catastrophe claims compared to premiums earned.

(4) GAAP net premiums written for the quarter ended September 30, 2005 include Hurricane Katrina related reinstatement premiums of $27.0 million; $17.6 million for Personal Lines and $9.4 million for Commercial Lines.

(5) GAAP combined ratio is a common industry measurement of the results of property and casualty insurance underwriting. This ratio is the sum of incurred claims, claim expenses and underwriting expenses incurred to premiums earned. Our GAAP combined ratios also include the impact of catastrophes. Federal income taxes, net investment income and other non-underwriting expenses are not reflected in the GAAP combined ratio. Our GAAP combined ratios include the impact of reinstatement premium, resulting from Hurricane Katrina, which represents increases of 5.8, 7.9 and 6.7 points to our Personal Lines, Commercial Lines and Total GAAP combined ratios, respectively for the quarter ended September 30, 2005.

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The following table summarizes GAAP underwriting results for the Personal Lines, Commercial Lines and Other Property and Casualty segments and reconciles it to GAAP segment income.

	Quarter Ended September 30,							
	2006				2005			
	Personal Lines	Commercial Lines	Other Property and Casualty	Total	Personal Lines	Commercial Lines	Other Property and Casualty	Total
GAAP underwriting profit (loss), excluding prior year reserve development and catastrophes	**$ 13.1**	**$ (1.7)**	**$ (0.1)**	**$ 11.3**	$ 31.3	$ 5.0	$ (0.2)	$ 36.1
Prior year reserve development favorable (unfavorable)	**13.6**	**25.7**	**(0.1)**	**39.2**	13.4	11.2	(1.2)	23.4
Catastrophe effect	**(20.7)**	**(43.5)**	**-**	**(64.2)**	(101.7)	(143.8)	-	(245.5)
GAAP underwriting profit (loss)	**6.0**	**(19.5)**	**(0.2)**	**(13.7)**	(57.0)	(127.6)	(1.4)	(186.0)
Net investment income (1)	**26.7**	**26.0**	**3.2**	**55.9**	25.6	25.3	1.3	52.2
Other income	**3.4**	**4.1**	**13.4**	**20.9**	4.8	3.2	6.0	14.0
Other operating expenses	**(1.1)**	**(2.9)**	**(6.3)**	**(10.3)**	(1.2)	(1.9)	(4.8)	(7.9)
Segment income (loss)	**$ 35.0**	**$ 7.7**	**$ 10.1**	**$ 52.8**	$ (27.8)	$ (101.0)	$ 1.1	$ (127.7)

(1) We manage investment assets for our property and casualty business based on the requirements of the entire Property and Casualty group and allocate net investment income to each of our Property and Casualty segments.

Personal Lines

Personal Lines net premiums written increased $29.7 million, or 8.4%, to $383.2 million in the third quarter of 2006. In 2005, net premiums written were negatively impacted by a reinstatement premium of $17.6 million, resulting from Hurricane Katrina. Excluding the impact of this reinstatement premium, Personal Lines net premiums written increased $12.1 million, or 3.3%. This was primarily attributable to an increase in new business written in the personal automobile line due to the introduction of our product, *Connections Auto* and the related appointment of new agents.

Policies in force in the personal automobile line of business increased 5.6% as compared to policies in force at the end of the third quarter of 2005. The increase in policies in force compared to the prior year was due to new business growth in selected states as a result of our strategy to introduce our *Connections Auto* product and the related appointment of new agents. This increase was partially offset by reduced exposures in Massachusetts and New Jersey, where the decline in policies in force is primarily due to the termination of certain unprofitable agency relationships and certain employer and affinity group accounts that were not well aligned with our current strategy.

Policies in force in the homeowners line of business decreased 2.0% compared to policies in force at the end of the third quarter of 2005, while decreasing modestly by 0.3% as compared to June 30, 2006. The decrease from prior year primarily reflects declines in Michigan, Massachusetts and New Jersey. In Michigan, policies in force declined 2.5% compared to the third quarter of 2005, while decreasing by 1.0% as compared to June 30, 2006, due to the slowing economy in the state affecting new business production. In Massachusetts, the decrease was primarily driven by our decision to exit certain unprofitable agency relationships that were not well aligned with our current strategy and, to a lesser extent, by our actions to reduce coastal exposures. In New Jersey, we exited certain employer and affinity groups that were also not well aligned with our current strategy.

Personal Lines segment income increased $62.8 million to $35.0 million for the third quarter of 2006, compared to a loss of $27.8 million for the same period in 2005. Catastrophe related activity decreased $81.0 million, from $101.7 million in the third quarter of 2005 to $20.7 million in the same period of 2006. Excluding the impact of catastrophe related activity, segment income would have decreased $18.2 million as compared to 2005. Segment income was negatively affected by higher underwriting and LAE expenses of $18.1 million primarily attributable to an increase in variable compensation costs, an unusually large premium tax refund in Michigan in the third quarter of last year, higher expenses in

our claims operations, the impact of the new accounting for stock-based compensation in 2006 and investments in technology. In addition, there was an increase in the proportion of the corporate overhead expenses assigned to this segment.

Our ability to increase Personal Lines net written premiums and to maintain and improve underwriting results may be affected by price competition, the ability to achieve acceptable margins on new business written, regulatory actions and our plans to continue to reduce coastal exposures.

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Commercial Lines

Commercial Lines net premiums written increased $31.2 million, or 16.6%, to $219.7 million in the third quarter of 2006. In 2005, net premiums written were negatively impacted by a reinstatement premium of $9.4 million, resulting from Hurricane Katrina. Excluding the impact of this reinstatement premium, Commercial Lines net premium written increased $21.8 million, or 11.0%. This increase is primarily attributable to an increase in new business driven by growth in our other commercial lines businesses, primarily bonds and inland marine. Also, to a lesser extent, written premiums grew in the commercial multiple peril line of business.

Commercial Lines segment income increased $108.7 million to $7.7 million in the third quarter of 2006, compared to a loss of $101.0 million in 2005. Catastrophe related activity decreased $100.3 million, from $143.8 million in the third quarter of 2005 to $43.5 million in the same period of 2006. Excluding the impact of catastrophe related activity, segment income would have increased $8.4 million as compared to 2005. Segment income was positively affected by increased favorable development on prior years loss and LAE reserves excluding Hurricane Katrina of $14.5 million, to $25.7 million in the third quarter of 2006, from $11.2 million in the same period of 2005, driven primarily by the workers compensation, commercial automobile and commercial multiple peril lines of business. In addition, current accident year results improved by an estimated $10 million, primarily due to earned premium growth and favorable loss performance in our bond and inland marine lines of business. These items were partially offset by higher underwriting expenses of $15.2 million, primarily attributable to an increase in variable compensation costs, investments in technology, higher expenses in support of our specialty lines and the impact of the new accounting for stock-based compensation in 2006. In addition, there was an increase in the proportion of the corporate overhead expenses assigned to this segment.

Our ability to increase Commercial Lines net premiums written while maintaining or improving underwriting results may be affected by increased price competition.

Other Property and Casualty

Segment income of the Other Property and Casualty segment increased $9.0 million, to $10.1 million in the third quarter of 2006, from $1.1 million for the same period in 2005. Segment income in the third quarter of 2006 includes a payment to Opus Investment Management, Inc. (Opus) in the amount of $7.0 million in settlement of claims which Opus alleged in a lawsuit filed in 2003 against various parties. Excluding this settlement, Other Property and Casualty segment income would have increased $2.0 million as compared to 2005. The increase is principally due to additional net investment income in our holding company, primarily resulting from the sale of our variable life insurance and annuity business at the end of 2005.

Investment Results

Net investment income increased $3.7 million, or 7.1%, to $55.9 million for the quarter ended September 30, 2006. The increase in net investment income reflects an increase in average invested assets due to increased operational cash flows and proceeds from the sale of the variable life insurance and annuity business, partially offset by cash outflows related to our share repurchase program and payments for losses related to Hurricane Katrina. The average pre-tax yield on fixed maturities was 5.5% for the third quarter of 2006 and the third quarter of 2005.

Nine Months Ended September 30, 2006 Compared to Nine Months Ended September 30, 2005

The following table summarizes the impact of catastrophes on results for the nine months ended September 30, 2006 and 2005:

	Nine Months Ended September 30,	
(In millions)	**2006**	**2005**
Hurricane Katrina:		
Losses	**$ 40.2**	$ 184.1
LAE	**8.4**	3.6
Reinstatement premiums	**-**	27.0
Total impact of Katrina (1)	**48.6**	214.7

Other		**42.4**		50.1
Total catastrophes	**$**	**91.0**	$	264.8

(1) Includes a reallocation of $3.5 million from Hurricane Katrina reserves to Hurricane Rita reserves during the first quarter of 2006.
Property and Casualty segment income increased $206.5 million, to $230.7 million, for the nine months ended September 30, 2006, compared to $24.2 million in the same period in 2005. Catastrophe related activity decreased $173.8 million, from $264.8 million in 2005 to $91.0 million in 2006. In the nine months ended September 30, 2005, we experienced significant catastrophe related activity due primarily to Hurricane Katrina, and to a lesser extent, Hurricane Rita. For the nine months

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ended September 30, 2006, we increased our catastrophe reserves for Hurricane Katrina. In addition, segment income was positively affected by the aforementioned litigation settlement which resulted in a $7.0 million benefit for the nine months ended September 30, 2006. Excluding the impact of catastrophe related activity and the litigation settlement, segment income would have increased $25.7 million as compared to 2005. Segment income was positively affected by an increase of $38.3 million of favorable development on prior years loss and LAE reserves excluding Hurricane Katrina, to $91.3 million in the first nine months of 2006, from $53.0 million in the same period of 2005. Also positively affecting segment income was improved current accident year underwriting results of an estimated $38 million, primarily due to favorable loss activity in both our Commercial and Personal lines of business and earned premium growth in our bond and inland marine lines of business. Net investment income increased by $14.0 million, primarily due to improved operational cash flows in the first nine months of 2006. These items were partially offset by increased underwriting and LAE expenses of $69.2 million, primarily attributable to an increase in variable compensation costs, higher expenses in our claims operations, investments in technology and the impact of the new accounting for stock-based compensation in 2006. In addition, there was an increase in the proportion of the corporate overhead expenses assigned to the Property and Casualty group as a result of the disposal of the variable life insurance and annuity business in December 2005.

Underwriting Results

The following table summarizes GAAP net premiums written and GAAP loss, LAE, expense and combined ratios for the Personal Lines and Commercial Lines segments. These items are not meaningful for our Other Property and Casualty segment.

	Nine Months Ended September 30,					
	2006			2005		
(In millions, except ratios)	**GAAP Net Premiums Written**	**GAAP Loss Ratios (1), (2)**	**Catastrophe Loss Ratios (3)**	**GAAP Net Premiums Written (4)**	**GAAP Loss Ratios (1), (2)**	**Catastrophe Loss Ratios (3)**
Personal Lines:						
Personal automobile	**$ 749.7**	**56.0**	**0.3**	$ 719.0	61.3	0.6
Homeowners	**305.6**	**51.5**	**8.5**	288.6	73.0	29.9
Other personal	**30.2**	**31.5**	**5.5**	29.4	39.6	4.5
Total Personal Lines	**1,085.5**	**53.9**	**2.8**	1,037.0	64.0	8.9
Commercial Lines:						
Workers compensation	**90.5**	**57.9**	**N/M**	96.9	82.6	N/M
Commercial automobile	**154.3**	**44.8**	**1.3**	151.9	50.2	0.1
Commercial multiple peril	**275.4**	**53.0**	**15.2**	251.0	99.0	55.1
Other commercial	**169.3**	**37.8**	**9.7**	110.9	38.9	5.8
Total Commercial Lines	**689.5**	**48.5**	**8.7**	610.7	74.7	24.5
Total	**$ 1,775.0**	**52.0**	**5.0**	$ 1,647.7	67.9	14.5

	2006			2005		
	GAAP LAE Ratios	**GAAP Expense Ratios**	**GAAP Combined Ratios (5)**	**GAAP LAE Ratios**	**GAAP Expense Ratios**	**GAAP Combined Ratios (5)**
Personal lines	**11.4**	**29.9**	**95.2**	9.4	28.1	101.5
Commercial lines	**10.9**	**41.5**	**100.9**	10.0	37.5	122.2
Total	**11.2**	**34.2**	**97.4**	9.6	31.4	108.9

(1) GAAP loss ratio is a common industry measurement of the results of property and casualty insurance underwriting. This ratio reflects incurred claims compared to premiums earned. Our GAAP loss ratios include catastrophe losses.

(2) Includes policyholders dividends.

(3) Catastrophe loss ratio reflects incurred catastrophe claims compared to premiums earned.

(4) GAAP net premiums written for the nine months ended September 30, 2005 include Hurricane Katrina related reinstatement premiums of $27.0 million; $17.6 million for Personal Lines and $9.4 million for Commercial Lines.

(5) GAAP combined ratio is a common industry measurement of the results of property and casualty insurance underwriting. This ratio is the sum of incurred claims, claim expenses and underwriting expenses incurred to premiums earned. Our GAAP combined ratios also include the impact of catastrophes. Federal income taxes, net investment income and other non-underwriting expenses are not reflected in the GAAP combined ratio. Our GAAP combined ratios include the impact of reinstatement premium, resulting from Hurricane Katrina, which represents increases of 1.7, 1.9 and 1.7 points to our Personal Lines, Commercial Lines and Total GAAP combined ratios, respectively, for the nine months ended September 30, 2005.

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The following table summarizes GAAP underwriting results for the Personal Lines, Commercial Lines and Other Property and Casualty segments and reconciles it to GAAP segment income.

	Nine Months Ended September 30,							
	2006				2005			
	Personal Lines	Commercial Lines	Other Property and Casualty	Total	Personal Lines	Commercial Lines	Other Property and Casualty	Total
GAAP underwriting profit (loss), excluding prior year reserve development and catastrophes	**$ 41.9**	**$ 1.0**	**$ -**	**$ 42.9**	$ 65.0	$ 1.3	$ 0.4	$ 66.7
Prior year reserve development favorable (unfavorable)	**39.0**	**53.7**	**(1.4)**	**91.3**	32.5	22.9	(2.4)	53.0
Catastrophe effect	**(31.8)**	**(59.2)**	**-**	**(91.0)**	(112.9)	(151.9)	-	(264.8)
GAAP underwriting profit (loss)	**49.1**	**(4.5)**	**(1.4)**	**43.2**	(15.4)	(127.7)	(2.0)	(145.1)
Net investment income (1)	**80.1**	**78.3**	**10.0**	**168.4**	75.7	74.8	3.9	154.4
Fee income	**11.6**	**12.1**	**25.0**	**48.7**	12.4	9.4	17.3	39.1
Other operating expenses	**(3.1)**	**(9.0)**	**(17.5)**	**(29.6)**	(3.9)	(6.0)	(14.3)	(24.2)