

SELECTIVE INSURANCE GROUP INC
Form 10-K
February 21, 2013

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

FORM 10-K
(Mark One)

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended: December 31, 2012
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 001-33067

SELECTIVE INSURANCE GROUP, INC.
(Exact Name of Registrant as Specified in Its Charter)
New Jersey
(State or Other Jurisdiction of Incorporation or
Organization)

22-2168890
(I.R.S. Employer Identification No.)

40 Wantage Avenue, Branchville, New Jersey
(Address of Principal Executive Offices)

07890
(Zip Code)

Registrant's telephone number, including area code: (973) 948-3000
Securities registered pursuant to Section 12(b) of the Act:
Title of each class
Common Stock, par value \$2 per share

Name of each exchange on which registered
NASDAQ Global Select Market

5.875% Senior Notes due February 9, 2043
7.5% Junior Subordinated Notes due September 27, 2066

New York Stock Exchange
New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.
 Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.
 Yes No

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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 No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes No

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer <input checked="" type="checkbox"/>	Accelerated filer <input type="checkbox"/>
Non-accelerated filer <input type="checkbox"/>	Smaller reporting company <input type="checkbox"/>

(Do not check if a smaller reporting company)

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

The aggregate market value of the voting company common stock held by non-affiliates of the registrant, based on the closing price on the NASDAQ Global Select Market, was \$933,516,947 on June 30, 2012. As of February 15, 2013, the registrant had outstanding 55,454,587 shares of common stock.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's definitive Proxy Statement for the 2013 Annual Meeting of Stockholders to be held on April 24, 2013 are incorporated by reference into Part III of this report.

SELECTIVE INSURANCE GROUP, INC.

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PART I

Item 1. Business.

Overview

Selective Insurance Group, Inc. (referred to as the “Parent”) is a New Jersey holding company that was incorporated in 1977. The Parent has nine insurance subsidiaries that are licensed by various state departments of insurance to write specific lines of property and casualty insurance in the standard market. Two of these subsidiaries, Selective Casualty Insurance Company and Selective Fire and Casualty Insurance Company, were created in 2012 and began writing direct premium in 2013. In addition, in December 2011 we acquired one subsidiary, Mesa Underwriters Specialty Insurance Company (“MUSIC”), that is authorized by various state insurance departments to write property and casualty insurance in the excess and surplus lines (“E&S”) market. Our ten insurance subsidiaries are collectively referred to as the “Insurance Subsidiaries.” The Parent and its subsidiaries are collectively referred to as “we,” “us,” or “our” in this document.

Our main office is located in Branchville, New Jersey and the Parent’s common stock is publicly traded on the NASDAQ Global Select Market under the symbol “SIGL.” In 2012, we were ranked as the 49th largest property and casualty group in the United States based on 2011 net premium written (“NPW”) in A.M. Best and Company’s (“A.M. Best”) annual list of “Top 200 U.S. Property/Casualty Writers.” We have provided a glossary of terms as Exhibit 99.1 to this Form 10-K, which defines certain industry-specific and other terms that are used in this Form 10-K.

We classify our business into three operating segments:

Standard Insurance Operations - in which we sell commercial lines (“Commercial Lines”) and personal lines (“Personal Lines”) insurance products and services that are sold in the standard marketplace including flood business through the National Flood Insurance Program (“NFIP”);

E&S Insurance Operations - in which we sell Commercial Lines insurance products and services that are unavailable in the standard market due to the market conditions or characteristics of the insured that are caused by the insured's claim history or the characteristics of their business; and

Investments - in which we invest the premiums our Standard Insurance Operations and E&S Insurance Operations collect.

Prior to this year, we classified our business into two segments: Insurance Operations and Investments. The addition of the E&S segment resulted from the acquisitions that we made in 2011 related to this business. For information regarding these acquisition, see Note 12. “Business Combinations” of Item 8. “Financial Statements and Supplementary Data” of this Form 10-K. As our E&S segment currently meets the quantitative threshold for separate segment reporting, our revised segments are reflected throughout this report for all periods presented.

We derive substantially all of our income in three ways:

Underwriting income from our insurance operations. Underwriting income is comprised of revenues, which are the premiums earned on our insurance products and services, less expenses. The gross premiums we bill our insureds are direct premium written (“DPW”) plus premiums assumed from other insurers. Gross premiums billed less premium ceded to reinsurers, is NPW. NPW is recognized as revenue ratably over a policy’s term as net premiums earned (“NPE”). Expenses related to our insurance operations fall into three main categories: (i) losses associated with claims and various loss expenses incurred for adjusting claims (referred to as “loss and loss expenses”); (ii) expenses related to insurance policy issuance, such as agent commissions, premium taxes, reinsurance, and other expenses incurred in

issuing and maintaining policies, including employee compensation and benefits (referred to as “underwriting expenses”); and (iii) policyholder dividends.

Net investment income from investments. We generate income from investing: (i) insurance premiums from the time they are collected until the time we need to make certain expenditures such as paying loss and loss expenses, underwriting expenses; (ii) policyholder dividends; and (iii) equity and debt offering obligations. Net investment income consists primarily of interest earned on fixed maturity investments, dividends earned on equity securities, and other income primarily generated from our alternative investment portfolio.

Net realized gains and losses on investment securities from the investments segment. Realized gains and losses from the investment portfolios of the Insurance Subsidiaries and the Parent are typically the result of sales, maturities, calls, and redemptions. They also include write downs from other-than-temporary impairments (“OTTI”).

We measure the performance of our insurance operations segments by the combined ratio. Under U.S. generally accepted accounting principles ("GAAP"), the combined ratio is calculated by adding: (i) the loss and loss expense ratio, which is the ratio of incurred loss and loss expense to NPE; (ii) the expense ratio, which is the ratio of policy acquisition and other underwriting expenses to NPE; and (iii) the dividend ratio, which is the ratio of policyholder dividends to NPE. Statutory accounting principles ("SAP") provides a calculation of the combined ratio that differs from GAAP in that the statutory expense ratio is the ratio of policy acquisition and other underwriting expenses to NPW, not NPE. A combined ratio under 100% generally indicates an underwriting profit and a combined ratio over 100% generally indicates an underwriting loss. The combined ratio does not reflect investment income, federal income taxes, or other non-insurance related income or expense.

We measure the performance of our investments segment by pre-tax investment income and the associated return on invested assets. Our investment philosophy includes setting certain risk and return objectives for the fixed maturity, equity, and other investment portfolios. We generally measure our performance by comparing our returns for each of these components of our portfolio to a weighted-average benchmark of comparable indices.

Our operations are heavily regulated by the state insurance regulators in the states in which our Insurance Subsidiaries are organized and licensed or authorized to do business. In these states, the Insurance Subsidiaries are required to file financial statements prepared in accordance with SAP, that are promulgated by the National Association of Insurance Commissioners ("NAIC") and adopted by the various states. Because of these regulatory requirements, we use SAP to manage our insurance operations. The purpose of state insurance regulation is to protect policyholders, so SAP focuses on solvency and liquidation value unlike GAAP, which focuses on the potential for shareholder profits. Consequently, significant differences exist between SAP and GAAP that are discussed further under "Measure of Insurance Operations Profitability."

Insurance Segments (Standard and E&S)

Overview

We derive all of our insurance operations revenue from selling insurance products and services to businesses and individuals for premium. Our Commercial Lines sales are to businesses, non-profit organizations, and local government entities, and between Standard Insurance Operations and E&S Insurance Operations, represent about 83% of our NPW. Our Personal Lines sales including our flood business are to individuals and represents about 17% of our NPW. The majority of our sales are annual insurance policies. Commercial Lines sales are seasonally heaviest in January and July and lightest during the fourth quarter of the year.

Insurance Segments Products and Services

The types of insurance we sell in our insurance operations fall into four broad categories:

Standard market property insurance, which generally covers the financial consequences of accidental loss of an insured's real and/or personal property. Property claims are generally reported and settled in a relatively short period of time;

Standard market casualty insurance, which generally covers the financial consequences of employee injuries in the course of employment and bodily injury and/or property damage to a third party as a result of an insured's negligent acts, omissions, or legal liabilities. Some casualty claims may take several years to be reported and settled;

Flood insurance, which generally covers property losses under the Federal Government's Write Your Own ("WYO") program of the National Flood Insurance Program ("NFIP"). Flood insurance premiums and losses are 100% ceded to

the NFIP; and

E&S insurance, which generally provides property and casualty coverage through established underwriting guidelines to small commercial accounts with moderate degrees of hazard that do not have access to coverage in the standard markets because of their small premium size, unique/niche risk characteristics, and/or regulatory restrictions that prevent standard markets from offering appropriate underwriting terms and conditions. E&S property claims are generally reported and settled in a relatively short period of time, whereas E&S casualty claims may take several years to be reported and settled.

We underwrite and insure Commercial Lines of business primarily through traditional insurance and, to a lesser extent, through alternative risk management products, such as retrospective rating plans, self-insured group retention programs, or individual self-insured accounts. The following table shows the principal types of policies we write in our Standard Insurance Operations and our E&S Insurance Operations:

Type of Policy	Category of Insurance	Standard Insurance Operations	E&S Insurance Operations
Commercial Property	Property	X	X
Commercial Automobile	Property/Casualty	X	
General Liability (including Excess Liability/Umbrella)	Casualty	X	X
Workers Compensation	Casualty	X	
Business Owners Policy	Property/Casualty	X	
Bonds (Fidelity and Surety)	Casualty	X	
Flood ¹	Property	X	

¹Flood insurance premiums and losses are 100% ceded to the federal government's WYO Program. Certain other policies contain minimal Flood or Flood related coverages.

The main Personal Lines business that we underwrite and insure are as follows:

Type of Policy	Category of Insurance	Standard Insurance Operations
Homeowners	Property/Casualty	X
Personal Automobile	Property/Casualty	X
Flood ¹	Property	X

¹Flood insurance premiums and losses are 100% ceded to the federal government's WYO Program. Certain other policies contain minimal Flood or Flood related coverages.

Product Development and Pricing

Our insurance policies are contracts that specify our coverages – what we will pay to or for an insured upon specified losses. We develop our coverages internally and by adopting and modifying forms and statistical data licensed from third party aggregators, notably Insurance Services Office, Inc. ("ISO") and the National Council on Compensation Insurance, Inc. ("NCCI"). Determining the price to charge for our coverages is complicated. At the time we underwrite and issue a policy, we do not know what our actual costs for the policy will be in the future. To calculate and project future costs, we examine and analyze historical statistical data and factor in expected changes in loss trends. In the last five years, we have also developed predictive models for certain of our standard insurance lines. Predictive models analyze historical statistical data regarding our insureds and their loss experience, rank our policies based on this analysis, and apply this risk data to current and future insureds to predict the likely profitability of an account. A model's predictive capabilities are limited by the amount and quality of the statistical data available. As a regional insurance group, our loss experience is not always statistically large enough to analyze and project future costs. Consequently, we use ISO data to supplement our own.

Customers and Customer Markets

Commercial Lines customers represent 83% of our total DPW. We categorize this business as follows:

	Percent of Total Commercial Lines	Average Premium per Policy	Description
Small Business	21	% \$2,488	

Standard insurance policies generally under \$25,000, with certain restrictions for hazard grade and exposure that can be written through our internet-based One & Done® and Two & Done automated underwriting templates.

Middle Market Business	62	% \$9,323	Standard insurance policies that cannot be written through our automated systems and are the focus of our field-based underwriters, known as agency management specialists (“AMSs”).
Large Account Business	10	% \$142,140	Standard insurance policies that are larger in size or include alternative risk transfer. This business is written by large account specialists. Approximately 25% of these accounts include alternative risk transfer mechanisms.
E&S Business	7	% \$2,564	E&S insurance policies that are generally written through contract binding authority under established underwriting guidelines with our wholesale general agency partners.

We do not subdivide our Personal Lines customers by size or class. No one customer accounts for 10% or more of our Standard or E&S Insurance Operations segments.

Geographic Markets

We principally sell our standard insurance products and services in 22 states and the District of Columbia in the Eastern and Midwestern regions of the United States. However, we also provide Flood and E&S insurance in all 50 states and the District of Columbia. We believe this geographic diversification lessens our exposure to regulatory, competitive, and catastrophic risk. The following table lists the principal states in which we write business and the percentage of total NPW each represents for the last three fiscal years:

% of NPW	Year Ended December 31,		
	2012	2011	2010
New Jersey	23.3	% 25.3	26.2
Pennsylvania	12.0	13.0	13.8
New York	7.6	8.3	9.0
Maryland	5.7	6.4	6.9
Illinois	4.9	5.5	5.5
Virginia	4.9	5.3	5.3
Indiana	5.0	4.9	4.8
Michigan	3.5	3.6	3.0
Georgia	3.1	3.1	3.1
North Carolina	3.1	3.0	3.3
South Carolina	3.0	2.7	2.6
Ohio	2.6	2.7	2.5
Other states	21.3	16.2	14.0
Total	100.0	% 100.0	100.0

Distribution and Marketing

We sell and distribute our Standard Insurance Operations products and services through independent retail insurance agents. Our Standard Insurance Operations, excluding our flood business, had retail agency agreements with approximately 1,100 independent agencies, as of December 31, 2012, many of which have multiple offices. In total, approximately 1,800 independent agency offices are selling this business for us. In addition, we have approximately 5,000 agents selling our flood products. We sell and distribute our E&S Insurance Operations products through 95 wholesale general agencies, to which we have given contract binding authority for the business they receive from independent retail insurance agents. We pay our agencies commissions and other consideration for business placed with us. We seek to compensate our agencies fairly and consistent with market practices. No one agency is responsible for 10% or more of our combined insurance operations premium.

Independent retail insurance agents and brokers write approximately 80% of standard market commercial property and casualty insurance and approximately a third of the standard market personal lines insurance in the United States according to a study released in 2011 by the Independent Insurance Agents & Brokers of America and E&S business is written almost exclusively through wholesale general agents. We believe that independent retail insurance agents will remain a significant force in overall insurance industry premium production because they represent more than one insurance carrier and can provide a wider choice of commercial lines and personal lines insurance products to insureds. Because our agencies generally represent several of our competitors, we face competition within our distribution channel. As our customers rely heavily on their independent retail insurance agent, it is sometimes difficult to develop brand recognition with our customers, who cannot always differentiate between insurance coverage and insurance carriers.

Our primary marketing strategy with agents is to:

Use a business model that provides them resources within close geographic proximity, including: (i) field underwriters; (ii) regional office underwriters; (iii) safety management specialists; (iv) field claims personnel; and (v) field marketing specialists. These resources make timely underwriting and claim decisions based on established authority parameters.

- Develop close relationships with each agency and its principals: (i) by soliciting their feedback on products and services; (ii) by advising them concerning company developments; and (iii) through significant interaction with them focusing on producer recruitment, sales training, enhancing customer experience, online marketing, and agency operations.

Develop with each agency, and then carefully monitor, annual goals regarding: (i) types and mix of risks placed with us; (ii) amounts of premium or numbers of policies placed with us; (iii) customer service levels; and (iv) profitability of business placed with us.

In our most recent survey of our Standard Insurance Operations, which was conducted in 2012, we received an overall satisfaction score of 8.3 out of 10 from our agents, which highlighted our agents' satisfaction with our standard Commercial Lines products, the ease of reporting claims, and the professionalism and effectiveness of our employees.

Field and Technology Strategies Supporting Independent Retail Agent Distribution

We use the service mark "High-tech x High-touch = HTSM" to describe our Standard Insurance Operations business strategy. "High-tech" refers to our technology that we use to make it easy for our independent retail insurance agents and customers to do standard business with us. "High-touch" refers to the close relationships that we have with our independent retail insurance agents and customers due to our field business model that places underwriters, claims representatives, technical staff, and safety management representatives near our agents and customers.

Employees

To support our independent retail agents, we employ a field model in both underwriting and claims. The field model places various employees in the field, usually working from home offices near our agents. We believe that we build better and stronger relationships with our agents because of the close proximity of our field employees to our agents and the resulting direct and regular interaction with our agents and our customers.

At December 31, 2012, we had approximately 2,100 employees, 300 of which work in the field.

We provide support to our field model from our corporate headquarters in Branchville, New Jersey, and our six regional branches ("Regions"). The table below lists our Regions and where they have office locations:

Region	Office Location
Heartland	Carmel, Indiana
New Jersey	Hamilton, New Jersey
Northeast	Branchville, New Jersey
Mid-Atlantic	Allentown, Pennsylvania and Hunt Valley, Maryland
Southern	Charlotte, North Carolina
E&S	Horsham, Pennsylvania and Scottsdale, Arizona

Underwriting Process Involving Agents and Field Model

Our underwriting process requires communication and interaction among:

- Our independent retail agents, who act as front-line underwriters, our AMSs, our SMSs, our field marketing specialists ("FMSs"), as well as our corporate and regional underwriters;
- Our wholesale general agents, who use guidelines developed by our corporate E&S underwriters to write business that they receive from retail insurance agents under contract binding authority.
- Our flood agents who act as front-line underwriters for our business under the NFIP's WYO Program.
- Our corporate underwriting department, which includes our strategic business units ("SBUs"), organized by product and customer type, and our line-of-business units. These units develop our pricing and underwriting guidelines in conjunction with the Regions;
- Our Regions, which establish: (i) annual premium and pricing goals in consultation with the SBUs; (ii) agency new business targets; and (iii) agency profit improvement plans; and
-

Our Actuarial Department, located in our corporate headquarters, which assists in the determination of rate and pricing levels, while also monitoring pricing and profitability.

We also have an underwriting service center (“USC”) located in Richmond, Virginia. The USC assists our independent retail agents by servicing our Standard Insurance Operations through Personal Lines, Commercial Lines and Small Business and Middle Market accounts. At the USC, our employees are licensed agents who respond to customer inquiries about insurance coverage, billing transactions, and other matters. For the convenience of using the USC and our handling of certain transactions, our independent retail agents agree to receive a slightly lower than standard commission for the premium associated with the USC. As of December 31, 2012 our USC was servicing standard Commercial Lines NPW of \$47 million, and Personal Lines NPW of \$27 million. The \$74 million total serviced by the USC represents 4% of our total NPW.

We believe that our field model has a distinct advantage in its ability to provide a wide range of front-line safety management services focused on improving an insured's safety and risk management programs – and we have obtained the service mark “Safety Management: Solutions for a safer workplace®” Safety management services include: (i) risk evaluation and improvement surveys intended to evaluate potential exposures and provide solutions for mitigation; (ii) Internet-based safety management educational resources, including a large library of coverage-specific safety materials, videos and online courses, such as defensive driving and employee educational safety courses; (iii) thermographic infrared surveys aimed at identifying electrical hazards; and (iv) Occupational Safety and Health Administration construction and general industry certification training. Risk improvement efforts for existing customers are designed to improve loss experience and policyholder retention through valuable ongoing consultative service. Our safety management goal is to work with our insureds to identify and eliminate potential loss exposures.

Claims Management and Field Claims Model

Effective, fair, and timely claims management is one of the most important services that we provide our customers and agents. It also is one of the critical factors in achieving underwriting profitability. We have structured our claims organization to emphasize: (i) cost-effective delivery of claims services and control of loss and loss expenses; and (ii) maintenance of timely and adequate claims reserves. In connection with our Standard Insurance Operations, we believe that we can achieve lower claims expenses through our field model by locating claims representatives in close proximity to our customers and independent retail agents. For our E&S Insurance Operations, we use external adjusters who are situated close to claimants.

Claims management specialists (“CMSs”) are primarily responsible for investigating and settling the majority of our Standard Insurance Operations' non-workers compensation claims directly with insureds and claimants. By promptly and personally investigating claims, we believe CMSs are able to provide better customer and agent service and quickly resolve claims within their authority. All workers compensation claims are handled in the Regional Claim Offices. Workers compensation adjusters specialize in investigation, medical management or lost-time claims. Because of the special nature of property claims, CMSs refer those claims above certain amounts to our general property adjusters for consultation. We also refer complex liability claims to an experienced adjusting team that focuses solely on complex large exposure liability claims. All environmental claims are referred to our specialized corporate environmental unit. This structure allows us to provide experienced adjusting to each claim segment.

We also have a claims service center (“CSC”), co-located with the USC, in Richmond, Virginia. The CSC receives first notices of loss from our insureds and claimants related to our Standard Insurance Operations. The CSC is designed to help: (i) reduce the claims settlement time on first- and third-party automobile property damage claims; (ii) increase our use of body shops, glass repair shops, and car rental agencies that have contracted with us at discounted rates; (iii) handle and settle small property claims; and (iv) investigate and negotiate auto liability claims. Upon receipt of a claim, the CSC, as appropriate, will assign the matter to the appropriate Region or the specialized area at our corporate headquarters.

For our Standard and E&S Insurance Operations, we have a special investigations unit (“SIU”) that investigates potential insurance fraud and abuse, and supports efforts by regulatory bodies and trade associations to curtail the cost of fraud. The SIU adheres to uniform internal procedures to improve detection and take action on potentially fraudulent claims. It is our practice to notify the proper authorities of SIU findings, which we believe sends a clear message that we will not tolerate fraud against us or our customers. The SIU also supervises anti-fraud training for all claims adjusters and AMSs.

Technology

We leverage the use of technology in our business. In recent years, we have made significant investments in information technology platforms, integrated systems, internet-based applications, and predictive modeling initiatives. We did this to provide:

• Our independent retail agents, wholesale agents, and customers with access to accurate business information and the ability to process certain transactions from their locations, seamlessly integrating those transactions into our systems;

• Our SIU investigators access to our business intelligence systems to better identify claims with potential fraudulent activities;

• Our claims recovery and subrogation departments have the ability to expand and enhance their models through the use of our business intelligence systems, an effort that is expected to be completed over the coming year; and

• Our underwriters with targeted pricing tools to enhance profitability while growing the business.

In 2012, we received the Interface Partner Award from Applied Systems, an automated solutions provider to independent retail insurance agents for the fifth consecutive year. The award recognizes our leadership and innovation in our interface advancements in download and real-time rating. We also received the following four awards from the Association of Cooperative Operations Research and Development ("ACORD"):

The Property & Casualty Straight-Through Processing of Data Accomplishment Award, which recognizes automation of the policy life cycle using ACORD standards and forms, including real-time rating/submission, policy download, and endorsement processing.

The AUGIE (ACORD-User Group Information Exchange) Commercial Lines Download Accomplishment Award, which recognizes Selective's use of ACORD Standards to streamline workflows and improve quality of data available to users who need to service their customers.

The Property & Casualty AL3 Download Recognition Award, for using current electronic data interchange (EDI) standards and having a solid history of download success using AL3 standards.

The Property & Casualty Outstanding Contribution Accomplishment Award, for promoting the implementation and education of ACORD standards and best practices.

We manage our information technology projects through an Enterprise Project Management Office ("EPMO"). The EPMO is staffed by certified individuals who apply methodologies to: (i) communicate project management standards; (ii) provide project management training and tools; (iii) review project status and cost; and (iv) provide non-technology project management consulting services to the rest of the organization. The EPMO, which includes senior management representatives from all major business areas, corporate functions and information technology, meets regularly to review all major initiatives and receives reports on the status of other projects. We believe the EPMO is an important factor in the success of our technology implementation. Our technology operations are located in Branchville, New Jersey and Glastonbury, Connecticut. We also have agreements with multiple consulting, information technology, and managed services providers for supplemental staffing services. Collectively, these providers supply approximately 26% of our skilled technology capacity. We retain management oversight of all projects and ongoing information technology production operations. We believe we would be able to manage an efficient transition to new vendors without significant impact to our operations if we terminated an existing vendor.

In 2012, we continued our program to enhance our customers' experience with us by introducing several initiatives to bring service improvements to our customers, including: (i) expanding usage of the Customer Self Service portal; (ii) launching a mobile application to allow customers to receive service through their smart phones; and (iii) conducting customer surveys regarding billing and claims transactions.

Insurance Segments Competition

Market Competition

The commercial lines property and casualty market is highly competitive and market share is fragmented among many companies. Despite a slight economic improvement and some encouraging signs of price firming, A.M. Best maintains its negative outlook for the commercial lines segment for 2013. We compete with four types of companies, primarily on the basis of price, coverage terms, claims service, safety management services, ease of technology, and financial ratings:

Regional insurers, such as Cincinnati Financial Corporation, Erie Indemnity Company, The Hanover Insurance Group, Inc., and United Fire Group, Inc., which offer commercial lines and personal lines products and services;

•

National insurers, such as Liberty Mutual Group, The Travelers Companies, Inc., The Hartford Financial Services Group, Inc., Nationwide Mutual Insurance Company, and Zurich Insurance Group which offer commercial lines and personal lines products and services;

Alternative risk insurers, which includes entities that self-insure their risks. Generally, only large entities have the capacity to self-insure. In the public sector, some small and mid-sized public entities have the opportunity to partially self-insure their risks through the use of risk pools or joint insurance funds that are generally created by legislative act; and

E&S lines insurers, such as Scottsdale, Nautilus, Colony, Markel, Western World, Century Surety and Burlington, which offer a variety of property and casualty insurance products on an E&S basis. In addition, we also face competition from E&S lines insurers who work directly with retail agencies such as U.S. Liability Insurance. Our E&S business is typically small-to-medium sized accounts that are subject to a lower level of competition than larger accounts.

We also face competition in personal lines, although the market is less fragmented than commercial lines and carriers have been more successful at obtaining rate increases. The A.M. Best industry outlook for personal lines is stable, as the industry's auto line continues to perform well with generally adequate and stable returns. Our Personal Lines business faces competition primarily from the regional and national carriers noted above, as well as direct insurers such as GEICO and The Progressive Corporation, which primarily offer personal lines coverage and market through a direct response model.

Some of these competitors are public companies and some are mutual companies. Some, like us, rely on independent retail and wholesale insurance agents for distribution of their products and services and have competition within their distribution channel. Others either employ their own agents who only represent one insurance carrier or use a combination of independent retail and captive agents.

Financial Ratings

Our Insurance Subsidiaries' ratings by major rating agencies, are as follows:

Rating Agency	Financial Strength Rating	Outlook
A.M. Best and Company	A	Stable
Standard & Poor's ("S&P")	A	Negative
Moody's Investors Service ("Moody's")	A2	Negative
Fitch Ratings ("Fitch")	A+	Stable

Because agent and customer concerns about an insurer's ability to pay claims in the future are such an important factor in our competitiveness, our financial ratings are important. Major financial rating agencies evaluate us on our financial strength, operating performance, strategic position, and ability to meet policyholder obligations. We believe that our ability to write insurance business is most significantly influenced by our rating from A.M. Best. We have been rated "A" or higher by A.M. Best for the past 82 years. In the second quarter of 2012, A.M. Best lowered our rating to "A (Excellent)", their third highest of 15 ratings, with a "Stable" outlook. In making this change, A.M. Best cited solid risk-adjusted capitalization, disciplined underwriting focus, increasing use of predictive modeling technology, and our strong independent retail agency relationships but stated our operating performance over the past five-year period was not as favorable as the commercial property casualty index and that we had been negatively impacted by record catastrophic and weather-related losses. A downgrade from A.M. Best to a rating below "A-" could: (i) affect our ability to write new business with customers and/or agents, some of whom are required (under various third-party agreements) to maintain insurance with a carrier that maintains a specified A.M. Best minimum rating; or (ii) be an event of default under our Line of Credit.

Our "A" financial strength rating was reaffirmed in the third quarter of 2012 by S&P, which cited our strong competitive position in Mid-Atlantic markets, financial flexibility, and relationships with independent retail agents while our outlook was revised to "negative" reflecting a modest decline in available capital and increased charges for underwriting risk, asset risk, and property catastrophe exposure as measured by Standard & Poor's capital adequacy model. On February 4, 2013, Moody's cited our strong regional franchise with established independent retail agency support, along with good risk adjusted capitalization and strong invested asset quality to reaffirm our financial strength rating of "A2" but revised our outlook to negative, citing that our underwriting results have lagged similarly rated peers. Fitch reaffirmed our "A+" rating and stable outlook in the fourth quarter of 2012, citing our conservative balance sheet with

solid capitalization and reserve strength, strong independent agency relationships, and improved diversification through our continued efforts to reduce our concentration in New Jersey.

While customers and agents may be aware of our S&P, Moody's and Fitch financial strength ratings, these ratings are not as important in insurance purchase decision-making. They do, however, affect our ability to access capital markets. For further discussion on this, please see the "Financial Condition, Liquidity, Short-term Borrowings, and Capital Resources" section of Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations." of this Form 10-K.

Other factors that might impact our competitiveness are discussed in Item 1A. "Risk Factors." of this Form 10-K.

Reinsurance

We use reinsurance to protect our capital resources and insure us against losses on property and casualty risks that we underwrite. We use two main reinsurance vehicles: (i) a reinsurance pooling agreement among our Insurance Subsidiaries in which each company agrees to share in premiums and losses based on certain specified percentages; and (ii) reinsurance contracts and arrangements with third parties that cover various policies that our insurance operations issue to insureds.

Reinsurance Pooling Agreement

The primary purposes of the reinsurance pooling agreement among our Insurance Subsidiaries are the following:

- Pool or share proportionately the underwriting profit and loss results of property and casualty insurance underwriting operations through reinsurance;

- Prevent any of our Insurance Subsidiaries from suffering undue loss;

- Reduce administration expenses; and

- Permit all of the Insurance Subsidiaries to obtain a uniform rating from A.M. Best.

We amended the Pooling Agreement twice in 2012: (i) to add MUSIC; and (ii) to add the formation of two new insurance companies, Selective Casualty Insurance Company ("SCIC") and Selective Fire and Casualty Insurance Company ("SFCIC").

The following illustrates the pooling percentages by company for the respective time frames throughout 2012:

Insurance Subsidiary	Pooling Percentage	
	January 1 - June 30, 2012	July 1 - December 31, 2012
Selective Insurance Company of America ("SICA")	44.5%	32.0%
Selective Way Insurance Company ("SWIC")	21.0%	21.0%
Selective Insurance Company of South Carolina ("SICSC")	9.0%	9.0%
Selective Insurance Company of the Southeast ("SICSE")	7.0%	7.0%
Selective Insurance Company of New York ("SICNY")	7.0%	7.0%
SCIC	—%	7.0%
Selective Auto Insurance Company of New Jersey ("SAICNJ")	6.0%	6.0%
MUSIC	5.0%	5.0%
Selective Insurance Company of New England ("SICNE")	0.5%	3.0%
SFCIC	—%	3.0%

Reinsurance Treaties and Arrangements

By entering reinsurance treaties and arrangements, we are able to increase underwriting capacity and accept larger risks and a larger number of risks without directly increasing capital or surplus. All of our reinsurance treaties are for traditional reinsurance; we do not purchase finite reinsurance. Under our reinsurance treaties, the reinsurer generally assumes a portion of the losses we cede to them in exchange for a portion of the premium. Amounts not reinsured are known as retention. Reinsurance does not legally discharge us from liability under the terms and limits of our policies,

but it does make our reinsurer liable to us for the amount of liability we cede to them. Accordingly, we have counterparty credit risk to our reinsurers. We attempt to mitigate this credit risk by: (i) pursuing relationships with reinsurers rated “A-” or higher; and (ii) obtaining collateral to secure reinsurance obligations when possible. Some of our reinsurance contracts include provisions that permit us to terminate or commute the reinsurance treaty if the reinsurer's financial condition or rating deteriorates. We continuously monitor the financial condition of our reinsurers. We also continuously review the quality of reinsurance recoverables and reserves for uncollectible reinsurance.

We primarily use the following three reinsurance treaty and arrangement types for property and casualty insurance:

- Treaty reinsurance, under which certain types of policies are automatically reinsured without prior approval by the reinsurer of the underlying individual insured risks;

- Facultative reinsurance, under which an individual insurance policy or a specific risk is reinsured with the prior approval of the reinsurer. We use facultative reinsurance for policies with limits greater than those available under our treaty reinsurance; and

Protection provided under the Terrorism Risk Insurance Act of 2002 as modified and extended through December 31, 2014 by the Terrorism Risk Insurance Program Reauthorization Act of 2007 (collectively referred to as “TRIA”). Under TRIA, terrorism coverage is mandatory for all primary workers compensation policies. Insureds with non-workers compensation commercial policies, however, have the option to accept or decline our terrorism coverage or negotiate with us for other terms. Under TRIA, each participating insurer is responsible for paying a deductible of specified losses based on a percentage of the prior year's applicable commercial lines direct premiums earned before federal assistance is available. In 2013, our deductible is approximately \$209 million. For losses above the deductible, the federal government will pay 85% and the insurer retains 15%. Although TRIA's provisions will mitigate our loss exposure to a large-scale terrorist attack, our deductible is substantial.

The following is a summary of our property reinsurance treaties and arrangements covering our Insurance Subsidiaries:

PROPERTY REINSURANCE ON INSURANCE PRODUCTS

Treaty Name	Reinsurance Coverage	Terrorism Coverage
Property Excess of Loss (covers standard lines)	\$38 million above \$2 million retention in two layers. Losses other than TRIA certified losses are subject to the following reinstatements and annual aggregate limits: - \$8 million in excess of \$2 million layer provides an unlimited reinstatements; and - \$30 million in excess of \$10 million layer provides three reinstatements, \$120 million in aggregate limits.	All nuclear, biological, chemical, and radioactive (“NBCR”) losses are excluded regardless of whether or not they are certified under TRIA. For non-NBCR losses, the treaty distinguishes between acts certified under TRIA and those that are not. The treaty provides annual aggregate limits for TRIA certified (other than NBCR) acts of \$24 million for the first layer and \$60 million for the second layer. Non-certified terrorism losses (other than NBCR) are subject to the normal limits under the treaty.
Property Catastrophe Excess of Loss (covers both standard and E&S lines)	\$585 million above \$40 million retention in four layers: - 97% of losses in excess of \$40 million up to \$100 million; - 96% of losses in excess of \$100 million up to \$225 million; and - 95% of losses in excess of \$225 million up to \$475 million.	All nuclear, biological, and chemical (“NBC”) losses are excluded regardless of whether or not they are certified under TRIA. TRIA losses related to foreign acts of terrorism are excluded from the treaty. Domestic terrorism is included regardless of whether it is certified under TRIA or not. Please see Item 1A. “Risk Factors.” of this Form 10-K for further discussion regarding changes in TRIA.

- 98% of losses in excess of \$475 million up to \$625 million.

- The treaty provides one reinstatement per layer for the first three layers and no reinstatements on the fourth layer. The annual aggregate limit is \$978.9 million, net of the Insurance Subsidiaries' co-participation.

Flood 100% reinsurance by the federal government's WYO Program. None

The following is a summary of our casualty reinsurance treaties and arrangements covering our Insurance Subsidiaries:

CASUALTY REINSURANCE ON INSURANCE PRODUCTS

Treaty Name	Reinsurance Coverage	Terrorism Coverage
Casualty Excess of Loss (covers standard lines)	<p>There are six layers covering 100% of \$88 million in excess of \$2 million. Losses other than terrorism losses are subject to the following reinstatements and annual aggregate limits:</p> <ul style="list-style-type: none"> - \$3 million in excess of \$2 million layer provides 23 reinstatements, \$72 million net annual aggregate limit; - \$7 million in excess of \$5 million layer provides three reinstatements, \$28 million annual aggregate limit; - \$9 million in excess of \$12 million layer provides two reinstatements, \$27 million annual aggregate limit; - \$9 million in excess of \$21 million layer provides one reinstatement, \$18 million annual aggregate limit; - \$20 million in excess of \$30 million layer provides one reinstatement, \$40 million annual aggregate limit; and - \$40 million in excess of \$50 million layer provides one reinstatement, \$80 million in net annual aggregate limit. 	<p>All NBCR losses are excluded. All other losses stemming from the acts of terrorism are subject to the following reinstatements and annual aggregate limits:</p> <ul style="list-style-type: none"> - \$3 million in excess of \$2 million layer provides four reinstatements for terrorism losses, \$15 million net annual aggregate limit; - \$7 million in excess of \$5 million layer provides two reinstatements for terrorism losses, \$21 million annual aggregate limit; - \$9 million in excess of \$12 million layer provides two reinstatements for terrorism losses, \$27 million annual aggregate limit; - \$9 million in excess of \$21 million layer provides one reinstatement for terrorism losses, \$18 million annual aggregate limit; - \$20 million in excess of \$30 million layer provides one reinstatement for terrorism losses, \$40 million annual aggregate limit; and - \$40 million in excess of \$50 million layer provides one reinstatement for terrorism losses, \$80 million in net annual aggregate limit.
Montpelier Re Quota Share and Loss Development Cover	<p>As part of the acquisition of MUSIC we entered into several reinsurance agreements that together provide protection for losses on</p>	<p>Provides full terrorism coverage including NBCR.</p>

(covers E&S lines) policies written prior to the acquisition and any development on reserves established by MUSIC as of the date of acquisition. The reinsurance recoverables under these treaties are 100% collateralized.

We also have other reinsurance treaties that we do not consider core to our reinsurance program for our standard insurance products, such as our Surety and Fidelity Excess of Loss Reinsurance Treaty, National Workers Compensation Reinsurance Pool ("NWCRP") that covers business assumed from the involuntary workers compensation pool, and our Equipment Breakdown Coverage Reinsurance Treaty. In addition, we have Property and Casualty Excess of Loss Reinsurance Treaties providing coverage on our E&S business. For further discussion on reinsurance, see the "Reinsurance" section of Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations." of this Form 10-K.

Claims Reserves

Net Loss and Loss Expense Reserves

We establish loss and loss expense reserves that are estimates of the amounts we will need to pay in the future for claims and related expenses for insured losses that have already occurred. Estimating reserves as of any date involves a considerable degree of judgment by management and is inherently uncertain. We regularly review our reserving techniques and our overall amount of reserves. We also review:

- Information regarding each claim for losses, including potential extra-contractual liabilities, or amounts paid in excess of the policy limits, which may not be covered by our contracts with reinsurers;

• Our loss history and the industry's loss history;

• Legislative enactments, judicial decisions and legal developments regarding damages;

• Changes in political attitudes; and

• Trends in general economic conditions, including inflation.

See “Critical Accounting Policies and Estimates” in Item 7. “Management’s Discussion and Analysis of Financial Condition and Results of Operations.” of this Form 10-K for full discussion regarding our loss reserving process.

Our loss and loss expense reserve development over the preceding 10 years is shown on the following table, which has five parts:

Section I shows the estimated liability recorded at the end of each indicated year for all current and prior accident year’s unpaid loss and loss expenses. The liability represents the estimated amount of loss and loss expenses for unpaid claims, including incurred but not reported (“IBNR”) reserves. In accordance with GAAP, the liability for unpaid loss and loss expenses is recorded gross of the effects of reinsurance. An estimate of reinsurance recoverables is reported separately as an asset. The net balance represents the estimated amount of unpaid loss and loss expenses outstanding reduced by estimates of amounts recoverable under reinsurance contracts.

Section II shows the re-estimated amount of the previously recorded net liability as of the end of each succeeding year. Estimates of the liability of unpaid loss and loss expenses are increased or decreased as payments are made and more information regarding individual claims and trends, such as overall frequency and severity patterns, becomes known.

Section III shows the cumulative amount of net loss and loss expenses paid relating to recorded liabilities as of the end of each succeeding year.

Section IV shows the re-estimated gross liability and re-estimated reinsurance recoverables through December 31, 2012.

Section V shows the cumulative net (deficiency)/redundancy representing the aggregate change in the liability from the original balance sheet dates and the re-estimated liability through December 31, 2012.

This table does not present accident or policy year development data. Conditions and trends that have affected past reserve development may not necessarily occur in the future. As a result, extrapolating redundancies or deficiencies based on this table is inherently uncertain.

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(\$ in millions)	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
I. Gross reserves for unpaid losses and loss expenses at December 31	\$1,403.4	1,587.8	1,835.2	2,084.0	2,288.8	2,542.5	2,641.0	2,745.8	2,830.1	3,144.9	4,068.9
Reinsurance recoverables on unpaid losses and loss expenses at December 31	\$(160.4)	(184.6)	(218.8)	(218.2)	(199.7)	(227.8)	(224.2)	(271.6)	(313.7)	(549.5)	(1,409.7)
Net reserves for unpaid losses and loss expenses at December 31	\$1,243.1	1,403.2	1,616.4	1,865.8	2,089.0	2,314.7	2,416.8	2,474.2	2,516.3	2,595.4	2,659.2
II. Net reserves estimate as of:											
One year later	\$1,258.1	1,408.1	1,621.5	1,858.5	2,070.2	2,295.4	2,387.4	2,430.6	2,477.6	2,569.8	
Two years later	1,276.3	1,452.3	1,637.3	1,845.1	2,024.0	2,237.8	2,324.6	2,368.1	2,428.6		
Three years later	1,344.6	1,491.1	1,643.7	1,825.2	1,982.4	2,169.7	2,286.0	2,315.0			
Four years later	1,371.5	1,522.9	1,649.8	1,808.9	1,931.1	2,155.8	2,264.9				
Five years later	1,413.8	1,529.2	1,653.6	1,780.7	1,916.0	2,151.5					
Six years later	1,420.8	1,538.4	1,639.5	1,777.3	1,924.4						
Seven years later	1,428.7	1,535.6	1,638.7	1,789.3							
Eight years later	1,430.0	1,539.1	1,648.0								
Nine years later	1,435.7	1,546.6									
Ten years later	1,445.1										

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Cumulative net redundancy (deficiency)	(202.1)	(143.4)	(31.6)	76.5	164.7	163.2	151.9	159.2	87.7	25.6
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III. Cumulative amount of net reserves paid through:

One year later	\$384.0	414.5	422.4	468.6	469.4	579.4	584.5	561.3	569.9	632.7
Two years later	653.3	691.4	729.5	775.0	841.3	945.5	966.8	936.7	990.8	
Three years later	836.3	903.7	942.4	1,026.9	1,080.0	1,201.6	1,238.3	1,235.8		
Four years later	966.2	1,033.5	1,101.0	1,174.2	1,235.2	1,388.7	1,439.5			
Five years later	1,044.6	1,128.4	1,189.2	1,267.1	1,347.0	1,513.0				
Six years later	1,110.0	1,184.5	1,245.4	1,341.8	1,426.8					
Seven years later	1,151.8	1,225.3	1,294.2	1,399.6						
Eight years later	1,183.0	1,262.5	1,333.8							
Nine years later	1,213.4	1,291.1								
Ten years later	1,235.4									

IV. Re-estimated gross liability	1,736.9	1,853.6	1,961.5	2,116.2	2,206.4	2,429.1	2,547.9	2,609.8	2,750.2	3,098.7
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Re-estimated reinsurance recoverables	(291.8)	(307.0)	(313.5)	(326.9)	(282.1)	(277.5)	(283.0)	(294.9)	(321.6)	(528.9)
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Re-estimated net liability	1,445.1	1,546.6	1,648.0	1,789.3	1,924.4	2,151.5	2,264.9	2,315.0	2,428.6	2,569.8
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V. Cumulative gross redundancy (deficiency)	(333.5)	(265.8)	(126.3)	(32.2)	82.4	113.4	93.1	136.0	79.9	46.2
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Cumulative net redundancy (deficiency)	(202.1)	(143.4)	(31.6)	76.5	164.7	163.2	151.9	159.2	87.7	25.6
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Note: Some amounts may not foot due to rounding.

In light of the many uncertainties associated with establishing the estimates and making the assumptions necessary to establish reserve levels, we review our reserve estimates on a regular basis and make adjustments in the period that the need for such adjustment is determined. These reviews could result in the identification of information and trends that would require us to increase some reserves and/or decrease other reserves for prior periods and could also lead to additional increases in loss and loss expense reserves, which could have a material adverse effect on our results of operations, equity, insurer financial strength, and debt ratings.

In 2012, we experienced overall favorable loss development of approximately \$26 million compared to \$39 million in 2011 and \$44 million in 2010. The following table summarizes the prior year development by line of business:

Favorable/(Unfavorable) Prior Year Development

(\$ in millions)	2012	2011	2010
General Liability	\$(3	) 12	26
Commercial Automobile	9	13	28
Workers' Compensation	(2	) (7	) (22
Business Owners' Policies	9	11	3
Commercial Property	3	6	3
Homeowners	9	4	6
Personal Automobile	—	(1	) (2
Other	1	1	2
Total	\$26	39	44

For a qualitative discussion of our prior year development, see Note 9. "Reserves for Losses and Loss Expenses" in Item 8. "Financial Statements and Supplementary Data." of this Form 10-K.

The following table reconciles losses and loss expense reserves under SAP and GAAP at December 31 as follows:

(\$ in thousands)	2012	2011
Statutory losses and loss expense reserves	\$2,654,418	2,591,570
Provision for uncollectible reinsurance	4,800	3,900
Other	(32	) (36
GAAP losses and loss expense reserves – net	2,659,186	2,595,434
Reinsurance recoverables on unpaid losses and loss expenses	1,409,755	549,490
GAAP losses and loss expense reserves – gross	\$4,068,941	3,144,924

Asbestos and Environmental Reserves

Our general liability, excess liability, and homeowners reserves include exposure to asbestos and environmental claims. Our exposure to environmental liability is primarily due to: (i) landfill exposures from policies written prior to the absolute pollution endorsement in the mid 1980s; and (ii) underground storage tank leaks mainly from New Jersey homeowners' policies. These environmental claims stem primarily from insured exposures in municipal government, small non-manufacturing commercial risks, and homeowners policies. The emergence of these claims is slow and highly unpredictable.

“Asbestos claims” are claims for bodily injury alleged to have occurred from exposure to asbestos-containing products. Our primary exposure arises from insuring various distributors of asbestos-containing products, such as electrical and plumbing materials. At December 31, 2012, asbestos claims constituted 28% of our \$27.8 million net asbestos and environmental reserves compared to 24% of our \$27.9 million net asbestos and environmental reserves at December 31, 2011.

“Environmental claims” are claims alleging bodily injury or property damage from pollution or other environmental contaminants other than asbestos. These claims include landfills and leaking underground storage tanks. Our landfill exposure lies largely in policies written on municipal governments, in their operation or maintenance of certain public lands. In addition to landfill exposures, in recent years, we have experienced a relatively consistent level of reported losses in the homeowners line of business related to claims for groundwater contamination from leaking underground heating oil storage tanks in New Jersey. In 2007, we instituted a fuel oil system exclusion on our New Jersey homeowners policies that limits our exposure to leaking underground storage tanks for certain customers. At that time, existing insureds were offered a one-time opportunity to buy back oil tank liability coverage. The exclusion applies to all new homeowners policies in New Jersey. These customers are eligible for the buy-back option only if the tank meets specific eligibility criteria.

Our asbestos and environmental claims are handled in our centralized and specialized asbestos and environmental claim unit. Case reserves for these exposures are evaluated on a claim-by-claim basis. The ability to assess potential exposure often improves as a claim develops, including judicial determinations of coverage issues. As a result, reserves are adjusted accordingly.

Estimating IBNR reserves for asbestos and environmental claims is difficult because of the delayed and inconsistent reporting patterns associated with these claims. In addition, there are significant uncertainties associated with estimating critical assumptions, such as average clean-up costs, third-party costs, potentially responsible party shares, allocation of damages, litigation and coverage costs, and potential state and federal legislative changes. Normal historically based actuarial approaches cannot be applied to environmental claims because past loss history is not indicative of future potential loss emergence. In addition, while certain alternative models can be applied, such models can produce significantly different results with small changes in assumptions. As a result, we do not calculate an asbestos and environmental loss range. Historically, our asbestos and environmental claims have been significantly lower in volume, with less volatility and uncertainty than many of our competitors in the commercial lines industry. This is due to the nature of the risks we insured, and the fact that we are the primary insurance carrier on the majority of these exposures, which provides more certainty in our reserve position compared to others in the insurance marketplace.

Measure of Insurance Segments Profitability

We manage and evaluate the performance and profitability of our Standard and E&S Insurance Operations segments in accordance with SAP, which differs from GAAP. Our rating agencies use SAP information to evaluate our performance, including measuring our performance against our industry peers. We base our incentive compensation to our independent retail agents and our wholesale general agents on the SAP results of our Standard Insurance Operations segment and our E&S Insurance Operations segment, respectively. In addition, we use the SAP results of our combined insurance operations as a basis for incentive compensation to employees.

We measure our statutory underwriting performance by four different ratios:

1. The loss and loss expense ratio, which is calculated by dividing incurred loss and loss expenses by NPE;
2. The underwriting expense ratio, which is calculated by dividing all expenses related to the issuance of insurance policies by NPW;
3. The dividend ratio, which is calculated by dividing policyholder dividends by NPE; and
4. The combined ratio, which is the sum of the loss and loss expense ratio, the underwriting expense ratio, and the dividend ratio.

SAP differs in several ways from GAAP, under which we report our financial results to shareholders and the United States Securities Exchange Commission (“SEC”):

• With regard to the underwriting expense ratio, NPE is the denominator for GAAP; whereas NPW is the denominator for SAP.

• With regard to certain income:

Underwriting expenses that are incremental and directly related to the successful acquisition of insurance policies are deferred and amortized to expense over the life of an insurance policy under GAAP; whereas they are recognized when incurred under SAP.

Deferred taxes are recognized in our Consolidated Statements of Income as either a deferred tax expense or a deferred tax benefit under GAAP; whereas they are recorded directly to surplus under SAP.

Changes in the value of our alternative investments, which are part of our other investment portfolio on our Consolidated Balance Sheets, are recognized in income under GAAP; whereas they are recorded directly to surplus under SAP.

With regard to equity under GAAP and statutory surplus under SAP:

The timing difference in income due to the GAAP/SAP differences in expense recognition creates a difference between GAAP equity and SAP statutory surplus.

Regarding unrealized gains and losses on fixed maturity securities:

Under GAAP, unrealized gains and losses on available-for-sale (“AFS”) fixed maturity securities are recognized in equity; but they are not recognized in equity on purchased held-to-maturity (“HTM”) securities. Unrealized gains and losses on HTM securities transferred from an AFS designation are amortized from equity as a yield adjustment.

Under SAP, unrealized gains and losses on fixed maturity securities assigned certain NAIC Security Valuation Office ratings (specifically designations of one or two, which generally equate to investment grade bonds) are not recognized in statutory surplus. However, fixed maturity securities that have a designation of three or higher must recognize unrealized losses as an adjustment to statutory surplus.

Certain assets are designated under insurance regulations as “non-admitted,” including, but not limited to, certain deferred tax assets, overdue premium receivables, furniture and equipment, and prepaid expenses. These assets are excluded from statutory surplus under SAP, but are recorded in the Consolidated Balance Sheets net of applicable allowances under GAAP; and

Regarding recognition of the liability for our defined benefit plan:

Under GAAP, the liability is recognized in an amount equal to the excess of the projected benefit obligation over the fair value of the plan assets, and any changes in this balance not recognized in income are recognized in equity as a component of other comprehensive income (“OCI”).

Under SAP, the liability is recognized in an amount equal to the excess of the vested accumulated benefit obligation over the fair value of the plan assets, and any changes in this balance not recognized in income are recognized in statutory surplus.

Our combined insurance segments' statutory results for the last three completed fiscal years are shown on the following table:

(\$ in thousands)	Year Ended December 31,		
	2012	2011	2010
Insurance Operations Results			
NPW	\$1,666,633	1,485,349	1,388,556
NPE	\$1,583,869	1,439,313	1,414,612
Losses and loss expenses incurred	1,120,185	1,074,446	980,534
Net underwriting expenses incurred	542,335	470,892	445,172
Policyholders' dividends	3,449	5,284	3,878

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Underwriting loss	\$ (82,100)	(111,309)	(14,972)
Ratios:						
Loss and loss expense ratio	70.7		% 74.6		69.3	
Underwriting expense ratio	32.6		31.7		32.0	
Policyholders' dividends ratio	0.2		0.4		0.3	
Statutory Combined ratio	103.5		% 106.7		101.6	
GAAP combined ratio	104.0		% 107.2		101.4	

A comparison of certain statutory ratios for our combined insurance segments and our industry are shown in the following table:

	Simple Average of All Periods Presented	2012	2011	2010	2009	2008	
Insurance Operations Ratios:¹							
Loss and loss expense	69.9	70.7	74.6	69.3	67.9	67.2	
Underwriting expense	32.1	32.6	31.7	32.0	32.3	31.7	
Policyholders' dividends	0.3	0.2	0.4	0.3	0.3	0.3	
Statutory combined ratio	102.3	103.5	106.7	101.6	100.5	99.2	
Growth in NPW	1.5	12.2	7.0	(2.4) (4.7) (4.5)
Industry Ratios:^{1, 2}							
Loss and loss expense	74.4	78.0	77.9	72.1	70.8	73.1	
Underwriting expense	27.9	27.7	28.0	28.3	28.1	27.5	
Policyholders' dividends	0.6	0.6	0.6	0.7	0.6	0.6	
Statutory combined ratio	102.9	106.2	106.5	101.0	99.5	101.2	
Growth in NPW	0.7	4.9	3.5	1.0	(3.8) (1.9)
Favorable (Unfavorable) to Industry:							
Statutory combined ratio	0.6	2.7	(0.2	) (0.6	) (1.0	) 2.0
Growth in NPW	0.8	7.3	3.5	(3.4) (0.9) (2.6)

¹The ratios and percentages are based on SAP prescribed or permitted by state insurance departments in the states in which the Insurance Subsidiaries are domiciled.

²Source: A.M. Best. The industry ratios for 2012 have been estimated by A.M. Best.

Insurance Regulation

Primary Oversight from the States in Which We Operate

Our insurance operations are heavily regulated. The primary public policy behind insurance regulation is the protection of policyholders and claimants over all other constituencies, including shareholders. By virtue of the McCarran-Ferguson Act, Congress has largely delegated insurance regulation to the various states. For our Insurance Subsidiaries, the primary regulators of their business and financial condition are the departments of insurance in the states in which they are organized and are licensed. For a discussion of the broad regulatory, administrative, and supervisory powers of the various departments of insurance, refer to the risk factor that discusses regulation in Item 1A. "Risk Factors." of this Form 10-K.

Our various state insurance regulators are members of the NAIC. The NAIC has codified SAP and other accounting reporting formats and drafts model insurance laws and regulations governing insurance companies. An NAIC model only becomes law when the various state legislatures enact it. The adoption of certain NAIC model laws and regulations, however, is a key aspect of the NAIC Financial Regulations Standards and Accreditation Program, which also sets forth minimum staffing and resource levels for state insurance departments. The NAIC recently adopted a model law changing reinsurance collateral requirements for reinsurers not domiciled in the United States. The adoption of the model law by states in which we operate will likely impact our ability to obtain collateral from foreign reinsurers in the future.

NAIC Monitoring Tools

Among the various financial monitoring tools of the NAIC that are material to the regulators in which our Insurance Subsidiaries are organized are the following:

The Insurance Regulatory Information System (“IRIS”). IRIS identifies 13 industry financial ratios and specifies “usual values” for each ratio. Departure from the usual values on four or more of the financial ratios can lead to inquiries from individual state insurance departments about certain aspects of the insurer's business. Our Insurance Subsidiaries have consistently met the majority of the IRIS ratio tests.

Risk-Based Capital. Risk-based capital is measured by four major areas of risk to which property and casualty insurers are exposed: (i) asset risk; (ii) credit risk; (iii) underwriting risk; and (iv) off-balance sheet risk. Insurers with total adjusted capital that is two times or less than their calculated “Authorized Control Level,” are subject to different levels of regulatory intervention and action. Based upon the 2012 statutory financial statements, which have been prepared in accordance with NAIC statutory accounting principles, the total adjusted capital for each of our Insurance Subsidiaries substantially exceeded two times their Authorized Control Level.

Annual Financial Reporting Regulation (referred to as the “Model Audit Rule”). The Model Audit Rule, which is modeled closely on the Sarbanes-Oxley Act of 2002, regulates: (i) auditor independence; (ii) corporate governance; and (iii) internal control over financial reporting. As permitted under the Model Audit Rule, the Audit Committee of the Board of Directors (the “Board”) of the Parent also serves as the audit committee of each of our Insurance Subsidiaries.

Own Risk Solvency Assessment (“ORSA”) Model Law. ORSA requires insurers to maintain a framework for identifying, assessing, monitoring, managing and reporting on the “material and relevant risks” associated with the insurer’s (or insurance group’s) current and future business plans. ORSA, which is currently being considered for adoption by state insurance regulators, requires companies to file an internal assessment of their solvency with insurance regulators annually beginning in 2015. Although no specific capital adequacy standard is currently articulated in ORSA, it is possible that such standard will be developed over time and may increase insurers’ minimum capital requirements which could adversely impact our growth and return on equity.

Federal Regulation

Federal legislation and administrative policies also affect the insurance industry. Among the most notable are TRIA, the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”), and various privacy laws that apply to us because we have personal non-public information, including the Gramm-Leach-Bliley Act, the Fair Credit Reporting Act, the Drivers Privacy Protection Act, and the Health Insurance Portability and Accountability Act. Like all businesses, we also are required to enforce the economic and trade sanctions of the Office of Foreign Assets Control (“OFAC”).

In response to the financial markets crises in 2008 and 2009, the Dodd-Frank Act was enacted. This law provides for, among other things, the following:

- The establishment of the Federal Insurance Office (“FIO”);
- Federal Reserve oversight of financial services firms designated as systemically significant; and
- Corporate governance reforms for publicly traded companies.

For additional information on the potential impact of the Dodd-Frank Act, refer to the risk factor related to legislation within Item 1A. “Risk Factors.” of this Form 10-K.

Investment Segment

Like many other property and casualty insurance companies, we depend on income from our investment portfolio for a significant portion of our revenues and earnings. We are exposed to significant financial and capital markets risks, primarily relating to interest rates, credit spreads, equity prices, and the change in market value of our alternative investment portfolio. A decline in both income and our investment portfolio asset values could occur as a result of, among other things, volatile interest rates, a decrease in market liquidity, decreased dividend payment rates, negative market perception of credit risk with respect to types of securities in our portfolio, a decline in the performance of the underlying collateral of our structured securities, reduced returns on our alternative investment portfolio, or general market conditions.

Our Investment segment invests the premiums collected by our Standard Insurance Operations and E&S Insurance Operations to satisfy our equity and debt obligations and generate investment income. At December 31, 2012, our investment portfolio consisted of the following:

Category of Investment (\$ in millions)	Carrying Value	% of Investment Portfolio
Fixed maturities	\$3,850.1	89
Equities	151.4	3
Short-term investments	214.4	5
Other investments, including alternatives	114.1	3
Total	\$4,330.0	100

Our investment strategy includes setting certain return and risk objectives for the fixed maturity, equity and other investment portfolios. The primary fixed maturity portfolio return objective is to maximize after-tax investment yield and income while balancing risk. A secondary objective is to meet or exceed a weighted-average benchmark of public fixed maturity indices. Within the equity portfolio, the high dividend yield equities strategy is designed to generate consistent dividend income while maintaining an expected tracking error to the S&P 500 Index. Additional equity strategies are focused on meeting or exceeding strategy specific benchmarks of public equity indices. Although yield and income generation remain the key drivers to our investment strategy, our overall philosophy is to invest with a long-term horizon along with a predominantly “buy-and-hold” approach. The return objective of the other investment portfolio, which includes alternative investments, is to meet or exceed the S&P 500 Index.

For further information regarding our risks associated with the overall investment portfolio, see Item 7A. “Quantitative and Qualitative Disclosures About Market Risk.” and Item 1A. “Risk Factors.” of this Form 10-K. For additional information about investments, see the section entitled, “Investments,” in Item 7. “Management’s Discussion and Analysis of Financial Condition and Results of Operations.” and Item 8. “Financial Statements and Supplementary Data.” Note 5. of this Form 10-K.

Executive Officers of the Registrant

Biographical information about our Chief Executive Officer and other executive officers is as follows:

Name, Age, Title	Occupation and Background
Gregory E. Murphy, 57 Chairman, President, and Chief Executive Officer	<ul style="list-style-type: none"> · Present position since May 2000 · President, Chief Executive Officer, and Director, Selective, 1999 – 2000 · President, Chief Operating Officer, and Director, Selective, 1997 – 1999 · Other senior executive, management, and operational positions, Selective, since 1980 · Certified Public Accountant (New Jersey) (Inactive) · Trustee, Newton Medical Center Foundation, since 1999 · Director, Property Casualty Insurers Association of America, since 2008 · Director, Insurance Information Institute, since 2000 · Trustee, The Institutes, since June 2001 · Graduate of Boston College (B.S. Accounting) · Harvard University (Advanced Management Program) · M.I.T. Sloan School of Management
Dale A. Thatcher, 51 Executive Vice President and Chief Financial Officer	<ul style="list-style-type: none"> · Present position since April 2010 · Executive Vice President, Chief Financial Officer and Treasurer, 2003 – 2010 · Senior Vice President, Chief Financial Officer and Treasurer, Selective, 2000 – 2003 · Certified Public Accountant (Ohio) (Inactive) · Chartered Property and Casualty Underwriter (CPCU) · Chartered Life Underwriter (CLU) · Member, American Institute of Certified Public Accountants · Member, Ohio Society of Certified Public Accountants · Member, Financial Executives Institute · Member, Insurance Accounting and Systems Association · University of Cincinnati (B.B.A. Accounting; M.B.A. Finance) · Harvard University (Advanced Management Program)
Ronald J. Zaleski Sr., 58 Executive Vice President and Chief Actuary	<ul style="list-style-type: none"> · Present position since February 2003 · Senior Vice President and Chief Actuary, Selective, 2000 – 2003 · Vice President and Chief Actuary, Selective, 1999 – 2000 · Fellow of Casualty Actuarial Society · Member, American Academy of Actuaries · Loyola College (B.A. Mathematics)
Michael H. Lanza, 51 Executive Vice President, General Counsel, and Chief Compliance Officer	<ul style="list-style-type: none"> · Present position since October 2007 · Senior Vice President and General Counsel, Selective, 2004 – 2007 · Member, Society of Corporate Secretaries and Corporate Governance Professionals · Member, National Investor Relations Institute · University of Connecticut (B.A.) (Honors Scholar in Political Science) · University of Connecticut School of Law (J.D.)
John J. Marchioni, 43 Executive Vice President, Insurance Operations	<ul style="list-style-type: none"> · Present position since February 2010 · Executive Vice President, Chief Underwriting and Field Operations Officer, 2008 – February 2010 · Executive Vice President, Chief Field Operations Officer, Selective 2007 – 2008 · Senior Vice President, Director of Personal Lines, Selective 2005 – 2007

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- Various insurance operation and government affairs positions, Selective, 1998 – 2005
 - Director, Consumer Agent Portal, LLC, since September 2011
 - Chartered Property Casualty Underwriter (CPCU)
 - Princeton University (B.A. History)
 - Harvard University (Advanced Management Program)
- Ronald E. St. Clair, 48
Executive Vice President
and
Chief Information Officer
- Present position since April 2011
 - IT Executive, Enterprise Resource Organization, Progressive Casualty Insurance, 2008 – March 2011
 - IT Executive, Progressive Commercial Auto, Progressive Casualty Insurance, 2006 – 2008
 - Harding University (B.S. Computer Science)
 - Case Western Reserve University (M.B.A.)
- Kimberly Burnett, 55
Executive Vice President
and
Chief Human Resources
Officer
- Present position since February 2012
 - Vice President, Human Resources Operations, 2006 – 2012
 - Various human resources and other operational positions, Selective, 1989-2006
 - Senior Professional in Human Resources (SPHR)
 - Member, Society for Human Resource Management
 - The Ohio State University (B.A.)
 - Fairleigh Dickinson University, Human Resources Professional Development Certificate

Information about our Board is in our definitive Proxy Statement for the 2013 Annual Meeting of Stockholders to be held on April 24, 2013, in “Information About Proposal 1, Election of Directors,” and is also incorporated by reference into Part III of this Form 10-K.

Reports to Security Holders

We file with the SEC all required disclosures, including our Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, Proxy Statements, and other required information under Sections 13(a) or 15(d) of the Securities Exchange Act of 1934 (“Exchange Act”). We also provide access to these filed materials on our Internet website, www.selective.com.

Item 1A. Risk Factors

Any of the following risk factors could cause our actual results to differ materially from historical or anticipated results. They also could have a significant impact on our business, liquidity, capital resources, results of operations, financial condition, and debt ratings. These risk factors also might affect, alter, or change actions that we might take in executing our long-term capital strategy, including but not limited to, contributing capital to any or all of the Insurance Subsidiaries, issuing additional debt and/or equity securities, repurchasing our equity securities, redeeming our fixed income securities, or increasing or decreasing stockholders’ dividends. The following list of risk factors is not exhaustive, and others may exist.

Risks Related to Insurance Segments

The failure of our risk management strategies could have a material adverse effect on our financial condition or results of operations.

We employ a number of risk management strategies to reduce our exposure to risk that include, but are not limited to, the following:

- Being disciplined in our underwriting practices;
- Being prudent in our claims management practices and establishing adequate loss and loss expense reserves;
- Continuing to develop and implement various underwriting tools and automated analytics to examine historical statistical data regarding our insureds and their loss experience to: (i) classify such policies based on that information; (ii) apply that information to current and prospective accounts; and (iii) better predict account profitability; and
- Purchasing reinsurance.

All of these strategies have inherent limitations. We cannot be certain that an unanticipated event or series of unanticipated events will not occur and result in losses greater than we expect and have a material adverse effect on our results of operations, liquidity, financial condition, financial strength, and debt ratings.

Our loss and loss expense reserves may not be adequate to cover actual losses and expenses.

We are required to maintain loss and loss expense reserves for our estimated liability for losses and loss expenses associated with reported and unreported insurance claims. Our estimates of reserve amounts are based on facts and circumstances that we know, including our expectations of the ultimate settlement and claim administration expenses, predictions of future events, trends in claims severity and frequency, and other subjective factors relating to our insurance policies in force. There is no method for precisely estimating the ultimate liability for settlement of claims. From time-to-time, we adjust reserves and increase them if they are inadequate or reduce them if they are redundant. We cannot be certain that the reserves we establish are adequate or will be adequate in the future. An increase in reserves: (i) reduces net income and stockholders’ equity for the period in which the reserves are increased; and (ii) could have a material adverse effect on our results of operations, liquidity, financial condition, financial strength, and

debt ratings.

We are subject to losses from catastrophic events.

Our results are subject to losses from natural and man-made catastrophes, including but not limited to: hurricanes, tornadoes, windstorms, earthquakes, hail, terrorism, explosions, severe winter weather, floods and fires, some of which may be related to climate changes. The frequency and severity of these catastrophes are inherently unpredictable. One year may be relatively free of such events while another may have multiple events. For further discussion regarding man-made catastrophes that relate to terrorism, see the risk factor directly below regarding the potential for significant losses from acts of terrorism.

There is widespread interest among scientists, legislators, regulators, and the public regarding the effect that greenhouse gas emissions may have on our environment, including climate change. If greenhouse gases continue to shift our climate, it is possible that more devastating catastrophic events could occur.

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The magnitude of catastrophe losses is determined by the severity of the event and the total amount of insured exposures in the area affected by the event. Most of the risks underwritten by our insurance operations are concentrated geographically in the Eastern and Midwestern regions of the United States, particularly in New Jersey, which represented approximately 23% of our total NPW during the year ended December 31, 2012. Catastrophes in the Eastern and Midwestern regions of the United States could adversely impact our financial results, as was the case the past three years.

Although catastrophes can cause losses in a variety of property and casualty insurance lines, most of our historic catastrophe-related claims have been from commercial property and homeowners coverages. In an effort to limit our exposure to catastrophe losses, we purchase catastrophe reinsurance. Reinsurance could prove inadequate if: (i) the various modeling software programs that we use to analyze the Insurance Subsidiaries' risk result in an inadequate purchase of reinsurance by us; (ii) a major catastrophe loss exceeds the reinsurance limit or the reinsurers' financial capacity; or (iii) the frequency of catastrophe losses results in our Insurance Subsidiaries exceeding their one reinstatement on each of the first three layers of the catastrophe treaty. Even after considering our reinsurance protection, our exposure to catastrophe risks could have a material adverse effect on our results of operations, liquidity, financial condition, financial strength, and debt ratings.

We are subject to potential significant losses from acts of terrorism.

TRIA requires private insurers and the United States government to share the risk of loss on future acts of terrorism that are certified by the U.S. Secretary of the Treasury. As a Commercial Lines writer, we are required to participate in TRIA. Under TRIA, terrorism coverage is mandatory for all primary workers compensation policies. Insureds with non-workers compensation commercial policies, however, have the option to accept or decline our terrorism coverage or negotiate with us for other terms. In 2012, 87% of our Commercial Lines non-workers compensation policyholders purchased terrorism coverage.

TRIA rescinded all previously approved coverage exclusions for terrorism. Many of the states in which we write commercial property insurance, however, mandate that we cover fire following an act of terrorism. Under TRIA, each participating insurer is responsible for paying a deductible of specified losses before federal assistance is available. This deductible is based on a percentage of the prior year's applicable Commercial Lines premiums. In 2013, our deductible is approximately \$209 million. For losses above the deductible, the federal government will pay 85% of losses to an industry limit of \$100 billion, and the insurer retains 15%. Although TRIA's provisions will mitigate our loss exposure to a large-scale terrorist attack, our deductible is substantial and could have a material adverse effect on our results of operations, liquidity, financial condition, financial strength, and debt ratings. TRIA expires on December 31, 2014. Failure of Congress to renew TRIA could leave certain of our current risks for which state law requires coverage without any recourse to reinsurance in an act of terrorism.

Our ability to reduce our risk exposure depends on the availability and cost of reinsurance.

We transfer a portion of our underwriting risk exposure to reinsurance companies. Through our reinsurance arrangements, a specified portion of our losses and loss expenses are assumed by the reinsurer in exchange for a specified portion of premiums. The availability, amount, and cost of reinsurance depend on market conditions, which may vary significantly. Our major reinsurance contracts renew annually and may be impacted by the market conditions at the time of the renewal that are unrelated to our specific book of business or experience. Any decrease in the amount of our reinsurance will increase our risk of loss. Any increase in the cost of reinsurance that cannot be included in renewal price increases will reduce our earnings. Accordingly, we may be forced to incur additional expenses for reinsurance or may not be able to obtain sufficient reinsurance on acceptable terms. Either could adversely affect our ability to write future business or result in the assumption of more risk with respect to those policies we issue.

We expect the cost of reinsurance to increase generally in 2013 as a result of the losses incurred by the reinsurance and insurance industry generally from Hurricane Sandy. Because various Northeastern state officials did not issue hurricane warnings in 2012 related to Hurricane Sandy, which had winds exceeding the threshold of a Category 1 hurricane, both the reinsurance and insurance industry incurred higher losses than anticipated, as insurers like us were not permitted to impose hurricane deductibles.

We are exposed to credit risk.

We are exposed to credit risk in several areas of our insurance operations segments, including from:

Our reinsurers, who are obligated to us under our reinsurance agreements. The relatively small size of the reinsurance market and our objective to maintain an average weighted rating of “A” by A.M. Best on our current reinsurance programs constrains our ability to diversify this credit risk. However, some of our reinsurance credit risk is collateralized.

Some of our independent retail and wholesale agents, who collect premiums from insureds and are required to remit the collected premium to us.

Some of our insureds, who are responsible for payment of deductibles and/or premiums directly to us.

The invested assets in our defined benefit plan, which partially serve to fund the insurance operations liability associated with this plan. To the extent that credit risk adversely impacts the valuation and performance of the invested assets within our defined benefit plan, the funded status of the defined benefit plan could be adversely impacted and, as result, could increase the cost of the plan to us.

It is possible that current economic conditions could increase our credit risk. Our exposure to credit risk could have a material adverse effect on our results of operations, liquidity, financial condition, financial strength, and debt ratings.

The property and casualty insurance industry is subject to general economic conditions and is cyclical. The property and casualty insurance industry has experienced significant fluctuations in its historic results due to competition, occurrence or severity of catastrophic events, levels of capacity, general economic conditions, interest rates, and other factors. Demand for insurance is influenced by prevailing general economic conditions. The supply of insurance is related to prevailing prices, the levels of insured losses and the levels of industry capital which, in turn, may fluctuate in response to changes in rates of return on investments being earned in the insurance industry. In addition, pricing is influenced by the operating performance of insurers as increased pricing may be necessary to meet return on equity objectives. As a result, the insurance industry historically has been through cycles characterized by periods of intense price competition due to excessive underwriting capacity and periods when shortages of capacity and poor operating performance by insurers drives favorable premium levels. If competitors price business below technical levels, we might have to reduce our profit margin in order to protect our best business.

Pricing and loss trends impact our profitability. For example, assuming retention and all other factors remain constant:
▲ A pure price decline of approximately 1% would increase our statutory combined ratio by approximately 0.65 points;
▲ A 3% increase in our expected claim costs for the year would cause our loss and loss expense ratio to increase by approximately two points; and
▲ A combination of the two could raise the combined ratio approximately three points.

The industry's profitability also is affected by unpredictable developments, including:

- ▲ Natural and man-made disasters;
- ▲ Fluctuations in interest rates and other changes in the investment environment that affect investment returns;
- ▲ Inflationary pressures (medical and economic) that affect the size of losses;
- ▲ Judicial, regulatory, legislative, and legal decisions that affect insurers' liabilities;
- ▲ Changes in the frequency and severity of losses;
- ▲ Pricing and availability of reinsurance in the marketplace; and
- ▲ Weather-related impacts due to the effects of climate changes.

Any of these developments could cause the supply or demand for insurance to change and could have a material adverse effect on our results of operations, liquidity, financial condition, financial strength, and debt ratings.

Difficult conditions in global capital markets and the economy may adversely affect our revenue and profitability and harm our business, and these conditions may not improve in the near future.

General economic conditions in the United States and throughout the world and volatility in financial and insurance markets materially affect our results of operations. Concerns over such issues as the availability and cost of credit, the stability of the United States mortgage market, weak real estate markets, high unemployment, volatile energy and

commodity prices, and geopolitical issues, also have led to declines in business and consumer confidence. Declines in business and consumer confidence limit economic growth, which decreases insurance purchases and limits our ability to achieve price increases.

Factors such as consumer spending, business investment, government spending, the volatility and strength of the capital markets, and inflation all affect the business and economic environment and, indirectly, the amount and profitability of our business. With continuing high unemployment, lower family income, lower corporate earnings, lower business investment, and lower consumer spending, the demand for insurance products is adversely affected. In addition, we are impacted by the recent decrease in commercial and new home construction and home ownership because 34% of direct premiums written in our standard Commercial Lines business during 2012 were generated through insurance policies written to cover contractors. In addition, 37% of direct premiums written in our standard Commercial Lines business during 2012 were based on payroll/sales of our underlying insureds. An economic downturn in which our customers decline in revenue or employee count can adversely affect our audit and endorsement premium in Commercial Lines, as it did in 2010 and 2009. Further unfavorable economic developments could adversely affect our earnings if our customers have less need for insurance coverage, cancel existing insurance policies, modify coverage, or choose not to renew with us. Challenging economic conditions also may impair the ability of our customers to pay premiums as they come due. We are unable to predict the likely duration and severity of the current economic conditions in the United States and other countries, which may have a material adverse effect on our results of operations, liquidity, financial condition, financial strength, and debt ratings.

A downgrade or a potential downgrade in our financial strength or credit ratings could result in a loss of business and could have a material adverse effect on our financial condition and results of operations.

Our financial strength ratings, as issued by the following Nationally Recognized Statistical Rating Organizations ("NRSROs"), are as follows:

NRSRO	Financial Strength Rating	Outlook
A.M. Best and Company	"A"	Stable
S&P	"A"	Negative
Moody's Investor Service	"A2"	Negative
Fitch Ratings	"A+"	Stable

A significant rating downgrade, particularly from A.M. Best, could: (i) affect our ability to write new or renewal business with customers, some of whom are required under various third party agreements to maintain insurance with a carrier that maintains a specified minimum rating; or (ii) be an event of default under our line of credit with Wells Fargo Bank, National Association ("Line of Credit"). The Line of Credit requires our Insurance Subsidiaries to maintain an A.M. Best rating of at least "A-" (one level below our current rating) and a default could lead to acceleration of any outstanding principal. Such an event also could trigger default provisions under certain of our other debt instruments and negatively impact our ability to borrow in the future. As a result, any significant downgrade in our financial strength ratings could have a material adverse effect on our results of operations, liquidity, financial condition, financial strength and debt ratings.

NRSROs also rate our long-term debt creditworthiness. Credit ratings indicate the ability of debt issuers to meet debt obligations in a timely manner and are important factors in our overall funding profile and ability to access certain types of liquidity. Our current senior credit ratings are as follows:

NRSRO	Credit Rating	Long Term Credit Outlook
A.M. Best and Company	"bbb+"	Stable
S&P	"BBB"	Negative
Moody's Investor Service	"Baa2"	Negative
Fitch Ratings	"BBB+"	Stable

Downgrades in our credit ratings could have a material adverse effect on our financial condition and results of operations in many ways, including making it more expensive for us to access capital markets.

Because of the difficulties experienced by many financial institutions during the recent credit crisis, including insurance companies, and the public criticism of NRSROs, we believe it is possible that the NRSROs: (i) may continue to heighten their level of scrutiny of financial institutions; (ii) may increase the frequency and scope of their reviews; and (iii) may adjust upward the capital and other requirements employed in their models for maintaining certain rating levels. We cannot predict possible actions NRSROs may take regarding our ratings that could adversely affect our business or the possible actions we may take in response to any such actions.

We have many competitors and potential competitors.

The insurance industry is highly competitive. The current economic environment has only served to further increase competition. We compete with regional, national, and direct-writer property and casualty insurance companies for customers, agents, and employees. Some competitors are public companies and some are mutual companies. Many competitors are larger and may have lower operating costs or costs of capital. They also may have the ability to absorb greater risk while maintaining their financial strength ratings. Consequently, some competitors may be able to price their products more competitively. These competitive pressures could result in increased pricing pressures on a number of our products and services, particularly as competitors seek to win market share, and may impair our ability to maintain or increase our profitability. We also face competition, primarily in Commercial Lines, from entities that self-insure their own risks. Because of its relatively low cost of entry, the internet has also emerged as a significant place of new competition, both from existing competitors and new competitors. It is also possible that reinsurers, who have significant knowledge of the primary property and casualty insurance business because they reinsure it, could enter the market to diversify their operations. New competition could also cause changes in the supply or demand for insurance and adversely affect our business.

We have less loss experience data than our larger competitors.

We believe that insurance companies are competing and will continue to compete on their ability to use reliable data about their insureds and loss experience in complex analytics and predictive models to project risk profitability and more effectively match price to risk. With the consistent expansion of computing power and the decline in its cost, we believe that data and analytics use will continue to increase and become more complex and accurate. As a regional insurance group, the loss experience from our insurance operations is not large enough in all circumstances to analyze and project our future costs. In addition, we have limited data regarding our E&S business, which we assumed in 2011 and began writing directly in 2012. We use data from ISO and NCCI to obtain sufficient industry loss experience data. While statistically relevant, that data is not specific to the performance of risks we have underwritten. Larger competitors, particularly national carriers, have significantly more data regarding the performance of risks that they have underwritten. The analytics of their loss experience data may be more predictive of profitability of their risks than our analysis using, in part, general industry loss experience. For the same reason, should Congress repeal the McCarran-Ferguson Act, which provides an anti-trust exemption for the aggregation of loss data, and we are unable to access data from ISO and NCCI, we will be at a competitive disadvantage to larger insurers who have more sufficient loss experience data on their own insureds.

We depend on independent retail insurance agents and wholesale agency partners.

We market and sell our insurance products through independent retail insurance agents and wholesale agents who are not our employees. We believe that independent retail and wholesale agents will remain a significant force in overall insurance industry premium production because they can provide insureds with a wider choice of insurance products than if they represented only one insurer. That, however, creates competition in our distribution channel and we must market our products and services to our agents before they sell them to our mutual customers. Our financial condition and results of operations are tied to the successful marketing and sales efforts of our products by our agents. In addition, under insurance laws and regulations and common law, we potentially can be held liable for business practices or actions taken by our agents.

We face risks regarding our flood business because of uncertainties regarding the NFIP

We are the sixth largest insurance group participating in the WYO arrangement of the NFIP, which is managed by the Mitigation Division of the FEMA in the U.S. Department of Homeland Security. For WYO participation, we receive an expense allowance for policies written and a servicing fee for claims administered. Under the program, all losses are 100% reinsured by the Federal Government. Currently, the expense allowance is 30.7% of premiums written. The servicing fee is the combination of 0.9% of direct written premiums and 1.5% of incurred losses.

The NFIP is funded by Congress. In the last several years, funding of the program has continued through short extensions as part of continuing resolutions to temporarily maintain current claims payments. At present, the program has been extended to September 30, 2017 through the Biggert-Waters Flood Insurance Reform Act of 2012 (the "Reform Act"). While the interpretation and the impact of the provisions in the Reform Act are uncertain at this time, the extension, (i) has a significant impact on the determination of flood policy premium; (ii) allows for installment premium payments; and (iii) increases minimum annual deductibles for properties that were built prior to the first Flood Insurance Rate Map that have not been substantially damaged or improved ("pre-FIRM" properties).

In addition, the Reform Act directs FEMA to develop a storm model to better define "wind" versus "water" claims and the responsibility of payment between the NFIP and private insurers. The Reform Act also directs FEMA to re-examine the way reimbursement rates to WYO carriers are being calculated to ensure that WYO carriers are being reimbursed based on actual expenses. These changes, and specifically potential changes in compensation of WYO carriers, may impact the financial viability of our participation in the program.

As a WYO carrier, we are required to follow certain NFIP procedures when administering flood policies and claims. Some of these requirements may be different from our normal business practices and may present a reputational risk to our brand. Insurance companies are regulated by states; however, NFIP is a federal program and there may be instances where requirements placed on WYO carriers by NFIP are not consistent with the regulations of a particular state. Consequently, we have the risk that our regulators' positions may conflict with NFIP's position on the same issue. In early 2013, elected officials in some of the Northeastern states impacted by Hurricane Sandy have discussed introducing or have introduced legislation attempting to set standards for NFIP claims practices. It is uncertain whether those proposals will become law or, if they do, whether they will withstand a federal pre-emption legal challenge.

There are many critics of the NFIP, including the new Chairman of the Financial Services Committee of the U.S. House of Representatives, Jeb Hensarling, and there is uncertainty regarding its future. On January 4, 2013, Rep. Hensarling indicated that his committee intended to take up legislation to "transition to a private, innovative, competitive, sustainable flood insurance market." However, if flood insurance was privatized and the current level of federal subsidization was eliminated, actuarially-justified flood insurance rates may be deemed to be too high by consumers and public officials. The uncertainty behind the public policy debate and politics of flood insurance funding and reform make it difficult for us to predict the future of the NFIP and the financial viability of our participation in the program.

We are heavily regulated and changes in regulation may reduce our profitability, increase our capital requirements and/or limit our growth.

Our Insurance Subsidiaries are heavily regulated by extensive laws and regulations that may change on short notice. The primary public policy behind insurance regulation is the protection of policyholders and claimants over all other constituencies, including shareholders. Historically and by virtue of the McCarran-Ferguson Act, our Insurance Subsidiaries are primarily regulated by the states in which they are domiciled and licensed. State insurance regulation is generally uniform throughout the U.S. by virtue of similar laws and regulations required by the NAIC to accredit state insurance departments so their examinations can be given full faith and credit by other state regulators. Despite their general similarity, various provisions of these laws and regulations vary from state to state. At any given time, there may be various legislative and regulatory proposals in each of the 50 states and District of Columbia that, if enacted, may affect our Insurance Subsidiaries.

The broad regulatory, administrative, and supervisory powers of the various state departments of insurance include the following:

Related to our financial condition, review and approval of such matters as minimum capital and surplus requirements, standards of solvency, security deposits, methods of accounting, form and content of statutory financial statements, reserves for unpaid loss and loss adjustment expenses, reinsurance, payment of dividends and other distributions to shareholders, periodic financial examinations, and annual and other report filings.

Related to our general business, review and approval of such matters as certificates of authority and other insurance company licenses, licensing and compensation of agents, premium rates (which may not be excessive, inadequate, or unfairly discriminatory), policy forms, policy terminations, reporting of statistical information regarding our premiums and losses, periodic market conduct examinations, unfair trade practices, participation in mandatory shared market mechanisms, such as assigned risk pools and reinsurance pools, participation in mandatory state guaranty funds, and mandated continuing workers compensation coverage post-termination of employment.

Related to our ownership of the Insurance Subsidiaries, we are required to register as an insurance holding company system in each state where an insurance subsidiary is domiciled and report information concerning all of our

operations that may materially affect the operations, management, or financial condition of the insurers. As an insurance holding company, the appropriate state regulatory authority may: (i) examine us or our Insurance Subsidiaries at any time; (ii) require disclosure or prior approval of material transactions of any of the Insurance Subsidiaries with us or each other; and (iii) require prior approval or notice of certain transactions, such as payment of dividends or distributions to us.

Although Congress has largely delegated insurance regulation to the various states by virtue of the McCarran-Ferguson Act, we are also subject to federal legislation and administrative policies, such as disclosure under the securities laws, including the Sarbanes-Oxley Act and the Dodd-Frank Act, TRIA, OFAC, and various privacy laws, including the Gramm-Leach-Bliley Act, the Fair Credit Reporting Act, the Drivers Privacy Protection Act, the Health Insurance Portability and Accountability Act, and the policies of the Federal Trade Commission. As a result of issuing workers compensation policies, we also are subject to Mandatory Medicare Secondary Payer Reporting under the Medicare, Medicaid, and SCHIP Extension Act of 2007.

The European Union has enacted Solvency II, which sets out new requirements on capital adequacy and risk management for insurers, which is expected to become effective in January 2015. The strengthened regime is intended to reduce the possibility of consumer loss or market disruption in insurance. Although Solvency II does not govern domestic American insurers; its existence in an increasingly global economy pressures domestic regulators to consider similar measures. The NAIC has recently adopted ORSA Model Law, which requires insurers to maintain a framework for identifying, assessing, monitoring, managing and reporting on the “material and relevant risks” associated with the insurer's (or insurance group's) current and future business plans. ORSA, which is currently being considered for adoption by state insurance regulators, requires companies to file an internal assessment of their solvency with insurance regulators annually beginning in 2015. Although no specific capital adequacy standard is currently articulated in ORSA, it is possible that such standard will be developed over time and may increase insurers' minimum capital requirements which could adversely impact our growth and return on equity.

We also are subject to non-governmental regulators, such as the NASDAQ Stock Market and the New York Stock Exchange, where we list our securities. Many of these regulators, to some degree, overlap with each other on various matters. They also have different regulations on the same legal issues that are subject to their individual interpretative discretion. Consequently, we have the risk that one regulator's position may conflict with another regulator's position on the same issue. As compliance is generally reviewed in hindsight, we also are subject to the risk that interpretations will change over time.

We believe that we are in compliance with all laws and regulations that have a material effect on our results of operations, but the cost of complying with various, potentially conflicting laws and regulations, and changes in those laws and regulations could have a material adverse effect on our results of operations, liquidity, financial condition, financial strength, and debt ratings.

We are subject to the risk that legislation will be passed significantly changing insurance regulation and adversely impacting our business, our financial condition, and our results of operations.

In 2009, the Dodd-Frank Act was enacted to address the financial markets crises in 2008 and 2009 and the issues regarding the American International Group, Inc. scandal. The Dodd-Frank Act created the Federal Insurance Office as part of the U.S. Department of Treasury to advise the federal government regarding insurance issues. The Dodd-Frank Act also requires the Federal Reserve through the Financial Services Oversight Council (“FSOC”) to supervise financial services firms designated as systemically significant. Selective is not considered one of these firms. The Dodd-Frank Act also included a number of corporate governance reforms for publicly traded companies, including proxy access, say-on-pay, and other compensation and governance issues requiring shareholder action. We anticipate that there will continue to be a number of legislative proposals discussed and introduced in Congress that could result in the federal government becoming directly involved in the regulation of insurance:

Repeal of the McCarran-Ferguson Act. While recent proposals for McCarran-Ferguson Act repeal have been directed primarily at health insurers, if enacted and applicable to property and casualty insurers, such repeal would significantly reduce our ability to compete and materially affect our results of operations because we rely on the anti-trust exemptions the law provides to obtain loss data from third party aggregators, such as ISO and NCCI, to predict future losses. Our inability to access data from ISO and NCCI would put us at a competitive disadvantage to larger insurers who have more sufficient loss experience data with their own insureds.

National Catastrophic Funds. Various legislative proposals have been introduced that would establish a federal reinsurance catastrophic fund as a federal backstop for future natural disasters. These bills generally encourage states to create catastrophe funds by creating a federal backstop for states that create the funds. If legislation of this type is passed, states may create catastrophe funds and mandate us to write insurance in geographic areas that are susceptible to catastrophe loss and could have a material adverse effect on our operations, liquidity, financial condition, financial

strength, and ratings.

Healthcare reform. The enactment of the Patient Protection and Affordable Care Act of 2010 (the "Healthcare Act") may have an impact on various aspects of our business, including our insurance operations. Because this legislation reduces the cost of healthcare services to health insurers, healthcare providers may charge more to insurers not covered under the Healthcare Act, which would increase our cost to provide workers compensation, automobile Personal Injury Protection ("PIP") and general liability coverages, among others. In addition, we will be impacted as a business enterprise by potential tax issues and changes in employee benefits. The Healthcare Act will be implemented over time and we continue to monitor and assess its impact.

Changes in Reinsurance Collateral requirements. In 2011, the NAIC adopted a model law changing reinsurance collateral requirements for reinsurers not domiciled in the United States. The law is now going through the adoption process in the various states. The adoption of the model law by states in which we operate impacts our ability to obtain collateral from foreign reinsurers.

Changes in rules for Department of Housing and Urban Development ("HUD"). In 2013, HUD finalized a new "Disparate Impact" regulation which may adversely impact insurers' ability to differentiate pricing for homeowners policies using traditional risk selection analysis. It is uncertain to what extent the application of this regulation will impact the property and casualty industry and underwriting practices, but it could increase litigation costs, force changes in underwriting practices, and impair our ability to write homeowners business profitably.

We expect the debate about the role of the federal government in regulating insurance to continue. The continued soft economy also has raised the possibility of future legislative and regulatory actions intended to help the economy, in addition to the enactment of Emergency Economic Stabilization Act of 2008, which could further impact our business.

In addition, in the aftermath of Hurricane Sandy, several Northeastern state officials have issued and extended orders that: (i) prevent or restrict the ability of insurers to cancel policies, even for non-payment of premiums, in areas impacted by Hurricane Sandy; and (ii) require certain service level standards related to Sandy-related claims processing that were not contemplated or priced for when the policies were issued.

We cannot predict whether any of these or any related proposal will be adopted, or what impact, if any, such proposals or the cost of compliance with such proposals, could have on our results of operations, liquidity, financial condition, financial strength, and debt ratings if enacted.

Class action litigation could affect our business practices and financial results.

Our industry has been the target of class action litigation, including the following areas:

• After-market parts;

• Urban homeowner insurance underwriting practices, including those related to architectural or structural features and attempts by federal regulators to expand the Federal Housing Administrations guidelines to determine unfair discrimination;

• Credit scoring and predictive modeling pricing;

• Investment disclosure;

• Managed care practices;

• Timing and discounting of personal injury protection claims payments;

• Direct repair shop utilization practices;

• Flood insurance claim practices; and

• Shareholder class action suits.

If we were to be named in such class action litigation, we could suffer reputational harm with purchasers of insurance and have increased litigation expenses that could have a materially adverse effect on our operations or results.

Changes in accounting guidance could impact the results of our operations and financial condition.

The Financial Accounting Standards Board ("FASB") is working with the International Accounting Standards Board ("IASB") on a joint project that could significantly impact today's insurance model. Potential changes include, but are not limited to: (i) redefining the revenue recognition process for insurance companies; and (ii) requiring loss reserve discounting. As indicated in Note 2. "Summary of Significant Accounting Policies" in Item 8. "Financial Statements and Supplementary Data." of this Form 10-K, our premiums are earned over the period that coverage is provided and we do not discount our loss and loss expense reserves. Final guidance from this joint project could have a material adverse

effect on our results of operations, liquidity, financial condition, financial strength, and debt ratings.

The FASB is also currently reviewing a number of proposed changes to existing accounting guidance, several of which are the result of joint projects with the IASB. Potential changes to accounting guidance regarding the treatment of financial instruments, fair value measurement, and leases could have a material adverse effect on our results of operations, liquidity, financial condition, financial strength, and debt ratings. It is uncertain as to how the NAIC will react to these potential accounting changes.

Risks Related to Our Investment Segment

The failure of our risk management strategies could have a material adverse effect on our financial condition or results of operations.

We employ a number of risk management strategies to reduce our exposure to risk that include, but are not limited to, the following:

- Being prudent in establishing our investment policy and appropriately diversifying our investments;
- Using complex financial and investment models to analyze historic investment performance and predict future investment performance under a variety of scenarios using asset concentration, asset volatility, asset correlation, and systematic risk; and
- Closely monitoring investment performance, general economic and financial conditions, and other relevant factors.

All of these strategies have inherent limitations. We cannot be certain that an event or series of unanticipated events will not occur and result in losses greater than we expect and have a material adverse effect on our results of operations, liquidity, financial condition, financial strength, and debt ratings.

Difficult conditions in global capital markets and the economy may adversely affect our revenue and profitability and harm our business, and these conditions may not improve in the near future.

Our results of operations are materially affected by conditions in the global capital markets and the economy generally, in both the U.S. and abroad. Concerns over the availability and cost of credit, the U.S. mortgage market, a weak real estate market in the U.S., high unemployment, volatile energy and commodity prices, and geopolitical issues, among other factors, have contributed to increased volatility in the financial markets, increased potential for credit downgrades, and decreased liquidity in certain investment segments. In addition, the low investment yield environment that is a result of a combination of Federal Reserve policy and the continuing economic conditions are expected to continue for the next several years. As our fixed income securities mature they are replaced with lower yielding securities, which negatively impact our overall portfolio yield. These conditions impact our ability to produce investment results consistent with historical performance.

Turbulent financial markets in 2012 were driven in part from the significant level of concern surrounding rising government debt levels across the globe and fiscal uncertainty in the U.S. Lack of confidence in the stability of the European Union, continued uncertainty about growth in global economies and U.S. Congress' continued delay in resolving debt and government spending issues may have an adverse effect on the valuation of our investment portfolio. As of December 31, 2012, the Company had approximately \$29.5 million, or 0.7% of invested assets, invested in Eurozone government, corporate, and equity securities. Our Eurozone sovereign debt exposure in the portfolio totals less than \$5.9 million and is backed by the full faith and credit of the German government. For further information regarding our European exposure, see Item 7A. "Quantitative and Qualitative Disclosures About Market Risk." of this Form 10-K.

We are exposed to interest rate and credit risk in our investment portfolio.

We are exposed to interest rate risk primarily related to the market price, and cash flow variability, associated with changes in interest rates. A rise in interest rates may decrease the fair value of our existing fixed maturity investments and declines in interest rates may result in an increase in the fair value of our existing fixed maturity investments. Our fixed income investment portfolio, which currently has a duration of 3.6 years excluding short term investments, contains interest rate sensitive instruments that may be adversely affected by changes in interest rates resulting from governmental monetary policies, domestic and international economic and political conditions, and other factors beyond our control. A rise in interest rates would decrease the net unrealized gain position of the investment portfolio, offset by our ability to earn higher rates of return on funds reinvested in new investments. Conversely, a decline in interest rates would increase the net unrealized gain position of the investment portfolio, offset by lower rates of return

on funds reinvested and new investments. Changes in interest rates will also have an effect on the calculated duration of certain securities in the portfolio. We seek to mitigate our interest rate risk associated with holding fixed maturity investments by monitoring and maintaining the average duration of our portfolio with a view toward achieving an adequate after-tax return without subjecting the portfolio to an unreasonable level of interest rate risk. Although we take measures to manage the economic risks of investing in a changing interest rate environment, we may not be able to mitigate the interest rate risk of our assets relative to our liabilities.

The value of our investment portfolio is subject to credit risk from the issuers and/or guarantors of the securities in the portfolio, other counterparties in certain transactions and, for certain securities, insurers that guarantee specific issuer's obligations. Defaults by the issuer or an issuer's guarantor, insurer, or other counterparties regarding any of our investments, could reduce our net investment income and net realized investment gains or result in investment losses. We are also subject to the risk that the issuers, or guarantors, of fixed maturity securities we own may default on principal and interest payments due under the terms of the securities. At December 31, 2012, our fixed maturity securities portfolio represented approximately 89% of our total invested assets. The occurrence of a major economic downturn, acts of corporate malfeasance, widening credit spreads, budgetary deficits, or other events that adversely affect the issuers or guarantors of these securities could cause the value of our fixed maturity securities portfolio and our net income to decline and the default rate of our fixed maturity securities portfolio to increase.

With economic uncertainty, credit quality of issuers or guarantors could be adversely affected and a ratings downgrade of the issuers or guarantors of the securities in our portfolio could also cause the value of our fixed maturity securities portfolio and our net income to decrease. For example, rating agency downgrades of monoline insurance companies during 2009 contributed to a decline in the carrying value and market liquidity of our municipal bond investment portfolio. A reduction in the value of our investment portfolio could have a material adverse effect on our business, results of operations, financial condition, and debt ratings. Levels of write downs are impacted by our assessment of the impairment, including a review of the underlying collateral of structured securities, and our intent and ability to hold securities that have declined in value until recovery. If we reposition or realign portions of the portfolio, so that we determine not to hold certain securities in an unrealized loss position to recovery, we will incur an other-than-temporary impairment ("OTTI") charge. For further information regarding credit and interest rate risk, see Item 7A. "Quantitative and Qualitative Disclosures About Market Risk." of this Form 10-K.

We are exposed to risk in our municipal bond portfolio.

Approximately 34% of our fixed maturity securities are state or local municipality obligations. There have been widespread reports regarding the stress on state and local governments emanating from: (i) declining revenues; (ii) large unfunded liabilities; and (iii) entrenched cost structures. Debt-to-gross domestic product ratios for many states have been deteriorating due to, among other factors: (i) declines in federal monetary assistance provided as the United States is currently experiencing the largest deficit in its history; and (ii) lower levels of sales and property tax revenue as unemployment remains elevated and the housing market continues to remain unstable. Although we closely monitor this portfolio, we may not be able to mitigate the exposure in our municipal portfolio if state and local governments are unable to fulfill their obligations. In addition at December 31, 2012, 30% of our investment portfolio was invested in tax-exempt municipal obligations. As such, the value of our investment portfolio could be adversely affected by legislation that changes the current tax preference of municipal obligations. Additionally, any such changes in tax law could reduce the overall net investment return of our portfolio.

Our statutory surplus may be materially affected by rating downgrades on investments held in our portfolio.

We are exposed to significant financial and capital markets risks, primarily relating to interest rates, credit spreads, equity prices, and the change in market value of our alternative investment portfolio. A decline in both income and our investment portfolio asset values could occur as a result of, among other things, a decrease in market liquidity, falling interest rates, decreased dividend payment rates, negative market perception of credit risk with respect to types of securities in our portfolio, a decline in the performance of the underlying collateral of our structured securities, reduced returns on our alternative investment portfolio, or general market conditions. A global decline in asset values will be more amplified in our financial condition, as our statutory surplus is leveraged at a 4.0:1 ratio to our investment portfolio.

With economic uncertainty, the credit quality and ratings of securities in our portfolio could be adversely affected. The NAIC could potentially apply a more adverse class code on a security than was originally assigned, which could

adversely affect statutory surplus because securities with NAIC class codes three through six require securities to be marked-to-market for statutory accounting purposes, as compared to securities with NAIC class codes of one or two that are carried at amortized cost.

Deterioration in the public debt and equity markets, as well as in the private investment marketplace, could lead to investment losses, which may adversely affect our results of operations, financial condition, liquidity, and debt ratings.

Like many other property and casualty insurance companies, we depend on income from our investment portfolio for a significant portion of our revenue and earnings. Our investment portfolio is exposed to significant financial and capital markets risks, and volatile changes in general market conditions could lead to a decline in the market value of our portfolio as well as the performance of the underlying collateral of our structured securities.

Our notes payable and Line of Credit are subject to certain debt-to-capitalization restrictions and net worth covenants, which could be impacted by a significant decline in investment value. Further OTTI charges could be necessary if there is a future significant decline in investment values. Depending on market conditions going forward, and in the event of extreme prolonged market events, such as the global credit crisis, we could incur additional realized and unrealized losses in future periods, which could have an adverse impact on our results of operations, financial condition, debt and financial strength ratings, and our ability to access capital markets as a result of realized losses, impairments, and changes in unrealized positions.

For more information regarding market interest rate, credit, and equity price risk, see Item 7A. “Quantitative and Qualitative Disclosures About Market Risk.” of this Form 10-K.

There can be no assurance that the actions of the U.S. Government, Federal Reserve, and other governmental and regulatory bodies will achieve their intended effect.

The Federal Reserve has taken a number of actions related to interest rates and purchasing of financial instruments intended to spur economic recovery. However, economic uncertainty is still prevalent within the markets, and, economic conditions suggest the risk of higher than expected inflation in the long term. Increased pressure on the price of our fixed income and equity portfolios may occur if these economic stimulus actions are not as effective as originally intended. These results could materially and adversely affect our results of operations, financial condition, liquidity and the trading price of our common stock. In the event of future material deterioration in business conditions, we may need to raise additional capital or consider other transactions to manage our capital position and liquidity.

A period of sustained low interest rates would have an adverse effect on investment income as higher yielding securities mature and we reinvest the proceeds at lower yields.

In addition, our investment activities are subject to extensive laws and regulations that are administered and enforced by a number of different governmental authorities and non-governmental self-regulatory agencies. In light of the current economic conditions, some of these authorities have implemented, or may in the future implement, new or enhanced regulatory requirements, such as those included in the Dodd-Frank Act, intended to restore confidence in financial institutions and reduce the likelihood of similar economic events in the future. These authorities may also seek to exercise their supervisory and enforcement authority in new or more robust ways. Such events could affect the way we conduct our business and manage our capital, and may require us to satisfy increased capital requirements. These developments, if they occurred, could have a material adverse effect on our results of operations, liquidity, financial condition, financial strength, and debt ratings.

We are subject to the types of risks inherent in investing in private limited partnerships.

Our other investments include investments in private limited partnerships that invest in various strategies such as private equity, mezzanine debt, distressed debt, and real estate. We are subject to risks arising from the fact that the determination of the fair value of these types of investments is inherently subjective. The general partner of each of these partnerships generally reports the change in the fair value of the interests in the partnership on a one quarter lag because of the nature of the underlying assets or liabilities. Since these partnerships’ underlying investments consist primarily of assets or liabilities for which there are no quoted prices in active markets for the same or similar assets, the valuation of interests in these partnerships is subject to a higher level of subjectivity and unobservable inputs than substantially all of our other investments and as such, is subject to greater scrutiny and reconsideration from one reporting period to the next. These factors may result in significant changes in the fair value of these investments between reporting periods, which could lead to significant decreases in their fair value. Since we record our investments in these various partnerships under the equity method of accounting, any decreases in the valuation of these investments would negatively impact our results of operations. In addition, pursuant to the various limited

partnership agreements of these partnerships, we are committed for the full life of each fund and cannot redeem our investment with the general partner. Liquidation is only triggered by certain clauses within the limited partnership agreements or at the funds' stated end date, at which time we will receive our final allocation of capital and any earned appreciation of the underlying investments. We also are subject to potential future capital calls in the aggregate amount of approximately \$57 million as of December 31, 2012.

We value our investments using methodologies, estimations, and assumptions that are subject to differing interpretations. Changes in these interpretations could result in fluctuations in the valuations of our investments that may adversely affect our results of operations or financial condition.

Fixed maturity, equity, and short-term investments, which are reported at fair value on our Consolidated Balance Sheet, represented the majority of our total cash and invested assets as of December 31, 2012. As required under accounting rules, we have categorized these securities into a three-level hierarchy, based on the priority of the inputs to the respective valuation technique. The fair value hierarchy gives the highest priority to quoted prices in active markets for identical assets or liabilities (Level 1). The next priority is to quoted prices in markets that are not active or inputs that are observable either directly or indirectly, including quoted prices for similar assets or liabilities or in markets that are not active and other inputs that can be derived principally from, or corroborated by, observable market data for substantially the full term of the assets or liabilities (Level 2). The lowest priority in the fair value hierarchy is to unobservable inputs supported by little or no market activity and that reflect the reporting entity's own assumptions about the exit price, including assumptions that market participants would use in pricing the asset or liability (Level 3).

An asset or liability's classification within the fair value hierarchy is based on the lowest level of significant input to its valuation. We generally use an independent pricing service and broker quotes to price our investment securities. At December 31, 2012, approximately 13% and 86% of these securities represented Level 1 and Level 2, respectively. However, prices provided by an independent pricing service and independent broker quotes can vary widely even for the same security. Rapidly changing and unprecedented credit and equity market conditions could materially impact the valuation of securities as reported within our consolidated financial statements ("Financial Statements") and the period-to-period changes in value could vary significantly. Decreases in value may result in an increase in non-cash OTTI charges, which could have a material adverse effect on our results of operations, liquidity, financial condition, financial strength, and debt ratings.

The determination of the amount of impairments taken on our investments is highly subjective and could materially impact our results of operations or our financial position.

The determination of the amount of impairments taken on our investments is based on our periodic evaluation and assessment of our investments and known and inherent risks associated with the various asset classes. Such evaluations and assessments are revised as conditions change and new information becomes available. Management updates its evaluations regularly and reflects changes in impairments as such evaluations are revised. There can be no assurance that our management has accurately assessed the level of impairments taken as reflected in our Financial Statements. Furthermore, additional impairments may need to be taken in the future. Historical trends may not be indicative of future impairments.

An investment in a fixed maturity or equity security is impaired if its fair value falls below its carrying value and the decline is considered to be other-than-temporary. We regularly review our entire investment portfolio for declines in value. Management's assessment of a decline in value includes, but is not limited to, current judgment as to the financial position and future prospects of the security issuer as well as general market conditions. For fixed maturity securities, if we believe that a decline in the value of a particular investment is temporary, and we do not have the intent to sell these securities and do not believe we will be required to sell these securities before recovery, we record the decline as an unrealized loss in accumulated other comprehensive income for those securities that are designated as available-for-sale. Our assessment of whether an equity security is other-than-temporarily-impaired also includes our intent to hold the security in the near term. For both fixed maturity and equity securities, if we believe the decline is other than temporary, we write down the carrying value of the investment and record a realized loss in our Consolidated Statements of Income.

Additionally, management considers a wide range of factors about the security issuer and uses its best judgment in evaluating the cause of the decline in the estimated fair value of the security and in assessing the prospects for near-term recovery. Inherent in management's evaluation of the security are assumptions and estimates about the operations of the issuer and its future earnings potential. Considerations in the impairment evaluation process include, but are not limited to: (i) whether the decline appears to be issuer or industry specific; (ii) the relationship of market prices per share to book value per share at the date of acquisition and date of evaluation; (iii) the price-earnings ratio at the time of acquisition and date of evaluation; (iv) the financial condition and near-term prospects of the issuer, including any specific events that may influence the issuer's operations; (v) the recent income or loss of the issuer; (vi) the independent auditors' report on the issuer's recent financial statements; (vii) the dividend policy of the issuer at the date of acquisition and the date of evaluation; (viii) any buy/hold/sell recommendations or price projections published by outside investment advisors; (ix) any rating agency announcements; (x) the length of time and the extent to which the fair value has been less than cost/amortized cost; and (xi) the evaluation of projected cash flows of the underlying collateral. For further information regarding our evaluation and considerations for determining whether a security is other-than-temporarily impaired, please refer to "Critical Accounting Policies and Estimates" in Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations" of this Form 10-K.

Risks Related to Our Corporate Structure and Governance

We are a holding company and our ability to declare dividends to our shareholders, pay indebtedness, and enter into affiliate transactions may be limited because our Insurance Subsidiaries are regulated.

Restrictions on the ability of the Insurance Subsidiaries to pay dividends, make loans or advances to us, or enter into transactions with us may materially affect our ability to pay dividends on our common stock or repay our indebtedness.

As of December 31, 2012, the Parent had stand-alone retained earnings of \$1.1 billion. Of this amount, \$1.0 billion is related to investments in our Insurance Subsidiaries and debt. The Insurance Subsidiaries have the ability to provide for \$106 million in annual dividends to us; however, as they are regulated entities, their ability to pay dividends or make loans or advances to us is subject to the approval or review of the insurance regulators in the states where they are domiciled. The standards for review of such transactions are whether: (i) the terms and charges are fair and reasonable; and (ii) after the transaction, the Insurance Subsidiary's surplus for policyholders is reasonable in relation to its outstanding liabilities and financial needs. Although dividends and loans to us from our Insurance Subsidiaries historically have been approved, we can make no assurance that future dividends and loans will be approved. For additional details regarding dividend restrictions, see Note 20. "Statutory Financial Information, Capital Requirements, and Restrictions on Dividends and Transfers of Funds" in Item 8. "Financial Statements and Supplementary Data." of this Form 10-K.

Because we are an insurance holding company and a New Jersey corporation, we may be less attractive to potential acquirers and the value of our common stock could be adversely affected.

Because we are an insurance holding company that owns insurance subsidiaries, anyone who seeks to acquire 10% or more of our stock must seek prior approval from the insurance regulators in the states in which the subsidiaries are organized and file extensive information regarding their business operations and finances.

Because we are organized under New Jersey law, provisions in our Amended and Restated Certificate of Incorporation also may discourage, delay, or prevent us from being acquired, including:

- Supermajority voting fair price requirements to approve business combinations;
- Supermajority voting requirements to amend the foregoing provisions; and
- The ability of our Board of Directors to issue "blank check" preferred stock.

Under the New Jersey Shareholders' Protection Act, we may not engage in specified business combinations with a shareholder having indirect or direct beneficial ownership of 10% or more of the voting power of our outstanding stock (an "interested shareholder") for a period of five years after the date the shareholder became an interested shareholder, unless: (i) the business combination is approved by our Board of Directors before the date they became an interested shareholder; (ii) the business combination is approved by two-thirds of our shareholders (other than the interested shareholder); or (iii) the business combination satisfies certain price criteria.

These provisions of our Amended and Restated Certificate of Incorporation and New Jersey law could have the effect of depriving our stockholders of an opportunity to receive a premium over our common stock's prevailing market price in the event of a hostile takeover and may adversely affect the value of our common stock.

Risks Related to Our General Operations

Operational risks, including human or systems failures, are inherent in our business.

Operational risks and losses can result from, among other things, fraud, errors, failure to document transactions properly or to obtain proper internal authorization, failure to comply with regulatory requirements, information

technology failures, or external events.

We believe that our underwriting, predictive modeling and business analytics, and information technology and application systems are critical to our business. We expect our information technology and application systems to remain an important part of our underwriting process and our ability to compete successfully. We have also licensed certain systems and data from third parties. We cannot be certain that we will have access to these, or comparable, service providers, or that our information technology or application systems will continue to operate as intended. A major defect or failure in our internal controls or information technology and application systems could: (i) result in management distraction; (ii) harm our reputation; or (iii) increase our expenses. We believe appropriate controls and mitigation procedures are in place to prevent significant risk of a defect in our internal controls around our information technology and application systems, but internal controls provide only a reasonable, not absolute, assurance as to the absence of errors or irregularities and any ineffectiveness of such controls and procedures could have a significant and negative effect on our business.

We are subject to attempted cyber-attacks and other cybersecurity risks.

The nature of our business requires that we store and exchange electronically with appropriate parties and systems significant amounts of personally identifiable information that may be targeted in an attempted cybersecurity breach. In addition, our business is heavily reliant on various information technology and application systems that may be impacted by a malicious cyber-attack. These cyber incidents may cause lost revenues or increased expenses stemming from reputational damage and fines related to the breach of personally identifiable information, inability to use certain systems for a period of time, loss of financial assets, remediation and litigation costs and increased cybersecurity protection costs. We have developed and continue to invest in a variety of controls to prevent, detect and appropriately react to such cyber-attacks including periodically testing our systems security and access controls. However, cybersecurity risks continue to become more complex and broad ranging and our internal controls provide only a reasonable, not absolute, assurance that we will be able to protect ourselves from significant cyber-attack incidents. By outsourcing certain business and administrative functions to third parties, we may be exposed to enhanced risk of data security breaches. Any breach of data security could damage our reputation and/or result in monetary damages, which, in turn, could have a material adverse effect on our results of operations, liquidity, financial condition, financial strength, and debt ratings. Although we have not experienced a material cyber-attack, we recently purchased insurance coverage to specifically address cybersecurity risks. The coverage provides protection up to \$20 million above a deductible of \$250,000 for various cybersecurity risks including privacy breach related incidents.

We depend on key personnel.

To a large extent, our businesses success depends on our ability to attract and retain key employees. Competition to attract and retain key personnel is intense. While we have employment agreements with certain key managers, all of our employees are at-will employees and we cannot ensure that we will be able to attract and retain key personnel. As of December 31, 2012, our workforce had an average age of approximately 47 and approximately 24% of our workforce was retirement eligible under our retirement and benefit plans.

If we experience difficulties with outsourcing relationships, our ability to conduct our business might be negatively impacted.

We outsource certain business and administrative functions to third parties for efficiencies and cost savings, and may do so increasingly in the future. If we fail to develop and implement our outsourcing strategies or our third-party providers fail to perform as anticipated, we may experience operational difficulties, increased costs, and a loss of business that may have a material adverse effect on our results of operations or financial condition.

We are subject to a variety of modeling risks, which could have a material adverse impact on our business results. We rely on complex financial models, such as predictive modeling, a claims fraud model, third party catastrophe models, an enterprise risk management capital model, and modeling tools used by our investment managers, which have been developed internally or by third parties to analyze historical loss costs and pricing, trends in claims severity and frequency, the occurrence of catastrophe losses, investment performance, and portfolio risk. Flaws in these financial models, or faulty assumptions used by these financial models, could lead to increased losses. We believe that statistical models alone do not provide a reliable method of monitoring and controlling market risk. Therefore, such models are tools and do not substitute for the experience or judgment of senior management.

We have significant deferred tax assets that we may be unable to use if we do not generate sufficient future taxable income.

As of December 31, 2012, we had a deferred tax asset related to net operating losses ("NOLs") generated by our federal consolidated tax group in 2011 as well as NOLs acquired as a part of a recent stock purchase. Generally, NOLs can be carried back two years and carried forward 20 years. While we have sufficient carryback capacity to absorb the 2011 NOL, we have elected to forego the carryback period due to alternative minimum tax considerations and intend to carry forward the net operating losses to offset future taxable income. In the future, we would be

required to establish a valuation allowance against our deferred tax assets if: (i) it is determined that it is more likely than not that sufficient future income of the appropriate character will not be generated; and (ii) there are no valid tax planning strategies to generate taxable income of the appropriate character (i.e. ordinary loss or capital loss). The establishment of a valuation allowance would have a material adverse effect on our results of operations, liquidity, financial condition, financial strength, and debt ratings. As of December 31, 2012, no valuation allowance related to the NOLs generated in previous years has been recorded.

Item 1B. Unresolved Staff Comments.

None.

Item 2. Properties.

Our main office is located in Branchville, New Jersey on a site owned by a subsidiary with approximately 114 acres and 315,000 square feet of operational space. We lease all of our other facilities. The principal office locations related to our Standard and E&S Insurance Operations segments are described in the “Field and Technology Strategies Supporting Independent Agent Distribution” section of Item 1. “Business.” of this Form 10-K. We believe our facilities provide adequate space for our present needs and that additional space, if needed, would be available on reasonable terms.

Item 3. Legal Proceedings.

In the ordinary course of conducting business, we are named as defendants in various legal proceedings. Most of these proceedings are claims litigation involving our Insurance Subsidiaries as either: (a) liability insurers defending or providing indemnity for third-party claims brought against insureds; or (b) insurers defending first-party coverage claims brought against them. We account for such activity through the establishment of unpaid loss and loss expense reserves. We expect that the ultimate liability, if any, with respect to such ordinary course claims litigation, after consideration of provisions made for potential losses and costs of defense, will not be material to our consolidated financial condition, results of operations, or cash flows.

Our Insurance Subsidiaries are also from time-to-time involved in other legal actions, some of which assert claims for substantial amounts. These actions include, among others, putative class actions seeking certification of a state or national class. Such putative class actions have alleged, for example, improper reimbursement of medical providers paid under workers compensation and personal and commercial automobile insurance policies. Our Insurance Subsidiaries are also involved from time-to-time in individual actions in which extra-contractual damages, punitive damages, or penalties are sought, such as claims alleging bad faith in the handling of insurance claims. We believe that we have valid defenses to these cases. We expect that the ultimate liability, if any, with respect to such lawsuits, after consideration of provisions made for estimated losses, will not be material to our consolidated financial condition. Nonetheless, given the large or indeterminate amounts sought in certain of these actions, and the inherent unpredictability of litigation, an adverse outcome in certain matters could, from time-to-time, have a material adverse effect on our consolidated results of operations or cash flows in particular quarterly or annual periods.

PART II

Item 5. Market For Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.

(a) Market Information

Our common stock is traded on the NASDAQ Global Select Market under the symbol "SIGI." The following table sets forth the high and low sales prices, as reported on the NASDAQ Global Select Market, for our common stock for each full quarterly period within the two most recent fiscal years:

	2012		2011	
	High	Low	High	Low
First quarter	\$19.00	16.64	18.97	16.30
Second quarter	17.99	16.22	18.06	15.32
Third quarter	19.37	16.64	16.96	12.60
Fourth quarter	20.31	17.17	18.35	12.10

On February 15, 2013, the closing price of our common stock as reported on the NASDAQ Global Select Market was \$21.43.

(b) Holders

As of February 15, 2013, there were approximately 2,207 holders of record of our common stock, including beneficial holders whose securities were held in the name of the registered clearing agency or its nominee.

(c) Dividends

Dividends on shares of our common stock are declared and paid at the discretion of the Board based on our results of operations, financial condition, capital requirements, contractual restrictions, and other relevant factors. The following table provides information on the dividends declared for each quarterly period within our two most recent fiscal years:

Dividend Per Share	2012	2011
First quarter	\$0.13	0.13
Second quarter	0.13	0.13
Third quarter	0.13	0.13
Fourth quarter	0.13	0.13

Our ability to receive dividends, loans, or advances from our Insurance Subsidiaries is subject to the approval or review of the insurance regulators in the respective domiciliary states of our Insurance Subsidiaries. Such approval and review is made under the respective domiciliary states' insurance holding company acts, which generally require that any transaction between related companies be fair and equitable to the insurance company and its policyholders. Although our dividends have historically been met with regulatory approval, there is no assurance that future dividends will be approved given current market conditions. We currently expect to continue to pay quarterly cash dividends on shares of our common stock in the future. For additional information, see Note 20. "Statutory Financial Information, Capital Requirements, and Restrictions on Dividends and Transfers of Funds" in Item 8. "Financial Statements and Supplementary Data." of this Form 10-K.

(d) Securities Authorized for Issuance Under Equity Compensation Plans

The following table provides information about our common stock authorized for issuance under equity compensation plans as of December 31, 2012:

Plan Category	(a)	(b)	(c)	
	Number of securities to be issued upon exercise of outstanding options, warrants and rights	Weighted-average exercise price of outstanding options, warrants and rights	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a))	
Equity compensation plans approved by security holders	1,096,754	\$ 19.36	7,084,993	1

¹Includes 993,881 shares available for issuance under the Employee Stock Purchase Plan; 2,184,408 shares available for issuance under the Stock Purchase Plan for Independent Insurance Agencies; and 3,906,704 shares available for issuance under the Selective Insurance Group, Inc. 2005 Omnibus Stock Plan As Amended and Restated Effective as of May 1, 2010 ("Stock Plan"). Future grants under the Stock Plan can be made, among other things, as stock options, restricted stock units, or restricted stock.

(e) Performance Graph

The following chart, produced by Research Data Group, Inc., depicts our performance for the period beginning December 31, 2007 and ending December 31, 2012, as measured by total stockholder return on our common stock compared with the total return of the NASDAQ Composite Index and a select group of peer companies comprised of NASDAQ-listed companies in SIC Code 6330-6339, Fire, Marine, and Casualty Insurance.

This performance graph is not incorporated into any other filing we have made with the SEC and will not be incorporated into any future filing we may make with the SEC unless we so specifically incorporate it by reference. This performance graph also shall not be deemed to be "soliciting material" or to be "filed" with the SEC unless we specifically request so or specifically incorporate it by reference in any filing we make with the SEC.

(f) Purchases of Equity Securities by the Issuer and Affiliated Purchasers

The following table provides information regarding our purchases of our common stock in the fourth quarter of 2012:

Period	Total Number of Shares Purchased ¹	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Programs	Maximum Number of Shares that May Yet Be Purchased Under the Announced Programs
October 1 – 31, 2012	\$323	\$18.94	—	—
November 1 – 30, 2012	—	—	—	—
December 1 – 31, 2012	17,739	18.87	—	—
Total	\$18,062	\$18.87	—	—

¹During the fourth quarter of 2012, 1,624 shares were purchased from employees in connection with the vesting of restricted stock units and 16,438 shares were purchased from employees in connection with stock option exercises. These repurchases were made to satisfy tax withholding obligations and/or option costs with respect to those employees. These shares were not purchased as part of the publicly announced program. The shares that were purchased in connection with the vesting of restricted stock units were purchased at fair market value as defined in the Stock Plan. The shares purchased in connection with the option exercises were purchased at the current market prices of our common stock on the dates the options were exercised.

Item 6. Selected Financial Data.

Five-Year Financial Highlights¹

(All presentations are in accordance with

GAAP unless noted otherwise,

number of

weighted average shares and dollars

in

thousands, except per share amounts)

	2012	2011	2010	2009	2008
Net premiums written	\$1,666,883	1,485,349	1,390,541	1,422,665	1,492,738
Net premiums earned	1,584,119	1,439,313	1,416,598	1,431,047	1,504,187
Net investment income earned	131,877	147,443	145,708	118,471	131,032
Net realized gains (losses)	8,988	2,240	(7,083)	(45,970)	(49,452)
Total revenues	1,734,102	1,597,475	1,564,621	1,514,018	1,589,939
Catastrophe losses	98,608	118,769	56,465	8,519	31,740
Underwriting (loss) profit	(64,007)	(103,584)	(19,974)	2,111	(21)
Net income from continuing operations ²	37,963	22,683	70,746	44,480	44,001
Total discontinued operations, net of tax ²	—	(650)	(3,780)	(8,260)	(343)
Net income	37,963	22,033	66,966	36,220	43,658
Comprehensive income (loss)	49,709	57,303	86,450	126,806	(136,841)
Total assets	6,794,216	5,685,469	5,178,704	5,060,333	4,891,240
Notes payable and debentures	307,387	307,360	262,333	274,606	273,878
Stockholders' equity	1,090,592	1,058,328	1,018,041	947,881	836,177
Statutory premiums to surplus ratio	1.6	1.4	1.3	1.5	1.7
Statutory combined ratio	103.5	% 106.7	101.6	100.5	99.2
Impact of catastrophe losses on statutory combined ratio ⁴	5.8	pts 8.3	4.0	0.6	2.1
GAAP combined ratio	104.0	% 107.2	101.4	99.9	100.0
Yield on investments, before tax	3.1	3.7	3.8	3.2	3.6
Debt to capitalization	22.0	22.5	20.5	22.5	24.7
Return on average equity	3.5	2.1	6.8	4.1	4.7
Non-GAAP measures ³ :					
Operating income	\$32,121	21,227	75,350	74,361	76,145
Operating return on average equity	3.0	% 2.0	7.7	8.3	8.2

Per share data:

Net income from continuing operations²:

Basic	\$0.69	0.42	1.33	0.84	0.85
Diluted	0.68	0.41	1.30	0.83	0.83

Net income:

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Basic	\$0.69	0.41	1.26	0.69	0.84
Diluted	0.68	0.40	1.23	0.68	0.82
Dividends to stockholders	\$0.52	0.52	0.52	0.52	0.52
Stockholders' equity	19.77	19.45	18.97	17.80	15.81
Price range of common stock:					
High	20.31	18.97	18.94	23.28	30.40
Low	16.22	12.10	14.13	10.06	16.33
Close	19.27	17.73	18.15	16.45	22.93
Number of weighted average shares:					
Basic	54,880	54,095	53,359	52,630	52,104
Diluted	55,933	55,221	54,504	53,397	53,319

¹ Data for 2008 through 2011 has been restated to reflect the implementation of ASU 2010-26, Financial Services-Insurance (Topic 944): Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts, which was adopted on January 1, 2012.

² In 2009, we sold our Selective HR Solutions operations. See Note 7. "Fair Value Measurements" in Item 8. "Financial Statements and Supplementary Data." of this Form 10-K for additional information.

³ Operating income and operating return on average equity are non-GAAP measures. See the Glossary of Terms attached to this Form 10-K as Exhibit 99.1 for definitions of these items and see the "Financial Highlights" section in Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations." of this Form 10-K for a reconciliation of operating income to net income.

⁴The impact of catastrophe losses on the 2012 statutory combined ratio includes catastrophe losses, the reinstatement premium on the catastrophe reinsurance program and the flood claims handling fees generated as a result of Hurricane Sandy.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.

Forward-looking Statements

Certain statements in this report, including information incorporated by reference, are "forward-looking statements" as that term is defined in the Private Securities Litigation Reform Act of 1995 ("PSLRA"). The PSLRA provides a safe harbor under the Securities Act of 1933 and the Exchange Act for forward-looking statements. These statements relate to our intentions, beliefs, projections, estimations or forecasts of future events or future financial performance and involve known and unknown risks, uncertainties and other factors that may cause us or the industry's actual results, levels of activity, or performance to be materially different from those expressed or implied by the forward-looking statements. In some cases, forward-looking statements may be identified by use of the words such as "may," "will," "could," "would," "should," "expect," "plan," "anticipate," "target," "project," "intend," "believe," "estimate," "predict," "potential," "likely," or "continue" or other comparable terminology. These statements are only predictions, and we can give no assurance that such expectations will prove to be correct. We undertake no obligation, other than as may be required under the federal securities laws, to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

Factors that could cause our actual results to differ materially from those we have projected, forecasted or estimated in forward-looking statements are discussed in further detail in Item 1A. "Risk Factors." of this Form 10-K. These risk factors may not be exhaustive. We operate in a continually changing business environment, and new risk factors emerge from time-to-time. We can neither predict such new risk factors nor can we assess the impact, if any, of such new risk factors on our businesses or the extent to which any factor or combination of factors may cause actual results to differ materially from those expressed or implied in any forward-looking statements in this report. In light of these risks, uncertainties and assumptions, the forward-looking events discussed in this report might not occur.

Introduction

We classify our business into three operating segments:

Standard Insurance Operations - comprised of both commercial lines ("Commercial Lines") and personal lines ("Personal Lines") insurance products and services that are sold in the standard marketplace;

E&S Insurance Operations - comprised of Commercial Lines insurance products and services that are unavailable in the standard market due to the market conditions or characteristics of the insured that are caused by the insured's claim history or the characteristics of their business; and

Investments - invests the premiums collected by our Standard and E&S Insurance Operations.

These segments reflect a change from our historical segments of Insurance Operations and Investments. This change resulted from the acquisitions that we made in 2011 related to our E&S business and reflects how senior management evaluates our results.

Our Standard Insurance Operations products and services are sold through nine subsidiaries that write Commercial Lines and Personal Lines business, some of which write flood business through the NFIP's WYO program. Two of these subsidiaries, Selective Casualty Insurance Company ("SCIC") and Selective Fire and Casualty Insurance Company ("SFCIC"), were created in 2012. These subsidiaries began writing direct premium in 2013 and have been included in our reinsurance pooling agreement as of July 1, 2012. See the "Reinsurance" section below for details regarding the pooling change.

Our E&S Insurance Operations products and services are sold through a subsidiary that was acquired in December of 2011. This subsidiary, Mesa Underwriters Specialty Insurance Company ("MUSIC"), provides a nationally-authorized non-admitted platform to write commercial and personal Excess and Surplus Lines business. For additional information regarding our E&S acquisitions, refer to Note 12. "Business Combinations" in Item 8. "Financial Statements

and Supplementary Data.” of this Form 10-K.

Our ten insurance subsidiaries are collectively referred to as the "Insurance Subsidiaries".

The purpose of the Management’s Discussion and Analysis (“MD&A”) is to provide an understanding of the consolidated results of operations and financial condition and known trends and uncertainties that may have a material impact in future periods.

In the MD&A, we will discuss and analyze the following:

• Critical Accounting Policies and Estimates;

• Financial Highlights of Results for Years Ended December 31, 2012, 2011, and 2010;

• Results of Operations and Related Information by Segment;

• Federal Income Taxes;

• Financial Condition, Liquidity, Short-term Borrowings, and Capital Resources;

• Ratings;

• Off-Balance Sheet Arrangements; and

• Contractual Obligations, Contingent Liabilities, and Commitments.

Critical Accounting Policies and Estimates

We have identified the policies and estimates described below as critical to our business operations and the understanding of the results of our operations. Our preparation of the Financial Statements requires us to make estimates and assumptions that affect the reported amount of assets and liabilities, disclosure of contingent assets and liabilities at the date of our Financial Statements, and the reported amounts of revenue and expenses during the reporting period. There can be no assurance that actual results will not differ from those estimates. Those estimates that were most critical to the preparation of the Financial Statements involved the following: (i) reserves for losses and loss expenses; (ii) deferred policy acquisition costs; (iii) pension and post-retirement benefit plan actuarial assumptions; (iv) OTTI; and (vi) reinsurance.

Reserves for Losses and Loss Expenses

Significant periods of time can elapse between the occurrence of an insured loss, the reporting of the loss to the insurer, and the insurer's payment of that loss. To recognize liabilities for unpaid losses and loss expenses, insurers establish reserves as balance sheet liabilities representing an estimate of amounts needed to pay reported and unreported net losses and loss expenses. As of December 31, 2012, we had accrued \$4.1 billion of gross loss and loss expense reserves compared to \$3.1 billion at December 31, 2011, the increase of which is largely attributable to the loss and loss expense reserves associated with Hurricane Sandy that are 100% reinsured by the federal government under the National Flood Insurance Program. The gross loss and loss expense reserves under this program were \$909.9 million as of December 31, 2012 compared to \$157.7 million as of December 31, 2011.

The following tables provide case and IBNR reserves for losses and loss expenses, and reinsurance recoverable on unpaid losses and loss expenses as of December 31, 2012 and 2011:

As of December 31, 2012

(\$ in thousands)	Losses and Loss Expense Reserves			Reinsurance Recoverable on Unpaid Losses and Loss Expenses	Net Reserves
	Case Reserves	IBNR Reserves	Total		
Commercial automobile	\$127,270	221,452	348,722	15,474	333,248
Workers compensation	494,467	586,141	1,080,608	158,035	922,573
General liability	214,216	902,087	1,116,303	116,791	999,512
Commercial property	71,903	12,925	84,828	35,639	49,189
Business owners' policies	44,620	66,783	111,403	20,410	90,993
Bonds	2,441	6,915	9,356	425	8,931
Other	1,265	1,071	2,336	1,200	1,136
Total standard Commercial Lines	956,182	1,797,374	2,753,556	347,974	2,405,582
Personal automobile	107,670	92,759	200,429	67,615	132,814
Homeowners	37,652	35,495	73,147	28,950	44,197
Other	865,469	56,037	921,506	911,928	9,578
Total standard Personal Lines	1,010,791	184,291	1,195,082	1,008,493	186,589
E&S Insurance Operations	18,738	101,565	120,303	53,288	67,015
Total	\$1,985,711	2,083,230	4,068,941	1,409,755	2,659,186

December 31, 2011

(\$ in thousands)	Losses and Loss Expense Reserves			Reinsurance Recoverable on Unpaid Losses and Loss Expenses	Net Reserves
	Case Reserves	IBNR Reserves	Total		
Commercial automobile	\$119,930	236,809	356,739	11,126	345,613
Workers compensation	475,498	569,050	1,044,548	146,912	897,636
General liability	202,704	870,711	1,073,415	98,952	974,463
Commercial property	53,701	8,383	62,084	8,338	53,746
Business owners' policies	32,826	63,714	96,540	6,593	89,947
Bonds	3,766	7,010	10,776	502	10,274
Other	1,040	1,113	2,153	996	1,157
Total standard Commercial Lines	889,465	1,756,790	2,646,255	273,419	2,372,836
Personal automobile	108,570	93,422	201,992	68,222	133,770

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Homeowners	32,014	33,645	65,659	5,374	60,285
Other	142,552	26,901	169,453	158,496	10,957
Total standard Personal Lines	283,136	153,968	437,104	232,092	205,012
E&S Insurance Operations	12,954	48,611	61,565	43,979	17,586
Total	\$1,185,555	1,959,369	3,144,924	549,490	2,595,434

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How reserves are established

When a claim is reported to an Insurance Subsidiary, claims personnel establish a “case reserve” for the estimated amount of the ultimate payment. The amount of the reserve is primarily based upon a case-by-case evaluation of the type of claim involved, the circumstances surrounding each claim, and the policy provisions relating to the type of losses. The estimate reflects the informed judgment of such personnel based on their knowledge, experience, and general insurance reserving practices. Until the claim is resolved, these estimates are revised as deemed appropriate by the responsible claims personnel based on subsequent developments and periodic reviews of the case.

In addition to case reserves, we maintain estimates of reserves for losses and loss expenses that have been incurred but not reported to us (referred to as “IBNR”). Using generally accepted actuarial reserving techniques, we project our estimate of ultimate losses and loss expenses at each reporting date. The difference between: (i) the projected ultimate loss and loss expense reserves; and (ii) the case loss reserves and the loss and loss expenses reserved thereon are carried as the IBNR reserve. The actuarial techniques used are part of a comprehensive reserving process that includes two primary components. The first component is a detailed quarterly reserve analysis performed by our internal actuarial staff. In completing this analysis, the actuaries must gather substantially similar data in sufficient volume to ensure statistical credibility of the data, while maintaining appropriate differentiation. This process defines the reserving segments, to which various actuarial projection methods are applied. When applying these methods, the actuaries are required to make numerous assumptions including, for example, the selection of loss and loss expense development factors and the weight to be applied to each individual projection method. These methods include paid and incurred versions for the following: loss and loss expense development, Bornhuetter-Ferguson, Berquist-Sherman, and frequency/severity modeling (chain-ladder approach). The second component of the analysis is the projection of the expected ultimate loss and loss expense ratio for each line of business for the current accident year. This projection is part of our planning process wherein we review and update expected loss and loss expense ratios each quarter. This review includes actual versus expected pricing changes, loss and loss expense trend assumptions, and updated prior period loss and loss expense ratios from the most recent quarterly reserve analysis.

In addition to the quarterly reserve analysis, a range of possible IBNR reserves is estimated annually and continually considered, among other factors, in establishing IBNR for each reporting period. Loss and loss expense trends are also considered, which include, but are not limited to, large loss activity, environmental claim activity, large case reserve additions or reductions for prior accident years, and reinsurance recoverable issues. We also consider factors such as: (i) per claim information; (ii) company and industry historical loss experience; (iii) legislative enactments, judicial decisions, legal developments in the imposition of damages, and changes in political attitudes; and (iv) trends in general economic conditions, including the effects of inflation. Based on the consideration of the range of possible IBNR reserves, recent loss and loss expense trends, uncertainty associated with actuarial assumptions and other factors, IBNR is established and the ultimate net liability for losses and loss expenses is determined. Such an assessment requires considerable judgment given that it is frequently not possible to determine whether a change in the data is an anomaly until sometime after the event. Even if a change is determined to be permanent, it is not always possible to reliably determine the extent of the change until sometime later. There is no precise method for subsequently evaluating the impact of any specific factor on the adequacy of reserves because the eventual deficiency or redundancy is affected by many factors. The changes in these estimates, resulting from the continuous review process and the differences between estimates and ultimate payments, are reflected in the Consolidated Statements of Income for the period in which such estimates are changed. Any changes in the liability estimate may be material to the results of operations in future periods.

Range of reasonable reserves

We have estimated a range of reasonably possible reserves for net loss and loss expense claims to be \$2,456 million to \$2,805 million at December 31, 2012, which compares to \$2,395 million to \$2,716 million at December 31, 2011.

These ranges reflect low and high reasonable reserve estimates which were selected primarily by considering the range of indications calculated using generally accepted actuarial techniques. Such techniques assume that past experience, adjusted for the effects of current developments and anticipated trends, are an appropriate basis for predicting future events. Although these ranges reflect likely scenarios, it is possible that the final outcomes may fall above or below these amounts. The ranges do not include a provision for potential increases or decreases associated with asbestos, environmental, and other continuous exposure claims, as traditional actuarial techniques cannot be effectively applied to these exposures.

Major trends by line of business creating additional loss and loss expense reserve uncertainty

The Insurance Subsidiaries are multi-state, multi-line property and casualty insurance companies and, as such, are subject to reserve uncertainty stemming from a variety of sources. These uncertainties are considered at each step in the process of establishing loss and loss expense reserves. However, as market conditions change, certain trends are identified that management believes create an additional amount of uncertainty. A discussion of recent trends, by line of business, that have been recognized by management follows.

Standard Market General Liability Line of Business

At December 31, 2012, our general liability line of business had recorded reserves, net of reinsurance, of \$1.0 billion, which represented 38% of our total net reserves. In calendar year 2012, this line experienced nominal adverse development of \$3 million, which was driven by increased severities in the 2010 and 2011 accident years. This unfavorable development was largely offset by continued favorable development in premises and products in accident years 2007 and 2009, which showed lower frequencies of large losses, particularly in the umbrella coverage. During the 2011 and 2010 calendar years this line of business experienced overall favorable reserve development that was largely attributable to accident years 2006 through 2009, which showed generally lower frequencies. The broad nature of this line of business, and the longer tailed nature of the claims settlement process, makes it more susceptible to changes in litigation and the tort environment. This line of business also includes excess policies that provide additional limits above underlying automobile and general liability coverages, which is subject to catastrophic losses, and therefore influenced by the factors noted above to a greater degree.

Standard Market Workers Compensation Line of Business

At December 31, 2012, our workers compensation line of business recorded reserves, net of reinsurance, of \$923 million or 35% of our total net reserves. During the past three years this line experienced unfavorable reserve development. The 2012 unfavorable development was driven by the 2011 accident year, due to an increase in the ultimate severity. This was partially offset by earlier accident years, in particular 2007 and 2008, due to a decrease in expected severities for those years. The unfavorable reserve development of \$2 million during calendar year 2012 was substantially less than those in the prior two years, which were \$7 million in 2011 and \$22 million in 2010. The decrease in the development over the past three years reflects the significant underwriting and reserving actions taken on this line.

In addition to the uncertainties associated with actuarial assumptions and methodologies described above, the workers compensation line of business can be impacted by a variety of issues, such as the following:

Unexpected changes in medical cost inflation - Variability in our historical workers compensation medical costs, along with uncertainty regarding future medical inflation, creates the potential for additional volatility in our reserves;

Changes in statutory workers compensation benefits - Benefit changes may be enacted such that they affect all outstanding claims, regardless of having occurred in the past. Depending upon the social and political climate, these changes may be such that they either increase or decrease associated claim costs;

Changes in overall economic conditions - Higher levels of unemployment could ultimately impact both the severity and frequency of workers compensation claims. There is also potential for an increase in severity if the longevity of workers compensation claims increases. Injured workers could have less incentive to return to work when their company is in financial distress or injured workers could be laid off while on workers compensation. Conversely, there is potential for a decrease in frequency if workers are reluctant to file claims or have less work and less exposure to injury.

In addition, changes in the economy could impact reserves in other ways. For example, in 2011, audit and endorsement activity resulted in additional premium of \$11.2 million, and in 2012, audit and endorsement activity resulted in additional premiums of \$14.3 million. These years represent a reversal from the immediately prior years, where audit and endorsement activity resulted in significant return premiums. Since premiums earned are used as a basis for setting initial reserves on the current accident year, our reserves could be impacted. While audit and endorsement premiums are modeled within our annual budgeting process, they remain uncertain and therefore provide additional variability to the resulting loss and loss expense ratio estimates.

Standard Market Commercial Automobile Line of Business

At December 31, 2012, our commercial automobile line of business had recorded reserves, net of reinsurance, of \$333 million, which represented 13% of our total net reserves. In 2012 this line experienced favorable development of \$9 million, largely driven by accident year 2009, which represents a continued trend driven by better than expected reported emergence in this year. As a result, our view of the ultimate severity for this year has decreased. This favorable development was partially offset by unfavorable development on the 2011 accident year, due to higher frequency of claims. The variability of frequencies creates additional uncertainty in our analysis for the more recent accident years. The commercial automobile line is sensitive to changes in driving patterns and general economic conditions. These factors greatly influence miles driven, which can significantly affect frequencies.

Standard Market Personal Automobile Line of Business

At December 31, 2012, our personal automobile line of business had recorded reserves, net of reinsurance, of \$133 million, which represented 5% of our total net reserves. Over the past several years, the New Jersey personal automobile marketplace has continued to be extremely competitive, while at the same time we have been growing our market share in our other personal lines footprint states; the result of which has been a gradually changing overall mix of business. We review the reserves for states other than New Jersey on a combined basis so that there is a sufficient volume of data to ensure statistical credibility. However, the state mix of business changes over time may increase the uncertainty surrounding our personal automobile reserves.

Other Lines of Business

At December 31, 2012, no other individual line of business had recorded reserves of more than \$90 million, net of reinsurance. We have not identified any recent trends that would create additional significant reserve uncertainty for these other lines of business.

Other impacts creating additional loss and loss expense reserve uncertainty

Claims Initiative Impacts

In addition to the line of business specific issues mentioned above, these lines of business have been impacted by a number of initiatives undertaken by our claims department that have resulted in volatility in the average level of case reserves. Some of these initiatives have also effected changes in claims settlement rates. These changes impact the data upon which the ultimate loss and loss expense projections are made. While these changes in case reserve levels and settlement rates increase the uncertainty in the short run, the longer-term benefit is a more refined management of the claims process.

Some of the specific actions implemented are as follows:

- The introduction of a new workers compensation claims handling process, which focuses individuals on specific areas of expertise. This allows for a more streamlined process while providing expertise on the right claims at the right time.

- Increased focus on reducing workers compensation medical costs through more favorable PPO contracts and greater PPO penetration.

- The introduction of a Complex Claims Unit to which all significant and complex liability claims are assigned. This unit has been staffed with personnel that have significant experience in handling and settling these types of claims.

- Increased activity in the areas of fraud investigation and salvage/subrogation recoveries. These efforts have been supported by the introduction of predictive models which allow us to better focus these efforts.

Our internal reserve analyses incorporate actuarial projection methods which make adjustments for changes in case reserve adequacy and claims settlement rates. These methods adjust our historical loss experience to the current level of case adequacy or settlement rate, which provides a more consistent basis for projecting future development patterns. These methods have their own assumptions and judgments associated with them, so as with any projection method, they are not definitive in and of themselves. Furthermore, given that the benefits from our claims initiatives take time to fully manifest, we do not take full credit for the anticipated benefit in establishing our loss and loss expense reserves. Therefore, these initiatives may prove more or less beneficial than currently reflected, which will affect development in future years. Our various projection methods provide an indication of these potential future impacts. These impacts would be greatest within our larger reserve lines of workers compensation, general liability, and commercial automobile liability, within the more recent accident years.

Economic Inflationary Impacts

Although inflationary volatility is expected to be low in the near term, current United States' monetary policy and global economic conditions bring additional uncertainty in the long-term given the long-tail nature of these lines of business. Uncertainty regarding future inflation or deflation creates the potential for additional volatility in our reserves for these lines of business.

Sensitivity analysis: Potential impact on reserve uncertainty due to changes in key assumptions

Our process to establish reserves includes a variety of key assumptions, including, but not limited to, the following:

- The selection of loss and loss expense development factors;
- The weight to be applied to each individual actuarial projection method;
- Projected future loss trends; and
- Expected ultimate loss and loss expense ratios for the current accident year.

The importance of any single assumption depends on several considerations, such as the line of business and the accident year. If the actual experience emerges differently than the assumptions used in the process to establish reserves, changes in our reserve estimate are possible and may be material to the results of operations in future periods. Set forth below are sensitivity tests which highlight potential impacts to loss and loss expense reserves under different scenarios, for the major casualty lines of business. It is important to note that these tests consider each assumption and line of business individually, without any consideration of correlation between lines of business and accident years, and therefore, does not constitute an actuarial range. While the figures represent possible impacts from variations in key assumptions as identified by management, there is no assurance that the future emergence of our loss and loss expense experience will be consistent with either our current or alternative sets of assumptions.

While the sources of variability discussed above are generated by different underlying trends and operational changes, they ultimately manifest themselves as changes in the expected loss and loss expense development patterns. These patterns are a key assumption in the reserving process. In addition to the expected development patterns, the expected loss and loss expense ratios are another key assumption in the reserving process. These expected ratios are developed via a rigorous process of projecting recent accident years' experience to an ultimate settlement basis, and then adjusting it to the current accident year's pricing and loss cost levels. Impact from changes in the underwriting portfolio and changes in claims handling practices are also quantified and reflected, where appropriate. As is the case with all estimates, the ultimate loss and loss expense ratios may differ from those currently estimated.

The sensitivities of loss and loss expense reserves to these key assumptions are illustrated below for the major casualty lines. The first table shows the estimated impacts from changes in expected reported loss and loss expense development patterns. It shows reserve impacts by line of business, if the actual calendar year incurred amounts are greater or less than current expectations by the selected percentages. The second table shows the estimated impacts from changes to the expected loss and loss expense ratios for the current accident year. It shows reserve impacts by line of business, if the expected loss and loss expense ratios for the current accident year are greater or less than current expectations by the selected percentages. While the selected percentages by line are judgmentally based, they reflect the relative contribution of the specific line of business to the overall reserve range.

Reserve Impacts of Changes to Prior Years Expected Loss and Loss Expense Reporting Patterns

(\$ in millions)	Percentage Decrease/Increase		Decrease to Future Calendar Year Reported	Increase to Future Calendar Year Reported
General liability	7	%	(70	) 70
Workers compensation	10	%	(55	) 55
Commercial automobile liability	10	%	(30	) 30
Personal automobile liability	10	%	(10	) 10

Reserve Impacts of Changes to Current Year Expected Ultimate Loss and Loss Expense Ratios

(\$ in millions)	Percentage Decrease/Increase		Decrease to Current Accident Year Expected Loss and Loss Expense Ratio	Increase to Current Accident Year Expected Loss and Loss Expense Ratio
General liability	7	%	(26	) 26
Workers compensation	10	%	(26	) 26
Commercial automobile liability	7	%	(15	) 15
Personal automobile liability	7	%	(7	) 7

Note that there is some overlap between the impacts in the two tables. For example, increases in the calendar year development would ultimately impact our view of the current accident year's loss and loss expense ratios. Nevertheless, these tables provide perspective into the sensitivity of each of these key assumptions.

Asbestos and Environmental Reserves

Included in our losses and loss expense reserves are amounts for asbestos and environmental claims. The total carried net losses and loss expense reserves for these claims were \$27.8 million as of December 31, 2012 and \$27.9 million as of December 31, 2011. Our asbestos and environmental claims have arisen primarily from insured exposures in municipal government, small commercial risks, and homeowners policies. The emergence of these claims is slow and highly unpredictable. For example, within our standard Commercial Lines book, certain landfill sites are included on the National Priorities List ("NPL") by the United States Environmental Protection Agency ("USEPA"). Once on the NPL, the USEPA determines an appropriate remediation plan for these sites. A landfill can remain on the NPL for many years until final approval for the removal of the site is granted from the USEPA. The USEPA also has the authority to re-open previously closed sites and return them to the NPL. We currently have reserves for six insureds related to four sites on the NPL.

Estimating IBNR reserves for asbestos and environmental claims is difficult because of the delayed and inconsistent reporting patterns associated with these claims. In addition, there are significant uncertainties associated with estimating critical assumptions, such as average clean-up costs, third-party costs, potentially responsible party shares, allocation of damages, litigation and coverage costs, and potential state and federal legislative changes. Normal historically based actuarial approaches cannot be applied to environmental claims because past loss history is not indicative of future potential environmental losses. In addition, while certain alternative models can be applied, such models can produce significantly different results with small changes in assumptions. As a result, we do not calculate an asbestos and environmental loss range.

Deferred Policy Acquisition Costs

On January 1, 2012, we adopted Accounting Standards Update 2010-26, Financial Services-Insurance (Topic 944): Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts ("ASC 2010-26"). This standard limits deferred policy acquisition costs to only those costs that are incremental or directly related to the successful acquisition of new or renewal insurance contracts. These costs include, among other items, sales commissions paid to agents, premium taxes, and the portion of employee salaries and benefits directly related to time spent on acquired contracts. Prior period amounts presented in this Form 10-K have been restated to reflect the retroactive adoption of this guidance. For quantitative data regarding the impact of this adoption, see Note 3. "Summary of Significant Accounting Policies" in Item 8. "Financial Statements and Supplementary Data." of this Form 10-K. Policy acquisition costs that are deferred are amortized into expense over the life of the policies.

We regularly conduct reviews for potential premium deficiencies. A premium deficiency exists if the sum of the anticipated losses and loss expenses, unamortized acquisition costs, policyholder dividends, and other expenses exceed the related unearned premium and anticipated investment income. Accounting guidance requires that premium deficiency analyses be performed at the level an entity acquires, services, and measures the profitability of its insurance contracts. We currently perform two premium deficiency analyses, one for Standard Insurance Operations and one for E&S Insurance Operations, considering the following:

Our marketing efforts for all of our product lines within our Standard Insurance Operations revolve around independent retail agencies and their touch points with our shared customers, the policyholders, while our E&S Insurance Operations revolve around our wholesale general agents.

We service our Standard Insurance Operations' agency distribution channel through our field model, which includes FMSs, AMSs, SMSs, CMSs, and our Underwriting and Claims Service Centers, all of which service the entire population of insurance contracts acquired through each agency. For our E&S Insurance Operations, we use external adjusters to service claims on behalf of our customers.

We measure the profitability of our business for the Standard and E&S Insurance Operations separately, which is evident in, among other items, the structure of our incentive compensation programs. We measure the profitability and calculate the compensation of our independent retail agents based on the results of our Standard Insurance

Operations, and we measure the profitability and calculate the compensation of our wholesale general agents based on the results of our E&S Standard Insurance Operations Segment.

We had deferred policy acquisition costs of \$155.5 million at December 31, 2012 compared to \$135.8 million at December 31, 2011.

Pension and Post-retirement Benefit Plan Actuarial Assumptions

Our pension and post-retirement benefit obligations and related costs are calculated using actuarial methods, within the framework of U.S. GAAP. Two key assumptions, the discount rate and the expected return on plan assets, are important elements of expense and/or liability measurement. We evaluate these key assumptions annually. Other assumptions involve demographic factors such as retirement age, mortality, turnover, and rate of compensation increases.

The discount rate enables us to state expected future cash flows at their present value on the measurement date. The purpose of the discount rate is to determine the interest rates inherent in the price at which pension benefits could be effectively settled. Our discount rate selection is based on high-quality, long-term corporate bonds. A lower discount rate increases the present value of benefit obligations and increases pension expense. We decreased our discount rate to 4.42% for 2012, from 5.16% for 2011, reflecting ongoing pressure on market interest rates. To determine the expected long-term rate of return on the plan assets, we consider the current and expected asset allocation, as well as historical and expected returns on each plan asset class. A lower expected rate of return on pension plan assets would increase pension expense. Our long-term expected return on plan assets was lowered 35 basis points to 7.40% in 2012 as compared to 7.75% in 2011, reflecting the lower interest rate environment that is anticipated in the near term despite our 2012 total return of 12.3%. We had a pension and post-retirement benefit plan obligation of \$309.1 million at December 31, 2012 compared to \$259.9 million at December 31, 2011.

As of December 31, 2012, our pension assets were \$207.1 million, up from \$182.6 million at the end of 2011. In 2012, we made \$8.6 million in contributions to the plan. Volatility in the marketplace, coupled with changes in the discount rate assumption, could materially impact our pension valuation in the future.

For additional information regarding our pension and post-retirement benefit plan obligations, see Note 15. "Retirement Plans" in Item 8. "Financial Statements and Supplementary Data." of this Form 10-K.

Other-Than-Temporary Investment Impairments

When the fair value of any investment is lower than its cost/amortized cost, an assessment is made to determine if the decline is other than temporary. We regularly review our entire investment portfolio for declines in fair value. If we believe that a decline in the value of an AFS security is temporary, we record the decline as an unrealized loss in AOCI. Temporary declines in the value of an HTM security are not recognized in the Financial Statements. Our assessment of a decline in fair value includes judgment as to the financial position and future prospects of the entity that issued the investment security, as well as a review of the security's underlying collateral for fixed maturity investments. Broad changes in the overall market or interest rate environment generally will not lead to a write-down.

Fixed Maturity Securities and Short-Term Investments

Our evaluation for OTTI of a fixed maturity security or a short-term investment may include, but is not limited to, the evaluation of the following factors:

- Whether the decline appears to be issuer or industry specific;
- The degree to which the issuer is current or in arrears in making principal and interest payments on the fixed maturity security;
- The issuer's current financial condition and ability to make future scheduled principal and interest payments on a timely basis;
- Evaluation of projected cash flows;
- Buy/hold/sell recommendations published by outside investment advisors and analysts; and
- Relevant rating history, analysis, and guidance provided by rating agencies and analysts.

OTTI charges are recognized as a realized loss to the extent that they are credit related, unless we have the intent to sell the security or it is more likely than not that we will be required to sell the security. In those circumstances, the security is written down to fair value with the entire amount of the writedown charged to earnings as a component of realized losses. To determine if an impairment is other than temporary, discounted cash flow analyses (“DCF”) are performed on all fixed maturity securities meeting certain criteria. In addition, DCFs are performed on all previously-impaired debt securities in an unrealized loss position that continue to be held by us and all structured securities that were not of high-credit quality at the date of purchase. These impairment assessments include, but are not limited to, the following security types: commercial mortgage-backed securities (“CMBS”); residential mortgage-backed securities (“RMBS”); asset-backed securities (“ABS”); collateralized debt obligations (“CDOs”); and corporate fixed maturity securities.

For structured securities, including CMBS, RMBS, ABS, and CDOs, we also consider variables such as expected default, severity, and prepayment assumptions based on security type and vintage, taking into consideration information from credit agencies, historical performance, and other relevant economic and performance factors.

In making our assessment, we perform a DCF to determine the present value of future cash flows to be generated by the underlying collateral of the security. Any shortfall in the expected present value of the future cash flows, based on the DCF, from the amortized cost basis of a security is considered a “credit impairment,” with the remaining decline in fair value of a security considered as a “non-credit impairment.” As mentioned above, credit impairments are charged to earnings as a component of realized losses, while non-credit impairments are recorded to OCI as a component of unrealized losses.

Discounted Cash Flow Assumptions

The discount rate we use in the DCF is the effective interest rate implicit in the security at the date of acquisition for those structured securities that were not of high-credit quality at acquisition. For all other securities, we use a discount rate that equals the current yield, excluding the impact of previous OTTI charges, used to accrete the beneficial interest.

If applicable, we use a conditional default rate assumption in the DCF to estimate future defaults. The conditional default rate is the proportion of all loans outstanding in a security at the beginning of a time period that are expected to default during that period. Our assumption of this rate takes into consideration the uncertainty of future defaults as well as whether or not these securities have experienced significant cumulative losses or delinquencies to date.

If applicable, conditional default rate assumptions apply at the total collateral pool level held in the securitization trust. Generally, collateral conditional default rates will “ramp-up” over time as the collateral seasons, because the performance begins to weaken and losses begin to surface. As time passes, depending on the collateral type and vintage, losses will peak and performance will begin to improve as weaker borrowers are removed from the pool through delinquency resolutions. In the later years of a collateral pool’s life, performance is generally materially better as the resulting favorable selection of the portfolio improves the overall quality and performance.

For CMBS, we also consider the net operating income (“NOI”) generated by the underlying properties. Our assumptions of the properties’ ultimate cash flows takes into consideration both an immediate reduction to the reported NOIs and decreases to projected NOIs.

If applicable, we also use a loan loss severity assumption in our DCF that is applied at the loan level of the collateral pool. The loan loss severity assumptions represent the estimated percentage loss on the loan-to-value exposure for a particular security. For CMBS, the loan loss severities applied are based on property type. Losses generated from the evaluations are then applied to the entire underlying deal structure in accordance with the original service agreements.

Equity Securities

Evaluation for OTTI of an equity security, may include, but is not limited to, an evaluation of the following factors:

- Whether the decline appears to be issuer or industry specific;
 - The relationship of market prices per share to book value per share at the date of acquisition and date of evaluation;
 - The price-earnings ratio at the time of acquisition and date of evaluation;
 - The financial condition and near-term prospects of the issuer, including any specific events that may influence the issuer’s operations, coupled with our intention to hold the securities in the near term;
 - The recent income or loss of the issuer;
 - The independent auditors’ report on the issuer’s recent financial statements;
 - The dividend policy of the issuer at the date of acquisition and the date of evaluation;
 - Buy/hold/sell recommendations or price projections published by outside investment advisors;
 - Rating agency announcements;
 - The length of time and the extent to which the fair value has been, or is expected to be, less than cost in the near term;
- and

Our expectation of when the cost of the security will be recovered.

If there is a decline in the fair value on an equity security that we do not intend to hold, or if we determine the decline is other-than-temporary, including declines driven by market volatility for which we cannot assert will recover in the near term, we will write down the carrying value of the investment and record the charge through earnings as a component of realized losses.

Other Investments

Our evaluation for OTTI of an other investment (i.e., an alternative investment) may include, but is not limited to, conversations with the management of the alternative investment concerning the following:

- The current investment strategy;
- Changes made or future changes to be made to the investment strategy;
- Emerging issues that may affect the success of the strategy; and
- The appropriateness of the valuation methodology used regarding the underlying investments.

If there is a decline in fair value on an other investment that we do not intend to hold, or if we determine the decline is other than temporary, we write down the cost of the investment and record the charge through earnings as a component of realized losses.

Reinsurance

Reinsurance recoverables on paid and unpaid losses and loss expenses represent estimates of the portion of such liabilities that will be recovered from reinsurers. Each reinsurance contract is analyzed to ensure that the transfer of risk exists to properly record the transactions in the Financial Statements. Amounts recovered from reinsurers are recognized as assets at the same time and in a manner consistent with the paid and unpaid losses associated with the reinsured policies. An allowance for estimated uncollectible reinsurance is recorded based on an evaluation of balances due from reinsurers and other available information. This allowance totaled \$4.8 million at December 31, 2012 and \$3.9 million at December 31, 2011. We continually monitor developments that may impact recoverability from our reinsurers and have available to us contractually provided remedies if necessary. For further information regarding reinsurance, see the “Reinsurance” section below and Note 8. “Reinsurance” in Item 8. “Financial Statements and Supplementary Data.” of this Form 10-K.

Financial Highlights of Results for Years Ended December 31, 2012, 2011, and 2010¹

(\$ in thousands, except per share amounts)	2012	2011	2012 vs. 2011	2010	2011 vs. 2010
GAAP measures:					
Revenues	\$1,734,102	\$1,597,475	9 %	1,564,621	2 %
Pre-tax net investment income	131,877	147,443	(11)	145,708	1
Pre-tax net income	37,635	10,400	262	78,334	(87)
Net income	37,963	22,033	72	66,966	(67)
Diluted net income per share	0.68	0.40	70	1.23	(67)
Diluted weighted-average outstanding shares	55,933	55,221	1	54,504	1
GAAP combined ratio	104.0 %	107.2 %	(3.2) pts	101.4	5.8 pts
Statutory combined ratio	103.5 %	106.7 %	(3.2)	101.6	5.1
Return on average equity	3.5 %	2.1 %	1.4	6.8	(4.7)
Non-GAAP measures:					
Operating income	\$32,121	\$21,227	51 %	75,350	(72) %
Diluted operating income per share	0.58	0.38	53	1.38	(72)
Operating return on average equity	3.0 %	2.0 %	1.0 pts	7.7	(5.7) pts

¹Refer to the Glossary of Terms attached to this Form 10-K as Exhibit 99.1 for definitions of terms used in this financial review.

The following table reconciles operating income and net income for the periods presented above:

(\$ in thousands, except per share amounts)	2012	2011	2010
Operating income	\$32,121	21,227	75,350
Net realized gains (losses), net of tax	5,842	1,456	(4,604)
Loss on discontinued operations, net of tax	—	(650)	(3,780)
Net income	\$37,963	22,033	66,966
Diluted operating income per share	\$0.58	0.38	1.38
Diluted net realized gains (losses) per share	0.10	0.03	(0.08)
Diluted net loss on discontinued operations per share	—	(0.01)	(0.07)
Diluted net income per share	\$0.68	0.40	1.23

We target a return on average equity that is three points higher than our cost of capital, currently 8%, excluding the impact of realized gains and losses, which is referred to as operating return on equity. Our operating return on average equity was 3.0%, 2.0%, and 7.7% in 2012, 2011, and 2010, respectively. These returns reflect our low levels of pre-tax operating income due to significant catastrophe losses in each of those years. Our operating return on average equity contribution by component is as follows:

Operating Return on Average Equity	2012	2011	2010
Insurance Operations	(3.9)%	(6.5)%	(1.3)%
Investments	9.3 %	10.7 %	11.3 %
Other	(2.4)%	(2.2)%	(2.3)%
Total	3.0 %	2.0 %	7.7 %

In all three years, pre-tax net investment income was negatively impacted by the declining interest rate environment, which has sequentially lowered returns within our fixed maturity portfolio when comparing years. However, strong returns in our alternative investment portfolio have partially offset the impact of the declining interest rates on the

investment segments operating ROE contribution.

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The following table provides a quantitative foundation for analyzing our overall Insurance Subsidiaries underwriting results:

All Lines (\$ in thousands)	2012	2011	2012 vs. 2011	2010	2011 vs. 2010	
GAAP Insurance Operations Results:						
NPW	1,666,883	1,485,349	12	% 1,390,541	7	%
NPE	1,584,119	1,439,313	10	1,416,598	2	
Less:						
Losses and loss expenses incurred	1,120,990	1,074,987	4	982,118	9	
Net underwriting expenses incurred	523,688	462,626	13	450,576	3	
Dividends to policyholders	3,448	5,284	(35)	) 3,878	36	
Underwriting (loss) income	(64,007)	(103,584)	38	% (19,974)	(419)	%
GAAP Ratios:						
Loss and loss expense ratio	70.8	% 74.7	(3.9	) pts 69.3	5.4	pts
Underwriting expense ratio	33.0	32.1	0.9	31.8	0.3	
Dividends to policyholders ratio	0.2	0.4	(0.2	) 0.3	0.1	
Combined ratio	104.0	107.2	(3.2	) 101.4	5.8	
Statutory Ratios:						
Loss and loss expense ratio	70.7	74.6	(3.9	) 69.3	5.3	
Underwriting expense ratio	32.6	31.7	0.9	32.0	(0.3)
Dividends to policyholders ratio	0.2	0.4	(0.2	) 0.3	0.1	
Combined ratio	103.5	% 106.7	(3.2	) pts 101.6	5.1	pts

The growth in NPW and NPE for our Insurance Subsidiaries in 2012 and 2011 reflect: (i) pure price increases that we have achieved on our Commercial Lines and Personal Lines standard business; (ii) higher retention in our Standard Insurance Operations; and (iii) additional premium resulting from our newly-acquired E&S business.

The combined ratios in the table above reflect levels of catastrophe losses that are well above the historical levels that we have experienced in the 10 years prior to 2010, which include a high of 2.7 points, a low of 0.3 points, and a median of 1.1 points. The following table provides catastrophe loss impacts on our overall underwriting profitability over the last three years, keeping in mind that combined ratios over 100% generally indicate an underwriting loss and combined ratios under 100% typically indicate underwriting profitability:

	2012	2011	2010
Combined ratio, as reported	104.0	% 107.2	101.4
Catastrophe loss points ¹	5.8	8.3	4.0
Combined ratio, excluding catastrophe losses	98.2	% 98.9	97.4

¹In addition to catastrophe losses, the catastrophe loss impact in 2012 includes the reinstatement premium on our catastrophe treaty and flood claims handling fees related to Hurricane Sandy.

Furthermore, catastrophe losses in 2012 and 2011 each contained individually significant storms. In 2012, Hurricane Sandy was the single largest event in our history and in 2011, Hurricane Irene was the second largest event in our history. Quantitative data regarding these storms is as follows:

(\$ in thousands)	Hurricane Sandy 2012	Hurricane Irene 2011
Total Insurance Operations (Excluding Flood):		
Gross losses	\$ 136,000	46,509
Reinsurance	(89,400	) (6,929
Net losses	46,600	39,580
Reinstatement premium	8,577	596
Flood :		
Gross losses	1,039,155	177,008
Reinsurance	(1,039,155	) (177,008
Net losses	—	—
Flood claims handling fees	(15,587	) (2,655
Net impact of storms	\$ 39,590	37,521

Outlook

A.M. Best noted in their year-end review that the industry's underwriting and operating performance continued to improve through late October 2012, as pricing momentum was sustained and catastrophe losses remained significantly below 2011 levels. However, similar to us, the industry's full-year results were substantially impacted by the October 29th arrival of Hurricane Sandy, which is likely to become the second costliest U.S. natural disaster in terms of insured losses after 2005's Hurricane Katrina, driving A.M. Best's 2012 combined ratio estimate to 106.2%.

As catastrophe losses are inherently unpredictable, we believe it is best to examine progress towards targeted combined ratio goals that exclude these losses. Although market conditions for new business remained challenged, the execution of our profit improvement initiatives had a positive impact on our 2012 results, excluding catastrophe losses and reserve development, which modestly beat our expectations. We established a three-year targeted statutory combined ratio of 95% by year-end 2014. This 95% combined ratio target becomes 92% after excluding three points of expected catastrophe losses.

For 2013, we expect a statutory combined ratio of 96% excluding catastrophes and any prior year development, favorable or unfavorable, and a three-point estimate for catastrophe losses. In addition, our newly acquired E&S segment is expected to produce a combined ratio between 100% and 102% for 2013 and is anticipated to be of a similar profitability level to our standard business in 2014.

A key component of meeting our combined ratio targets is our ability to generate Commercial Lines renewal pure price increases in excess of our predicted loss trends. Although A.M. Best is maintaining its negative outlook for the commercial lines market, it does anticipate that sustained pricing momentum will continue in 2013. We were able to achieve a 6.2% standard Commercial Lines renewal pure price increase in 2012, the trend of which has continued into 2013, with a 7.5% increase for the month of January 2013. The price increases that we have obtained demonstrate the overall strength of the relationships that we have with our independent retail agents, even in difficult economic and competitive times. As the marketplace becomes more successful at driving price, we will continue to capitalize on our relationships with our agents to generate on-going renewal price increases through the use of our granular pricing

capabilities.

In maintaining their negative outlook for the commercial lines marketplace, A.M. Best cites that the expectation of the continuing sluggish macroeconomic environment, including low investment yields, reduced levels of loss reserve redundancies, and the lingering effects of the soft market conditions will lead to more negative rating actions than positive actions in the upcoming year. The continued low interest rate environment has several significant impacts on our business, some of which are beneficial and some of which present a challenge to us. The benefits include lower inflation rates that suppress loss trends, as well as reduce our cost of capital. However, the interest rate environment presents a significant challenge in generating after-tax return on our investment portfolio as fixed income securities mature and money is re-invested at lower rates. As a result, for 2013, we anticipate after-tax investment income of approximately \$90 to \$95 million, lower than the \$100 million we earned on an after-tax basis this year.

Results of Operations and Related Information by Segment

Standard Insurance Operations

Our Standard Insurance Operations segment, which represents 93% of our combined insurance operations net premiums written ("NPW"), sells insurance products and services primarily in 22 states in the Eastern and Midwestern U.S. and the District of Columbia, through approximately 1,100 independent retail insurance agencies. This segment consists of two components: (i) Commercial Lines, which markets primarily to businesses and represents approximately 81% of the segment's NPW; and (ii) Personal Lines, including our flood business, which markets primarily to individuals and represents approximately 19% of NPW.

(\$ in thousands)	2012	2011	2012 vs. 2011	2010	2011 vs. 2010
GAAP Insurance Operations Results:					
NPW	\$ 1,553,586	1,461,216	6 %	1,390,541	5 %
NPE	1,504,890	1,435,399	5	1,416,598	1
Less:					
Losses and loss expenses incurred	1,057,787	1,071,815	(1)	982,118	9
Net underwriting expenses incurred	488,104	455,223	7	450,576	1
Dividends to policyholders	3,448	5,284	(35)	3,878	36
Underwriting (loss) income	\$(44,449)	(96,923)	54 %	(19,974)	(385)%
GAAP Ratios:					
Loss and loss expense ratio	70.3 %	74.7	(4.4)pts	69.3	5.4 pts
Underwriting expense ratio	32.5	31.7	0.8	31.8	(0.1)
Dividends to policyholders ratio	0.2	0.4	(0.2)	0.3	0.1
Combined ratio	103.0	106.8	(3.8)	101.4	5.4
Statutory Ratios:					
Loss and loss expense ratio	70.3	74.6	(4.3)	69.3	5.3
Underwriting expense ratio	32.0	31.4	0.6	32.0	(0.6)
Dividends to policyholders ratio	0.2	0.4	(0.2)	0.3	0.1
Combined ratio	102.5 %	106.4	(3.9)pts	101.6	4.8 pts

The improvements in NPW and NPE from 2010 through 2012 are primarily the result of the following:

(\$ in millions)	2012	2011	2010
Retention	84 %	83 %	81 %
Commercial Lines renewal pure price increase	6.2	2.8	3.1
Personal Lines renewal pure price increase	6.7	6.3	5.3
Direct new business premiums	\$285.9	262.3	272.8
Audit and endorsement additional (return) premiums	23.0	14.8	(47.4)
Catastrophe reinstatement premiums	(8.5)	(0.6)	—

The volatility in the GAAP loss and loss expense ratio is reflective of the very nature of property losses, which have been historically volatile. In addition to the catastrophe property losses illustrated in the table below, non-catastrophe property losses improved in 2012 compared to 2011 by 1.4 points.

Catastrophe Property Losses

(\$ in millions)

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For the Year ended December 31,	Losses Incurred	Impact on Loss Ratio ¹	Year-Over-Year Change
2012	96.9	6.4	pts (1.9)
2011	118.8	8.3	4.3
2010	56.5	4.0	N/A

¹ Reinstatement premiums associated with the catastrophe losses have been added back to net premiums earned to calculate the loss ratio impact for 2012.

In addition to the property losses, the GAAP loss and loss expense ratio was impacted by development as follows:
Favorable/(Unfavorable) Prior Year Casualty Development

(\$ in millions)	2012		2011		2010
General Liability	\$ (3)	)	12		26
Commercial Automobile	8		13		28
Workers Compensation	(2)	)	(7)	)	(22)
Business Owners' Policies	8		10		3
Homeowners	6		4		5
Personal Automobile	—		(3)	)	(3)
Other	1		1		2
Total	\$ 18		30		39

Favorable Impact on loss ratio¹ 1.2 pts 2.1 pts 2.8 pts

¹ Reinstatement premiums associated with the catastrophe losses have been added back to net premiums earned to calculate the loss ratio impact for 2012.

The increase in the GAAP underwriting expense ratio of 0.8 points in 2012 compared to 2011 is primarily related to: (i) the \$8.5 million reduction in NPE associated with the catastrophe reinstatement premium; and (ii) higher supplemental commissions to agents.

Review of Underwriting Results by Lines of Business

Standard Commercial Lines

(\$ in thousands)	2012	2011	2012 vs. 2011	2010	2011 vs. 2010
GAAP Insurance Operations					
Results:					
NPW	\$ 1,263,738	1,188,004	6	% 1,133,876	5 %
NPE	1,225,335	1,170,947	5	1,174,282	—
Less:					
Losses and loss expenses incurred	853,143	832,360	2	790,369	5
Net underwriting expenses incurred	409,679	383,255	7	379,855	1
Dividends to policyholders	3,448	5,284	(35)	) 3,878	36
Underwriting (loss) income	\$(40,935)	(49,952)	) 18	% 180	(27,851) %
GAAP Ratios:					
Loss and loss expense ratio	69.6	% 71.1	(1.5)	)pts 67.3	3.8 pts
Underwriting expense ratio	33.4	32.7	0.7	32.4	0.3
Dividends to policyholders ratio	0.3	0.5	(0.2)	) 0.3	0.2
Combined ratio	103.3	104.3	(1.0)	) 100.0	4.3
Statutory Ratios:					
Loss and loss expense ratio	69.6	71.0	(1.4)	) 67.3	3.7
Underwriting expense ratio	33.1	32.4	0.7	33.2	(0.8)
Dividends to policyholders ratio	0.3	0.5	(0.2)	) 0.3	0.2
Combined ratio	103.0	% 103.9	(0.9)	)pts 100.8	3.1 pts

The fluctuations in NPW and NPE from 2010 through 2012 is primarily the result of the following:

(\$ in millions)	For the Year Ended December 31,		
	2012	2011	2010

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Retention	82	% 80	% 79	%
Renewal pure price increases	6.2	% 2.8	% 3.1	%
Direct new business	\$236.1	212.1	210.8	
Audit and endorsement additional (return) premiums	23.5	14.5	(47.9)
Catastrophe reinstatement premiums	(4.6) (0.3) —	

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The variance in the GAAP loss and loss expense ratio in both periods presented is primarily attributable to catastrophe losses which were as follows:

(\$ in millions)	Catastrophes		
	Losses Incurred	Impact on Loss Ratio	Year-Over-Year Change
For the Year Ended December 31,			
2012	56.4	4.6	pts (1.8)
2011	75.2	6.4	3.1
2010	38.6	3.3	N/A

¹Reinstatement premiums associated with the catastrophe losses have been added back to net premiums earned to calculate the loss ratio impact for 2012.

The increase in the GAAP underwriting ratio of 0.7 points in 2012 compared to last year was primarily related to: (i) the \$4.6 million reduction in NPE associated with the catastrophe reinstatement premium; and (ii) higher supplemental commissions to agents.

The following is a discussion of our most significant standard Commercial Lines of business:

General Liability

(\$ in thousands)	2012	2011	2012 vs. 2011	2010	2011 vs. 2010	
Statutory NPW	\$387,888	351,561	10	% 323,276	9	%
Direct new business	66,826	59,135	13	56,672	4	
Retention	81	% 79	2	pts 78	1	pts
Renewal pure price increases	6.9	% 3.7	3.2	4.2	(0.5))
Statutory NPE	373,381	344,682	8	% 336,475	2	%
Statutory combined ratio	102.7	% 100.7	2.0	pts 96.4	4.3	pts
% of total statutory standard commercial NPW	31	% 30		29		

The growth in NPW and NPE for our general liability business in 2012 and 2011 reflect: (i) renewal pure price increases; (ii) stronger retention; (iii) higher new business; and (iv) improvements in audit and endorsement premium which increased NPW by \$9.1 million in 2012. We returned premiums to customers of \$3.9 million in 2011 and \$24.6 million in 2010.

The fluctuations in the statutory combined ratios were in part, due to changes in prior year development. Prior year development can be volatile year to year and, therefore, requires a longer period of time before true trends are fully recognized. The impact of the prior year development was as follows:

2012: unfavorable by 0.8 points, driven by increased severities in the 2010 and 2011 accident years.. This unfavorable development was largely offset by continued favorable development in the premises and products coverages in accidents years 2007 and 2009, which showed lower frequencies of large losses, particularly in the umbrella coverage.

2011: favorable by 3.3 points, driven by accident years 2006 through 2009, which showed generally lower frequencies.

2010: favorable by 7.9 points, driven by accident years 2006 through 2009, which showed generally lower frequencies.

Commercial Automobile

			2012		2011	
(\$ in thousands)	2012	2011	vs. 2011	2010	vs. 2010	
Statutory NPW	\$295,651	282,825	5	% 281,365	1	%
Direct new business	50,084	45,472	10	43,693	4	
Retention	82	% 81	1	pts 79	2	pts
Renewal pure price increases	5.1	% 1.7	3.4	2.9	(1.2))
Statutory NPE	288,010	279,610	3	% 291,495	(4))%
Statutory combined ratio	97.1	% 94.2	2.9	pts 90.2	4.0	pts
% of total statutory standard commercial NPW	23	% 24		25		

NPW increased in 2012 compared to 2011 driven by higher renewal pure prices and retention. NPW remained relatively flat in 2011 compared to 2010. NPE decreased in 2011 compared to 2010, reflecting the economic factors that put pressure on NPW as exposure levels declined in 2010.

The fluctuations in the statutory combined ratio were driven by favorable prior year casualty development as follows:
2012: 2.6 points driven by the 2009 accident year, representing a continued trend driven by better than expected reported emergence. This was partially offset by unfavorable development in the 2011 accident year, due to higher frequency of claims.

2011: 4.6 points, driven by the 2007 through 2009 accident years, representing a continued trend driven by lower frequencies in those years.

2010: 9.6 points, driven by lower than anticipated severity primarily in accident years 2004 through 2009.

Workers Compensation

			2012		2011	
(\$ in thousands)	2012	2011	vs. 2011	2010	vs. 2010	
Statutory NPW	\$263,767	261,348	1	% 237,409	10	%
Direct new business	44,417	46,104	(4)	) 46,758	(1))
Retention	81	% 79	2	pts 78	1	pts
Renewal pure price increases	8.0	% 3.6	4.4	2.2	1.4	
Statutory NPE	262,108	259,354	1	% 250,456	4	%
Statutory combined ratio	114.5	% 116.2	(1.7)	)pts 124.2	(8.0)	)pts
% of total statutory standard commercial NPW	21	% 22		21		

NPW remained relatively flat in 2012 compared to last year while NPW increased in 2011 compared to 2010. The 2011 NPW growth was favorably impacted by audit and endorsement additional premium of \$11.2 million in 2011 compared to return premium of \$20.5 million in 2010.

The fluctuations in the statutory combined ratio were primarily attributable to the impact of prior year casualty development as follows:

2012: unfavorable by 1.1 points, driven by the 2011 accident year, due to an increase in the ultimate severity, partially offset by accident years 2007 and 2008, due to a decrease in expected severity for those years.

2011: unfavorable by 2.7 points, driven by the 2010 accident year, representing a continued trend related to increased severities in recent years, partially offset by various earlier accident years.

2010: unfavorable by 8.3 points, driven by increased severity in the 2008 and 2009 accident years.

Commercial Property

(\$ in thousands)	2012	2011	2012 vs. 2011	2010	2011 vs. 2010	
Statutory NPW	\$213,321	195,927	9	% 194,382	1	%
Direct new business	44,553	35,673	25	35,516	—	
Retention	81	% 80	1	pts 78	2	pts
Renewal pure price increases	4.5	% 1.7	2.8	2.1	(0.4)
Statutory NPE	202,340	192,989	5	% 199,252	(3)%
Statutory combined ratio	99.1	% 109.9	(10.8	)pts 93.7	16.2	pts
% of total statutory standard commercial NPW	17	% 16		17		

NPW increased in 2012 compared to 2011 primarily due to: (i) growth in new business; (ii) increases in retention; and (iii) renewal pure price increases. NPW were relatively flat in 2011 compared to 2010.

The fluctuations in the statutory combined ratios over the three-year period were largely due to fluctuations in catastrophe losses as shown below:

(\$ in millions)

For the Year Ended	Catastrophe Losses Incurred	Impact on Loss Ratio ¹	Year-Over-Year Change
December 31, 2012	\$35.2	17.1	pts (13.8)
2011	59.7	30.9	14.9
2010	31.8	16.0	N/A

¹Reinstatement premiums associated with the catastrophe losses have been added back to net premiums earned to calculate the loss ratio impact for 2012.

Standard Personal Lines

(\$ in thousands)	2012	2011	2012 vs. 2011	2010	2011 vs. 2010	
GAAP Insurance Operations Results:						
NPW	\$289,848	\$273,212	6	% 256,665	6	%
NPE	279,555	264,452	6	242,316	9	
Less:						
Losses and loss expenses incurred	204,644	239,455	(15	) 191,749	25	
Net underwriting expenses incurred	78,425	71,968	9	70,721	2	
Underwriting loss	\$(3,514	) \$(46,971	) 93	% (20,154	) (133)%
GAAP Ratios:						
Loss and loss expense ratio	73.2	% 90.5	(17.3	)pts 79.1	11.4	pts
Underwriting expense ratio	28.1	27.3	0.8	29.2	(1.9)
Combined ratio	101.3	117.8	(16.5	) 108.3	9.5	
Statutory Ratios:						
Loss and loss expense ratio	73.1	90.5	(17.4	) 79.2	11.3	
Underwriting expense ratio	27.6	26.8	0.8	27.2	(0.4)
Combined ratio	100.7	% 117.3	(16.6)pts 106.4	10.9	pts

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The growth in NPW and NPE for our Personal Lines business in 2012 and 2011 reflected renewal pure price and retention increases as follows:

(\$ in millions)	2012		2011		2010	
Retention	86	%	86	%	85	%
Renewal pure price increase	6.7		6.3		5.3	
Catastrophe reinstatement premiums	(3.9	)	(0.3)	—	

In addition, new direct business added \$11.8 million of growth over 2010.

The GAAP loss and loss expense ratio decreased 17.3 points in 2012 compared to 2011 driven by: (i) the rate we have achieved on this book which has increased average premium per unit of exposure; (ii) a decrease in property losses, including a slight decrease in catastrophe losses; (iii) flood claims handling fees earned from our participation in the National Flood Insurance Program primarily related to Hurricane Sandy; and (iv) favorable prior year development.

The 11.4 point increase in the GAAP loss and loss expense ratio in 2011 compared to 2010 was primarily attributable to higher property losses including an unprecedented level of catastrophe losses.

The following table provides quantitative information regarding the catastrophe losses and the related flood claims handling fees:

(\$ in millions) For the Year Ended December 31,	Catastrophes		Flood Claim Revenues			Total Impact on Year-Over-Year Loss Ratio ¹ Change	
	Losses Incurred	Impact on Loss Ratio	Revenue Earned	Impact on Loss Ratio			
2012	40.5	14.3	pts 18.3	(6.5	)pts	7.8	(6.0
2011	43.6	16.5	7.1	(2.7	)	13.8	7.5
2010	17.9	7.4	2.8	(1.1	)	6.3	N/A

¹Reinstatement premiums associated with the catastrophe losses have been added back to net premiums earned to calculate the loss ratio impact for 2012.

The increase in the GAAP underwriting ratio of 0.8 points in 2012 compared to last year was primarily due to the catastrophe reinstatement premium.

E&S Insurance Operations

Our E&S Insurance Operations segment, which represents 7% of our combined insurance operations NPW, sells Commercial Lines insurance products and services in all 50 states and the District of Columbia through approximately 95 wholesale general agents. Insurance policies in this segment typically cover business risks with unique characteristics, such as the nature of the business or its claim history, that are difficult to profitably insure in the standard commercial lines market. E&S insurers have more flexibility in coverage terms and rates compared to standard market insurers, generally resulting in policies with higher rates and terms and conditions that are customized for specific risks.

(\$ in thousands)	2012	2011	2012 vs. 2011	
GAAP Insurance Operations Results:				
NPW	\$ 113,297	\$ 24,133	369	%
NPE	79,229	3,914	1,924	
Less:				
Losses and loss expenses incurred	63,203	3,172	1,893	
Net underwriting expenses incurred	35,584	7,403	381	
Underwriting loss	\$(19,558)	\$(6,661)	(194))%
GAAP Ratios:				
Loss and loss expense ratio	79.8	% 81.0	(1.2	)pts
Underwriting expense ratio	44.9	189.2	(144.3)
Combined ratio	124.7	270.2	(145.5)
Statutory Ratios:				
Loss and loss expense ratio	79.3	81.0	(1.7)

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Underwriting expense ratio	39.5	50.3	(10.8)
Combined ratio	118.8	% 131.3	(12.5)pts

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NPW and NPE in 2011 reflect E&S premiums that were generated from our August 2011 purchase of the renewal rights to an E&S book of business. As we purchased only the renewal rights to this book, all unearned premium reserves at the date of purchase remained with the selling entity and our premiums represent only those written on the renewal book subsequent to our acquisition. The increase in NPW and NPE in 2012 compared to 2011 reflects the increase in premiums written relative to this renewal book as well as additional premiums written as a result of an additional E&S acquisition on December 31, 2011. On December 31, 2011 we purchased a wholly-owned E&S subsidiary of Montpelier Re Holdings Ltd. This company, Mesa Underwriters Specialty Insurance Company (“MUSIC”) provides us with a nationally authorized platform to write E&S business.

Our E&S business is a small operation whose combined ratio is significantly impacted by volatility in loss and loss expenses, as well as underwriting expenses. The lower combined ratio in 2012 reflects a decrease in the initial start-up expenditures as well as the increased premium volume at full operations. Our focus in 2012 was integrating these operations, as well as reviewing the in-force business and we continue to effectively manage shared services and apply our best practices for underwriting and pricing of this business. As we continue to grow this business, we expect to generate a combined ratio between 100% and 102% in 2013.

Reinsurance: Standard and E&S Insurance Operations Segments

We have reinsurance contracts that separately cover our property and casualty insurance business. We use traditional forms of reinsurance and do not utilize finite risk reinsurance. Available reinsurance can be segregated into the following key categories: