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MERCHANTS GROUP INC  
Form 10-Q  
November 13, 2001

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

Form 10-Q  
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QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)  
OF THE SECURITIES EXCHANGE ACT OF 1934  
OR  
 TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d)  
OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE TRANSITION PERIOD FROM \_\_\_\_\_ TO \_\_\_\_\_.

FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2001

COMMISSION FILE NUMBER 1-9640  
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MERCHANTS GROUP, INC.  
(Exact name of registrant as specified in its charter)

DELAWARE  
(State or other jurisdiction of incorporation or organization)

16-1280763  
(I.R.S. Employer Identification No.)

250 MAIN STREET, BUFFALO, NEW YORK  
(Address of principal executive offices)

14202  
(Zip Code)

716-849-3333  
(Registrant's telephone number, including area code)

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of October 31, 2001.

2,217,852 SHARES OF COMMON STOCK.

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Item 1. Financial Statements

MERCHANTS GROUP, INC.

CONSOLIDATED BALANCE SHEET

(in thousands)

ASSETS -----	December 31, 2000 -----
Investments:	
Fixed maturities:	
Held to maturity at amortized cost (fair value \$13,576 in 2000 and \$14,271 in 2001)	\$ 12,874
Available for sale at fair value (amortized cost \$183,392 in 2000 and \$190,238 in 2001)	183,283
Preferred stock at fair value	13,911
Other long-term investments at fair value	1,036
Short-term investments	4,550
	-----
Total investments	215,654
Cash	5
Interest due and accrued	2,816
Premiums receivable, net of allowance for doubtful accounts of \$395 in 2000 and \$426 in 2001	19,843
Receivable from affiliate	-
Deferred policy acquisition costs	12,331
Ceded reinsurance balances receivable	13,089
Prepaid reinsurance premiums	4,326
Deferred income taxes	6,263
Other assets	7,537
	-----
Total assets	\$281,864 =====

See Notes to the Consolidated Financial Statements

MERCHANTS GROUP, INC.

CONSOLIDATED BALANCE SHEET

(in thousands except share amounts)

December 31,

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2000

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LIABILITIES AND STOCKHOLDERS' EQUITY

Liabilities:

Reserve for losses and loss adjustment expenses	\$ 145,075
Unearned premiums	50,857
Payable for securities	--
Payable to affiliate	608
Other liabilities	15,202
	-----

Total liabilities	211,742
	-----

Stockholders' equity:

Common stock, 10,000,000 shares authorized, 2,430,752 shares issued and outstanding at December 31, 2000 and 2,313,852 shares issued and outstanding at September 30, 2001	32
Additional paid in capital	35,680
Treasury stock, 811,100 shares at December 31, 2000 and 928,000 shares at September 30, 2001	(16,063)
Accumulated other comprehensive income (loss)	(875)
Accumulated earnings	51,348
	-----

Total stockholders' equity	70,122
	-----

Commitments and contingent liabilities	--
--	----

Total liabilities and stockholders' equity	\$ 281,864
	=====

See Notes to the Consolidated Financial Statements

MERCHANTS GROUP, INC.

CONSOLIDATED STATEMENT OF OPERATIONS

(in thousands except per share amounts)

Three Months

Nin

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	Ended September 30, 2000 ----	2001 ----	Ended 2000 ---- (unaudited)
<b>Revenues:</b>			
Net premiums earned	\$23,822	\$ 23,230	\$70,461
Net investment income	3,481	3,244	10,325
Net realized investment gains	104	30	109
Other revenues	81	161	163
	-----	-----	-----
Total revenues	27,488	26,665	81,058
	-----	-----	-----
<b>Expenses:</b>			
Net losses and loss adjustment expenses	17,387	20,298	51,583
Amortization of deferred policy acquisition costs	6,313	6,156	18,672
Other underwriting expenses	1,171	1,441	4,131
	-----	-----	-----
Total expenses	24,871	27,895	74,386
	-----	-----	-----
Income (loss) before income taxes	2,617	(1,230)	6,672
Income tax provision (benefit)	947	(421)	2,384
	-----	-----	-----
Net income (loss)	\$ 1,670	\$ (809)	\$ 4,288
	=====	=====	=====
Basic and diluted earnings (loss) per share	\$ .68	\$ (.35)	\$ 1.71
	=====	=====	=====
<b>Weighted average shares outstanding:</b>			
Basic	2,457	2,317	2,501
Diluted	2,459	2,321	2,503

See Notes to the Consolidated Financial Statements

MERCHANTS GROUP, INC.

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME (LOSS)

(in thousands)

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	Three Months Ended September 30,		2
	2000	2001	
	-----	-----	-----
			(unaudited)
Net income (loss)	\$ 1,670	\$ (809)	\$ 4
	-----	-----	-----
Other comprehensive income (loss) before taxes:			
Unrealized gains (losses) on securities	593	1,276	
Reclassification adjustment for gains and losses included in net income	(100)	(28)	
	-----	-----	-----
Other comprehensive income (loss) before taxes	493	1,248	
Income tax provision (benefit) related to items of other comprehensive income	186	464	
	-----	-----	-----
Other comprehensive income (loss)	307	784	
	-----	-----	-----
Comprehensive income (loss)	\$ 1,977	\$ (25)	\$ 4
	=====	=====	=====

See Notes to the Consolidated Financial Statements

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MERCHANTS GROUP, INC.

CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY

(in thousands)

Nine Months  
Ended September 3  
2000  
-----

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(unaudited)

Common stock, beginning and end	\$ 32
	-----
Additional paid in capital beginning and end:	35,680
	-----
Treasury stock:	
Beginning of period	(13,139)
Purchase of treasury shares	(2,695)
	-----
End of period	(15,834)
	-----
Accumulated other comprehensive income (loss):	
Beginning of period	(1,188)
Other comprehensive income	5
	-----
End of period	(1,183)
	-----
Accumulated earnings:	
Beginning of period	48,002
Net income	4,288
Cash dividends	(749)
	-----
End of period	51,541
	-----
Total stockholders' equity	\$ 70,236
	=====

See Notes to the Consolidated Financial Statements

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MERCHANTS GROUP, INC.

CONSOLIDATED STATEMENT OF CASH FLOWS

(in thousands)

Nine Months  
 Ended September  
 2000  
 -----

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(unaudited)

Cash flows from operations:	
Collection of premiums	\$ 70,333
Payment of losses and loss adjustment expenses	(50,443)
Payment of other underwriting expenses	(23,845)
Investment income received	9,850
Investment expenses paid	(304)
Income taxes paid	(2,059)
Other	163
	-----
Net cash provided by (used in) operations	3,695
	-----
Cash flows from investing activities:	
Proceeds from fixed maturities sold or matured	50,975
Purchase of fixed maturities	(46,057)
Net (increase) decrease in preferred stock	(961)
Net (increase) decrease in other long-term investments	(64)
Net (increase) decrease in short-term investments	(2,216)
	-----
Net cash provided by (used in) investing activities	1,677
	-----
Cash flows from financing activities:	
Settlement of affiliate balances	(897)
Cash borrowed to purchase securities	--
Decrease in demand loan, net	(1,025)
Purchase of treasury stock	(2,695)
Cash dividends	(749)
	-----
Net cash provided by (used in) financing activities	(5,366)
	-----
Increase in cash	6
Cash:	
Beginning of period	2
	-----
End of period	\$ 8
	=====

See Notes to the Consolidated Financial Statements

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MERCHANTS GROUP, INC.

CONSOLIDATED STATEMENT OF CASH FLOWS

RECONCILIATION OF NET INCOME TO NET CASH

PROVIDED BY (USED IN) OPERATIONS

(in thousands)

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	Nine Months Ended September 30, 2000 ----- (unaudited)
Net income	\$ 4,288
Adjustments:	
Accretion of bond discount	(382)
Realized investment gains	(109)
(Increase) decrease in assets:	
Interest due and accrued	(397)
Premiums receivable	(627)
Deferred policy acquisition costs	(236)
Ceded reinsurance balances receivable	(1,856)
Prepaid reinsurance premiums	(2,386)
Deferred income taxes	157
Other assets	97
Increase (decrease) in liabilities:	
Reserve for losses and loss adjustment expenses	2,713
Unearned premiums	3,277
Other liabilities	(844)
	-----
Net cash provided by (used in) operations	\$ 3,695 =====

See Notes to the Consolidated Financial Statements

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MERCHANTS GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. PRINCIPLES OF CONSOLIDATION AND BASIS OF PRESENTATION

The consolidated balance sheet as of September 30, 2001 and the related consolidated statements of operations, of comprehensive income, of changes in stockholders' equity and of cash flows for the three and nine month periods ended September 30, 2000 and 2001, respectively, are unaudited. In the opinion of management, the interim financial statements reflect all adjustments necessary for a fair presentation of financial position and results of operations. Such adjustments consist only of normal recurring items. Interim results are not necessarily indicative of results for a full year.

The consolidated financial statements include the accounts of Merchants Group,



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Inc. (the Company), its wholly-owned subsidiary, Merchants Insurance Company of New Hampshire, Inc. (MNH), and M.F.C. of New York, Inc., an inactive premium finance company which is a wholly-owned subsidiary of MNH. The accompanying consolidated financial statements should be read in conjunction with the following notes and the Notes to Consolidated Financial Statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2000.

The consolidated financial statements have been prepared in conformity with generally accepted accounting principles (GAAP) which differ in some respects from those followed in reports to insurance regulatory authorities. All significant intercompany balances and transactions have been eliminated.

### 2. RELATED PARTY TRANSACTIONS

The Company and MNH have no paid employees. Under a management agreement dated September 29, 1986 (the Management Agreement), Merchants Mutual Insurance Company (Mutual), which owned 11.0% of the Company's common stock at September 30, 2001, provides the Company and MNH with the facilities, management and personnel required to manage their day-to-day business. All underwriting, administrative, claims and investment expenses incurred on behalf of Mutual and MNH are shared on an allocated cost basis, determined as follows: for underwriting and administrative expenses, the respective share of total direct premiums written for Mutual and MNH serves as the basis of allocation; for claims expenses, the average number of outstanding claims is used; investment expenses are shared based on each company's share of total invested assets.

### 3. EARNINGS PER SHARE

Basic and diluted earnings per share were computed by dividing net income or loss by the weighted average number of shares of common stock outstanding during each period, increased by the assumed exercise of 8,000 shares of common stock options for the three and nine month periods in 2000 and the nine month period in 2001 and by the assumed exercise of 43,500 shares of common stock options for the three month period in 2001. The common stock options assumed to be exercised would have resulted in

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3,953 and 1,489 additional shares outstanding for the three month periods ended September 30, 2001 and 2000, respectively, and 2,229 and 1,432 additional shares outstanding for the nine month periods ending September 30, 2001 and 2000, respectively, assuming the proceeds to the Company from exercise were used to purchase shares of the Company's common stock at its average market value per share during the respective period.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

RESULTS OF OPERATIONS FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2001 AS COMPARED TO THE NINE MONTHS ENDED SEPTEMBER 30, 2000

Total revenues for the nine months ended September 30, 2001 were \$80,543,000, a decrease of \$515,000 or less than 1%, from \$81,058,000 for the nine months ended September 30, 2000.

Direct premiums written for the nine months ended September 30, 2001 were \$75,872,000, a decrease of \$6,420,000 or 8%, from \$82,292,000 for the nine months ended September 30, 2000. Voluntary direct premiums written for the nine months ended September 30, 2001 were \$72,770,000, a decrease of \$8,602,000 or

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11%, from \$81,372,000 for the nine months ended September 30, 2000.

Voluntary personal lines direct premiums written for the nine months ended September 30, 2001 were \$29,614,000, an increase of \$1,104,000 or 4%, from \$28,510,000 for the nine months ended September 30, 2000. Private passenger automobile (PPA) direct premiums written, which represented 74% and 75% of total voluntary personal lines direct premiums written for the nine months ended September 30, 2001 and 2000, respectively, increased 3% from the year earlier period. Homeowners direct premiums written for the nine months ended September 30, 2001 increased 7% compared to the nine months ended September 30, 2000 primarily due to a 7% increase in policies in force at September 30, 2001 as compared to September 30, 2000.

The Company implemented a program to underwrite specialized commercial auto insurance (the Auto Program) during the quarter ended June 30, 2000. All policies issued under the Auto Program were 100% reinsured through certain Lloyds syndicates and therefore had no impact on net premiums written, net premiums earned or net losses and loss adjustment expenses (LAE) incurred by the Company. The Company recorded all direct underwriting expenses incurred, including commissions with respect to the acquisition of these policies, which were offset by reinsurance commission income. The Auto Program was discontinued in 2001 and had no impact on current year net income.

Voluntary commercial lines direct premiums written for the nine months ended September 30, 2001 were \$43,156,000, a decrease of \$9,705,000 or 18%, from \$52,861,000 for the nine months ended September 30, 2000. This decrease was attributable in part to the aforementioned discontinuation of the Auto Program, which produced \$5,235,000 of direct written premiums in the nine months ended September 30, 2000.

The Company continues to experience higher loss frequency for certain of its commercial lines of business not adequately covered by premiums collected from those lines of business. As a response to these higher

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losses, the Company has filed for and received approval of rate increases in certain lines of business, revised its underwriting guidelines, and removed discretionary pricing credits where warranted. As a consequence of these actions, voluntary commercial lines direct premiums written, excluding Auto Program premiums written, for the nine months ended September 30, 2001 decreased \$4,486,000 or 9%, to \$43,140,000 from \$47,626,000 for the nine months ended September 30, 2000. Direct premiums written for all of the Company's commercial lines of business, except commercial package policies, decreased in the nine months ended September 30, 2001 compared to the nine months ended September 30, 2000. Commercial lines policies in force at September 30, 2001 decreased 17% compared to commercial lines policies in force at September 30, 2000.

The Company intends to continue to reduce direct written premiums in business segments that it believes can no longer provide the opportunity to earn a satisfactory return for its shareholders. The Company estimates that its voluntary direct written premiums will decline in 2002 with further reductions possible thereafter.

Involuntary direct premiums written, primarily PPA insurance, which comprised 4% and 1% of all direct premiums written during the nine months ended September 30, 2001 and 2000, respectively, increased by \$2,182,000, or 237%, to \$3,102,000 for the nine months ended September 30, 2001 from \$920,000 for the nine months ended September 30, 2000. The Company believes it is likely that, due to a decrease in

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the willingness of several major competitors to insure non-standard business voluntarily, the number of policies written by the New York Automobile Insurance Plan (NYAIP) will continue to increase and therefore the amount of the Company's involuntary direct written premiums will also continue to increase. However, the Company is unable to predict the volume of future assignments from the NYAIP.

Net premiums written decreased \$1,043,000, or 1%, to \$70,309,000 for the nine months ended September 30, 2001 from \$71,352,000 for the nine months ended September 30, 2000, due to a 2% decrease in non-Auto Program direct premiums written.

Net premiums earned for the nine months ended September 30, 2001 were \$69,737,000, a decrease of 1% from \$70,461,000 for the nine months ended September 30, 2000. This decrease is attributable to the 1% decrease in net premiums written.

Net investment income was \$10,279,000 for the nine months ended September 30, 2001, a decrease of \$46,000 or less than 1% from \$10,325,000 for the nine months ended September 30, 2000. A 1% increase in average invested assets for the nine months ended September 30, 2001 was more than offset by a decrease in the average pre-tax investment portfolio yield to 6.67% for the nine months ended September 30, 2001.

Other revenues were \$415,000 for the nine months ended September 30, 2001, an increase of \$252,000, or 155%, from \$163,000 for the nine months ended September 30, 2000. This increase resulted from an increase in installment fee income and a decrease in charge-offs related to uncollectible premiums receivable. The reduction in charge-offs related to a decline in the average age of the Company's premium receivable.

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Losses and LAE were \$56,679,000 for the nine months ended September 30, 2001, an increase of \$5,096,000 or 10%, from \$51,583,000 for the nine months ended September 30, 2000. The loss and LAE ratio increased to 81.3% for the nine months ended September 30, 2001 from 73.2% for the nine months ended September 30, 2000. Losses and LAE for the nine months ended September 30, 2001 include \$1,990,000 of losses and LAE related to the September 11, 2001 terrorist attacks on the World Trade Center ("WTC") in New York City. The Company had written 27 policies, primarily businessowners policies in the WTC and in lower Manhattan. The Company's estimate for losses related to the WTC event was derived using various actuarial techniques, as well as analyses of the claims received to date and of the policies in force in the affected area for which no claims have been received. The WTC event added 2.9 percentage points to the loss and LAE ratio for the nine months ended September 30, 2001.

Excluding the effect of the WTC event, the loss and LAE ratio increased 5.2 percentage points to 78.4 for the nine months ended September 30, 2001 from 73.2 for the nine months ended September 30, 2000. This increase in the loss and LAE ratio resulted from increased claim frequency and severity experienced in 2001, primarily for private passenger automobile, commercial automobile and workers' compensation policies.

The ratio of amortized deferred policy acquisition costs and other underwriting expenses to net premiums earned were 32.8% and 32.4% for the nine month periods ended September 30, 2001 and 2000, respectively. Commissions, premium taxes and other state assessments that vary directly with the Company's premium volume represented 20.3% of net premiums earned in the nine months ended September 30, 2001 compared to 20.0% for the nine months ended September 30, 2000.

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The Company's effective income tax rate for the nine months ended September 30, 2001 was 38.7%. This rate was calculated based upon the Company's estimate of its effective income tax rate for all of 2001.

### RESULTS OF OPERATIONS FOR THE THREE MONTHS ENDED SEPTEMBER 30, 2001 AS COMPARED TO THE THREE MONTHS ENDED SEPTEMBER 30, 2000

Total revenues for the three months ended September 30, 2001 were \$26,665,000, a decrease of \$823,000, or 3%, from \$27,488,000 for the three months ended September 30, 2000.

Voluntary personal lines direct premiums written for the three months ended September 30, 2001 were \$11,009,000, an increase of \$516,000, or 5%, from \$10,493,000 for the three months ended September 30, 2000. PPA direct premiums written increased 4% from the year earlier period, primarily due to a 3% increase in average premium per policy. Homeowners direct premiums written for the three months ended September 30, 2001 increased 8% compared to the three months ended September 30, 2000 primarily due to a 7% increase in policies in force.

Voluntary commercial lines direct premiums written excluding Auto Program premiums written for the three months ended September 30, 2001 were \$13,549,000, a decrease of \$936,000, or 6%, from \$14,485,000 for the three months ended September 30, 2000. This decrease in commercial lines direct written premiums is attributable to the same factors affecting voluntary commercial lines direct premiums

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written for the nine months ended September 30, 2001, and is expected to continue as discussed earlier in this item.

Involuntary direct premiums written for the three months ended September 30, 2001 were \$1,579,000, an increase of \$1,215,000, or 334%, from \$364,000 for the three months ended September 30, 2000. Involuntary written premiums are affected by the size of the involuntary markets in which the Company operates, primarily the New York Automobile Insurance Plan.

Net investment income was \$3,244,000 for the three months ended September 30, 2001, a decrease of \$237,000 or 7% from \$3,481,000 for the three months ended September 30, 2000, primarily due to a 29 basis point decrease in the average pre-tax investment portfolio yield to 6.51%.

Losses and LAE were \$20,298,000 for the three months ended September 30, 2001, an increase of \$2,911,000, or 17%, from \$17,387,000 for the three months ended September 30, 2000. The loss and LAE ratio increased to 87.4% for the three months ended September 30, 2001 from 73.0% for the three months ended September 30, 2000. The increase in the loss and LAE ratio is attributable to the same factors affecting losses and LAE for the nine months ended September 30, 2001 discussed earlier in this item. Excluding the impact of the WTC event, the loss and LAE ratio for the three months ended September 30, 2001 would have been 78.8%.

The ratio of amortized deferred policy acquisition costs and other underwriting expenses to net premiums earned increased to 32.7% for the three months ended September 30, 2001 from 31.4% for the three months ended September 30, 2000 primarily due to a \$300,000 increase in accrued contingent commissions payable related to the Company's profit sharing program with its agents. Commissions,

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premium taxes and other state assessments that vary with the Company's premium volume represented 20.1% of net premiums earned in the three months ended September 30, 2001 compared to 19.6% for the three months ended September 30, 2000. This increase was attributable to the aforementioned increase in contingent commissions.

### LIQUIDITY AND CAPITAL RESOURCES

In developing its investment strategy, the Company determines a level of cash and short-term investments which, when combined with expected cash flow, is estimated to be adequate to meet expected cash obligations. Historically, the excess of premiums collected over payments on claims, combined with cash flow from investments, has provided the Company with short-term funds in excess of normal operating demands for cash. However, the Company's intention to continue to reduce direct written premiums in business segments where returns are unsatisfactory will likely result in future negative cash flows from operations. The Company believes that careful management of the relationship between assets and liabilities will minimize the likelihood that investment portfolio sales will be necessary to fund insurance operations and that the effect of any such sale on the Company's surplus will not be material. Further, the Company believes that the WTC event will not require any unplanned liquidation of its investment portfolio.

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The Company's objectives with respect to its investment portfolio include maximizing total returns within investment guidelines while protecting stockholders' equity and maintaining flexibility. Like other property and casualty insurers, the Company relies on premiums as a major source of cash, and therefore liquidity. Cash flows from the Company's investment portfolio, either in the form of interest or principal payments, are an additional source of liquidity. Because the duration of the Company's investment portfolio relative to the duration of its liabilities are closely managed, increases or decreases in market interest rates are not expected to have a material effect on the Company's liquidity or its results of operations.

The Company generally designates newly acquired fixed maturity investments as available for sale and carries these investments at fair value. Unrealized gains and losses related to these investments are recorded as a component of accumulated other comprehensive income within stockholders' equity. At September 30, 2001, the Company had recorded \$1,897,000 of unrealized gains, net of taxes, associated with its investments classified as "available for sale" as accumulated other comprehensive income. During the nine months ended September 30, 2001 the Company recorded \$2,772,000 of unrealized gains, net of tax, associated with its available for sale investments as other comprehensive income.

At September 30, 2001, the Company's portfolio of fixed maturities represented 89.9% of invested assets. Management believes that this level of bond holdings is consistent with the Company's liquidity needs because it anticipates that cash receipts from net premiums written and investment income will enable the Company to satisfy its cash obligations. Furthermore, a portion of the Company's bond portfolio is invested in mortgage-backed and other asset-backed securities which, in addition to interest income, provide monthly paydowns of bond principal.

At September 30, 2001, \$76,402,000, or 33.2%, of the Company's fixed maturity portfolio was invested in mortgage-backed and other asset backed securities. The Company invests in a variety of collateralized mortgage obligation (CMO)

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products but has not invested in the derivative type of CMO products such as interest only, principal only or inverse floating rate securities. All of the Company's CMO investments have an active secondary market and their effect on the Company's liquidity does not differ from that of other fixed maturity investments. The Company does not own any other derivative financial instruments.

At September 30, 2001, \$10,302,000, or 4.5% of the Company's investment portfolio was invested in non-investment grade securities compared to \$9,480,000, or 4.5% at September 30, 2000. All of the Company's non-investment grade securities are currently performing to the Company's purchase expectations.

During the nine months ended September 30, 2001, the Company repurchased 116,900 shares of its common stock at an average price per share of \$18.49. The Company was holding 928,000 shares of its common stock in treasury at September 30, 2001.

The Company has arranged for a \$2,000,000 unsecured credit facility from a bank in the form of a master grid note. Any borrowings under this facility are payable on demand and carry an interest rate which can be fixed or variable and is negotiated at the time of each advance. This facility is available for general

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working capital purposes and for repurchases of the Company's common stock. At September 30, 2001, no amount was outstanding on this loan.

As a holding company, the Company is dependent on cash dividends from MNH to meet its obligations, pay any cash dividends and repurchase its shares. MNH is subject to New Hampshire insurance laws which place certain restrictions on its ability to pay dividends without the prior approval of state regulatory authorities. These restrictions limit dividends to those that, when added to all other dividends paid within the preceding twelve months, would not exceed 10% of the insurer's statutory policyholders' surplus as of the preceding December 31st. The maximum amount of dividends that MNH could pay during any twelve month period ending in 2001 without the prior approval of the New Hampshire Insurance Commissioner is \$5,061,000. MNH has paid \$5,060,000 of dividends to the Company in 2001.

MNH paid dividends in February 2001, May 2001 and September 2001, of \$2,200,000, \$1,350,000 and \$1,510,000, respectively, and as such is restricted from paying another dividend to the Company until February 2002. The Company has paid cash dividends to its common stockholders of \$.30 per share in 2001 amounting to \$704,000.

Under the Management Agreement, Mutual provides employees, services and facilities for MNH to conduct its insurance business on a cost reimbursed basis. The balance in the payable to or receivable from affiliate account represents the amount owing to or owed by Mutual to the Company for the difference between premiums collected and payments made for losses, employees, services and facilities by Mutual on behalf of MNH.

Industry and regulatory guidelines suggest that the ratio of a property-casualty insurer's annual net premiums written to its statutory surplus should not exceed 3 to 1. MNH has consistently followed a business strategy that would allow it to meet this 3 to 1 regulatory guideline. For the first nine months of 2001, MNH's ratio of net premiums written to statutory surplus, annualized for a full year,

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was 1.8 to 1.

### RELATIONSHIP WITH MUTUAL

The Company's and MNH's business and day-to-day operations are closely aligned with those of Mutual. This is the result of a combination of factors. Mutual has had a historical ownership interest in the Company and MNH. Prior to November 1986 MNH was a wholly-owned subsidiary of Mutual. Following the Company's initial public offering in November 1986 and until a secondary stock offering in July 1993 the Company was a majority-owned subsidiary of Mutual. Mutual currently owns 11.0% of the Company's common stock. Under the Management Agreement, Mutual provides the Company and MNH with all facilities and personnel to operate their business. The only officers of the Company or MNH who are paid full time employees are employees of Mutual whose services are purchased under the Management Agreement. Also, the operation of the Company's insurance business, which offers substantially the same lines of insurance as Mutual through the same independent insurance agents, creates a very close relationship among the companies.

During 1998, Mutual initiated discussions with the Company concerning proposals for the acquisition of the Company by Mutual. The Company determined that the terms proposed by Mutual were inadequate. The Company also determined that the Management Agreement prevents the Company's shareholders

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from realizing the Company's fair value in a sale or merger, and on July 23, 1998 the Company gave notice to Mutual of its intention to terminate the Management Agreement. The provisions of the Management Agreement require five year's prior written notice for its termination. The Company does not expect the notice of termination to have any material, short-term effect on the Company's operations. However, the Company believes that the Management Agreement, as currently written, creates conflicts of interest between the Company and Mutual in their joint operations and prevents the Company's shareholders from realizing the fair value of their shares.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

MARKET RISK

Market risk represents the potential for loss due to changes in the fair value of financial instruments. The market risk related to the Company's financial instruments primarily relates to its investment portfolio. The value of the Company's investment portfolio of \$229,619,000 at September 30, 2001 is subject to changes in interest rates and to a lesser extent on credit quality. Further, certain mortgage-backed and asset-backed securities are exposed to accelerated prepayment risk generally caused by interest rate movements. When interest rates decline, mortgage holders are more likely to refinance existing mortgages at lower rates. Acceleration of future repayments could adversely affect future investment income, if reinvestment of the accelerated receipts was made in lower yielding securities.

The following table provides information related to the Company's fixed maturity investments at September 30, 2001. The table presents cash flows of principal amounts and related weighted average interest rates by expected maturity dates. The cash flows are based upon the maturity date or, in the case of mortgage-backed and asset-backed securities, expected payment patterns. Actual cash flows could differ from those shown in the table.

Fixed Maturities

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Expected Cash Flows of Principal Amounts (\$ in 000's):

Held to Maturity	2001	2002	2003	2004	2005
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Mortgage & asset backed securities	\$ 0	\$ 642	\$ 1,644	\$ 2,284	\$ 2,083
Average interest rate	0.0%	7.1%	7.0%	7.0%	7.0%
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Total	\$ 0	\$ 642	\$ 1,644	\$ 2,284	\$ 2,083
	=====	=====	=====	=====	=====
Available for Sale					
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U.S. Treasury securities and obligations of U.S. Government corporations and agencies	\$4,994	\$ 3,837	\$ 4,201	\$ 0	\$ 0
Average interest rate	5.3%	6.9%	4.1%	0.0%	0.0%
Obligations of states and political subdivisions	600	1,484	5,386	0	0
Average interest rate	5.0%	5.6%	5.3%	0.0%	0.0%
Corporate securities	8,644	23,495	36,652	1,093	0
Average interest rate	6.6%	7.2%	5.5%	19.2%	0.0%
Mortgage & asset backed securities	5,154	13,643	18,106	14,190	2,715
Average interest rate	6.3%	6.8%	6.0%	5.7%	5.9%
	-----	-----	-----	-----	-----
Total	\$ 19,392	\$ 42,459	\$ 64,345	\$ 15,283	\$ 2,715
	=====	=====	=====	=====	=====

The discussion and the estimated amounts referred to above include forward-looking statements of market risk which involve certain assumptions as to market interest rates and the credit quality of the fixed maturity investments. Actual future market conditions may differ materially from such assumptions. Accordingly, the forward-looking statements should not be considered projections of future events by the Company.

PART II. OTHER INFORMATION

Item 6. Exhibits and Reports On Form 8-K  
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(b) Reports on Form 8-K.

No reports on Form 8-K were filed during the period for which this report is filed.

\* \* \* \* \*

"Safe Harbor" Statement under the Private Securities Litigation Reform Act of 1995:

With the exception of historical information, the matters and statements discussed, made or incorporated by reference in this Quarterly Report on Form 10-Q constitute forward-looking statements and are discussed, made or incorporated by reference, as the case may be, pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Such forward-looking statements involve certain assumptions, risks and uncertainties that could cause actual results to differ materially from those included in or contemplated by the statements. These assumptions, risks and uncertainties include, but are not limited to, those associated with factors affecting the property-casualty insurance industry generally, including price competition, size and frequency of claims, increasing crime rates, escalating damage awards, natural disasters, fluctuations in interest rates and general business conditions; the Company's dependence on investment income; the geographic concentration of the Company's business in the Northeastern United States and in particular in New York, New Hampshire, New Jersey, Rhode Island, Pennsylvania and Massachusetts; the adequacy of the Company's loss reserves; government regulation of the insurance industry; exposure to environmental claims; dependence of the Company on its relationship with Mutual; the Company's intention to reduce written premium in business segments that it believes no longer provide a satisfactory return; and the other risks and uncertainties discussed or indicated in all documents filed by the Company with the Commission. The Company expressly disclaims any obligation to update any forward-looking statements as a result of developments occurring after the date of this report.

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SIGNATURES

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

MERCHANTS GROUP, INC.  
(Registrant)

Date: November 13, 2001

By: /s/ Kenneth J. Wilson  
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Kenneth J. Wilson  
Chief Financial Officer and  
Treasurer (duly authorized  
officer of the registrant and  
chief accounting officer)