HANOVER INSURANCE GROUP, INC.
Form 10-K
March 01, 2007
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-K

x ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended December 31, 2006

OR

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

Commission file number: 1-13754

THE HANOVER INSURANCE GROUP, INC.

(Exact name of registrant as specified in its charter)

Delaware	**04-3263626**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**
440 Lincoln Street, Worcester, Massachusetts	**01653**
(Address of principal executive offices)	**(Zip Code)**

Registrant s telephone number, including area code: (508) 855-1000

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
Common Stock, $.01 par value, together with Stock Purchase Rights	**New York Stock Exchange**
7 5/8% Senior Debentures due 2025	**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 x 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 x

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of the 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, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act (check one):

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

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

Based on the closing sales price of June 30, 2006 the aggregate market value of the voting and non-voting common stock held by non-affiliates of the registrant was $2,396,698,724.

The number of shares outstanding of the registrant s common stock, $.01 par value, was 51,271,040 shares as of February 16, 2007.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of The Hanover Insurance Group, Inc. s Proxy Statement relating to the 2007 Annual Meeting of Shareholders to be held May 15, 2007 to be filed pursuant to Regulation 14A are incorporated by reference in Part III.

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PART I

ITEM 1 BUSINESS

ORGANIZATION

The Hanover Insurance Group, Inc. (THG) is a holding company organized as a Delaware corporation in 1995. Our consolidated financial statements include the accounts of THG; The Hanover Insurance Company (Hanover Insurance) and Citizens Insurance Company of America (Citizens), which are our principal property and casualty subsidiaries; First Allmerica Financial Life Insurance Company (FAFLIC), which is our life insurance and annuity subsidiary; and certain other insurance and non-insurance subsidiaries. In addition, our results of operations prior to December 30, 2005 include Allmerica Financial Life Insurance and Annuity Company (AFLIAC). On December 30, 2005, we sold AFLIAC through a stock purchase agreement, and reinsured 100% of the variable life insurance and annuity business of FAFLIC (see Life Companies on pages 46 to 49 in Management s Discussion and Analysis of Financial Condition and Results of Operations for further information). The results of operations for AFLIAC are reported as discontinued operations.

FINANCIAL INFORMATION ABOUT OPERATING SEGMENTS

Our business includes financial products and services in two major areas: Property and Casualty, and Life Companies. Within these broad areas, we have ongoing operations principally in three operating segments. These segments are Personal Lines, Commercial Lines, and Other Property and Casualty. Our fourth operating segment, Life Companies, is in run-off. We report interest expense related to our corporate debt separately from the earnings of our operating segments. Corporate debt consists of our junior subordinated debentures and our senior debentures.

Information with respect to each of our segments is included in Segment Results on pages 35 to 49 in Management s Discussion and Analysis of Financial Condition and Results of Operations and in Note 16 on pages 106 to 108 of the Notes to the Consolidated Financial Statements included in Financial Statements and Supplementary Data of this Form 10-K.

DESCRIPTION OF BUSINESS BY SEGMENT

Following is a discussion of each of our operating segments.

PROPERTY AND CASUALTY

GENERAL

Our Property and Casualty group manages its operations principally through three segments, identified as Personal Lines, Commercial Lines and Other Property and Casualty. We underwrite personal and commercial property and casualty insurance through Hanover Insurance and Citizens, primarily through an independent agent network concentrated in the Midwest, Northeast, and Southeast United States. Additionally, our Other Property and Casualty segment consists of our premium financing business, our investment management services business and our voluntary pools business, in which we have not actively participated since 1995.

Our strategy in the Property and Casualty group focuses on the fundamentals of the business, namely disciplined underwriting, pricing, quality claim handling, strong agency relationships, active agency management, effective expense management and customer service. We have a strong regional focus. Our Property and Casualty group constituted the 31st largest property and casualty insurance group in the United States based on 2005 direct premiums written, according to A.M. Best.

RISKS

The industry s profitability and cash flow can be significantly affected by: price; competition; volatile and unpredictable developments such as extreme weather conditions and natural disasters, including catastrophes; legal developments affecting insurer and insureds liability; extra-contractual liability; size of jury awards; acts of terrorism; fluctuations in interest rates and other factors that may affect investment returns; and other general economic conditions and trends, such as inflationary pressures, that may affect the adequacy of reserves. Additionally, the economic conditions in geographic locations where we conduct business, especially those locations where our business is concentrated, may affect the profitability of our business. The regulatory environments in those locations where we conduct business, including any pricing, underwriting or product controls, shared market mechanisms or mandatory pooling arrangements, and other conditions, such as our agency relationships, may also affect the profitability of our business. In addition, our loss and loss adjustment expense (LAE) reserves are based on our

estimates, principally involving actuarial projections, at a given time, of what we expect the ultimate settlement and administration of claims will cost based on facts and circumstances then known, predictions of future events, estimates of future trends in claims

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frequency and severity and judicial theories of liability, costs of repairs and replacement, legislative activity and other factors. Changes to these estimates may affect our profitability.

Reference is also made to Item 1A Risk Factors on pages 21 to 23 and Risks and Forward-Looking Statements on page 67 of Management s Discussion and Analysis of Financial Condition and Results of Operations of this Form 10-K.

LINES OF BUSINESS

We underwrite personal and commercial property and casualty insurance coverage.

Personal Lines

Our Personal Lines segment accounted for $1.5 billion, or 57.1%, of consolidated segment revenues and provided $186.7 million of segment income before federal income taxes for the year ended December 31, 2006. Personal Lines comprised 61.9% of the Property and Casualty group s net written premium in 2006. Personal automobile accounted for 68.9% and homeowners accounted for 28.4% of total personal lines net written premium in 2006.

Products

Personal Lines coverages include:

Personal automobile coverage insures individuals against losses incurred from personal bodily injury, bodily injury to third parties, property damage to an insured s vehicle, and property damage to other vehicles and other property. In 2006, we continued to introduce ***Connections Auto***, our multivariate auto product, which is now available in seventeen states. ***Connections Auto*** utilizes a multivariate rating application which is intended to allow agents to write a wide spectrum of drivers.

Homeowners coverage insures individuals for losses to their residences and personal property, such as those caused by fire, wind, hail, water damage (except for flooding), theft and vandalism, and against third party liability claims. In September of 2006, we released an upgrade to our homeowners product that enhanced our agents ease of doing business and decreased quote times. We expect to introduce further homeowners product enhancements in several states during the first half of 2007.

Other personal lines is comprised of miscellaneous coverages including inland marine, umbrella, fire, personal watercraft and earthquake.

Markets

Our top ten personal lines markets and the percent of our 2006 personal lines net written premium represented by these markets are:

For the Year Ended December 31, 2006

(In millions, except ratios)	GAAP Net Premiums Written	% Of Total
Michigan	$ 599.8	42.0%
Massachusetts	205.8	14.4
New York	127.7	8.9
New Jersey	92.6	6.5
Louisiana	56.4	4.0
Florida	48.0	3.4
Connecticut	45.6	3.2
Indiana	44.7	3.1
Virginia	37.9	2.7
Maine	37.0	2.6
Other	132.3	9.2
Total	$ 1,427.8	100.0%

In Michigan, according to A.M. Best, based upon direct written premium for 2005, we ranked 4th in the industry for personal lines business, with approximately 8% of the state s total market. Approximately 67% of our Michigan personal lines business is in the personal automobile line. Approximately 41% of our total personal automobile net written premium is in Michigan. In addition, approximately 31% of our Michigan personal lines business is in the homeowners line. Approximately 46% of our total homeowners net written premium is in Michigan. In Michigan, we are a principal provider with many of our agencies, averaging over $1.1 million of total written premium per agency in 2006.

In Massachusetts, approximately 75% of our personal lines business is in the personal automobile line and 22% is in the homeowners line.

Commercial Lines

Our Commercial Lines segment accounted for $1.0 billion, or 36.0%, of consolidated segment revenues and provided segment income before federal income taxes of $120.3 million for the year ended December 31, 2006. Commercial Lines comprised 38.1% of the Property and Casualty group s net written premium in 2006. Commercial multiple peril net written premium accounted for 40.0%, commercial automobile 22.0% and workers compensation 12.5% of total commercial lines net written premium in 2006. In addition, the combination of our inland marine, ocean marine and bond business accounted for 19.5% of total commercial lines net written premium in 2006.

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Products

Our ***Avenues***™ commercial lines product suite provides agents and customers with products designed for small, middle, and specialized markets. Commercial Lines coverages include:

Commercial multiple peril coverage insures businesses against third party liability from accidents occurring on their premises or arising out of their operations, such as injuries sustained from products sold. It also insures business property for damage, such as that caused by fire, wind, hail, water damage (except for flooding), theft and vandalism.

Commercial automobile coverage insures businesses against losses incurred from personal bodily injury, bodily injury to third parties, property damage to an insured s vehicle, and property damage to other vehicles and other property.

Workers compensation coverage insures employers against employee medical and indemnity claims resulting from injuries related to work. Workers compensation policies are often written in conjunction with other commercial policies.

Other commercial lines is comprised of various coverages including inland and ocean marine, bonds, umbrella, general liability, and fire.

Markets

We manage our commercial lines portfolio with a focus on growth from the most profitable industry segments, which varies by line of business and geography. Our top ten commercial lines markets and the percent of our 2006 commercial lines net written premium represented by these markets are:

For the Year Ended December 31, 2006

(In millions, except ratios)	**GAAP Net Premiums Written**	**% Of Total**
Michigan	**$ 150.2**	**17.1%**
New York	**111.5**	**12.7**
Massachusetts	**99.1**	**11.3**
New Jersey	**63.5**	**7.2**
Florida	**44.4**	**5.0**
Maine	**43.8**	**5.0**
Texas	**39.4**	**4.5**
Louisiana	**37.6**	**4.3**
Illinois	**33.4**	**3.8**
Indiana	**31.5**	**3.6**
Other	**224.9**	**25.5**
Total	**$ 879.3**	**100.0%**

Approximately 38.9% of commercial lines written premium is comprised of small policies having less than $10,000 in premium. Policies with premium between $10,000 and $100,000 account for an additional 49.1% of the total. The commercial lines segment seeks to maintain strong agency relationships as a strategy to secure and retain our agents best business. The quality of business written is monitored through an ongoing quality assurance program, accountability for which is shared at the local, regional and corporate levels.

Other Property and Casualty

The Other Property and Casualty segment consists of AMGRO, Inc. (AMGRO), our premium financing business; Opus Investment Management, Inc. (Opus), which provides investment advisory services to affiliates and to other institutions, including unaffiliated insurance companies, retirement plans and foundations; and run-off voluntary pools business in which we have not actively participated since 1995. In addition, the Other Property and Casualty segment includes earnings on holding company assets.

Premium Financing Services

Through AMGRO, we engage in the business of financing property and casualty insurance premiums to commercial customers, primarily those of unaffiliated carriers. Generally, these installment finance receivables are secured by the related unearned insurance premiums on such policies. The customers of AMGRO are those firms or persons that borrow from AMGRO to finance insurance premiums.

Investment Advisory Services

Through our registered investment advisor, Opus, we provide investment advisory services to affiliates and to other institutions, including unaffiliated insurance companies, retirement plans and foundations. At December 31, 2006, Opus had assets under management of approximately $7.3 billion, of which approximately $1.1 billion represented assets managed for entities unaffiliated with us.

Voluntary Pools

We have terminated our participation in virtually all voluntary pool business; however, we continue to be subject to claims related to years in which we were a participant. See also Reinsurance Facilities and Pools Voluntary Pools on page 11 of this Form 10-K.

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MARKETING AND DISTRIBUTION

We are licensed to sell property and casualty insurance in all fifty states in the United States, as well as the District of Columbia. In 2006, our top ten personal and commercial markets based on total net written premium in the state were:

	Personal Lines		Commercial Lines		Total	
(In millions, except ratios)	GAAP Net Premiums Written	% Of Total	GAAP Net Premiums Written	% Of Total	GAAP Net Premiums Written	% Of Total
Michigan	**$ 599.8**	**42.0%**	**$ 150.2**	**17.1%**	**$ 750.0**	**32.5%**
Massachusetts	**205.8**	**14.4**	**99.1**	**11.3**	**304.9**	**13.2**
New York	**127.7**	**8.9**	**111.5**	**12.7**	**239.2**	**10.4**
New Jersey	**92.6**	**6.5**	**63.5**	**7.2**	**156.1**	**6.8**
Louisiana	**56.4**	**4.0**	**37.6**	**4.3**	**94.0**	**4.1**
Florida	**48.0**	**3.4**	**44.4**	**5.0**	**92.4**	**4.0**
Maine	**37.0**	**2.6**	**43.8**	**5.0**	**80.8**	**3.5**
Indiana	**44.7**	**3.1**	**31.5**	**3.6**	**76.2**	**3.3**
Connecticut	**45.6**	**3.2**	**25.8**	**2.9**	**71.4**	**3.1**
Virginia	**37.9**	**2.7**	**26.5**	**3.0**	**64.4**	**2.8**
Other	**132.3**	**9.2**	**245.4**	**27.9**	**377.7**	**16.3**
Total	**$ 1,427.8**	**100.0%**	**$ 879.3**	**100.0%**	**$ 2,307.1**	**100.0%**

We have a strong regional focus. Our Property and Casualty group maintains twenty-three local branch sales and underwriting offices in nineteen states. Additional processing support is provided in Atlanta, Georgia; Worcester, Massachusetts; and Howell, Michigan. Administrative functions are centralized in our headquarters in Worcester, Massachusetts. This regional strategy allows us to maintain a strong focus on local markets and the flexibility to respond to specific market conditions. It also is a predominant factor in the establishment and maintenance of long-term relationships with mid-sized, well-established independent agencies.

Independent agents provide specialized knowledge of property and casualty products, local market conditions and customer demographics. Independent agents account for most of the sales of our property and casualty products. We compensate agents primarily through regular commissions and through a bonus plan that is tied to agency level written premium and profitability. This encourages agents to select customers whose risk characteristics are aligned with our underwriting philosophy.

Agencies are appointed based on profitability record, financial stability, staff experience and professionalism, and business strategy. Once appointed, we monitor each agency s performance and, in accordance with applicable legal and regulatory requirements, take actions as necessary to change these business relationships, such as discontinuing the authority of the agent to underwrite certain products or revising commissions or bonus opportunities.

We sponsor local and national agent advisory councils as forums to enhance relationships with our agents. These councils provide input on the development of products and services, help us to coordinate marketing efforts, provide support to our strategies, and help us enhance our local market presence.

For our Other Property and Casualty segment business, investment advisory services are marketed directly through Opus, while premium financing services are generally marketed through independent insurance agents to customers of many property and casualty carriers. Less than 1% of our premium financing services business is provided to customers of our Commercial Lines segment.

PRICING AND COMPETITION

We seek to achieve a targeted combined ratio in each of our product lines regardless of market conditions. The targeted combined ratios reflect current investment yield expectations, our loss payout patterns, and target returns on equity. This strategy is intended to better enable us to

achieve measured growth and consistent profitability. In addition, we seek to utilize our knowledge of local markets to achieve superior underwriting results. We rely on market information provided by our local agents and on the knowledge of our staff in the local branch offices. Also, we seek to gather objective and verifiable information during the underwriting process, such as past driving records and credit histories. Since we maintain a strong regional focus and a significant market share in a number of states, we can apply our knowledge and experience in making underwriting and rate setting decisions.

The property and casualty industry is a competitive market. Our competitors include national, regional and local companies that sell insurance through various distribution channels, including independent agencies, through a captive agency force and/or directly to consumers. We market through independent agents and

compete for business on the basis of product, price, agency and customer service, local relationship and ratings, among other things.

In Personal Lines, we face competition from national, regional and local companies that sell insurance through independent agents, captive agents and/or directly to consumers. We believe that our emphasis on maintaining strong agency relationships and a local presence in our markets, coupled with investments in products, operating efficiency and technology, will enable us to compete effectively.

In our Michigan personal lines business, where we market our products under the Citizens Insurance brand name, we compete with a number of national direct writers and regional and local companies. Principal personal lines competitors are AAA Auto Club of Michigan, State Farm Group and Auto Owners. We believe our agency relationships, Citizens Insurance brand recognition, the Citizens Best program and ***Connections Auto*** enable us to distribute our products competitively in Michigan.

Based on net written premium, approximately 16% of our 2006 personal automobile business was written in Massachusetts. The Massachusetts Commissioner of Insurance (the Commissioner) sets the rates for personal automobile business in the state. The Commissioner issued a decision decreasing the state-wide average rate by 11.7% effective April 1, 2007. Rates were decreased by 8.7% on January 1, 2006, and 1.7% on January 1, 2005. The impact of the rate change on our average policy premium as a result of the prior year changes was a decrease of 7.4% for 2006 and 1.2% for 2005.

Due to the unique nature of the personal lines rate setting process and the residual market mechanism in Massachusetts, we carefully manage our business in this state. In 2006 and 2005, our efforts included the termination of several agencies, the reduction or elimination of certain group business, and an enhanced cession strategy relating to the Massachusetts residual market. Also, we placed additional focus on claims handling practices for Massachusetts business. We believe these efforts have improved our Massachusetts underwriting performance compared to prior years. Our underwriting performance in this state is expected to be negatively impacted by the 2007 rate reduction and future rate reductions; we cannot predict the impact of potential changes to the residual market mechanism.

In Commercial Lines, we face competition primarily from national, regional and local companies that sell insurance through independent agents or captive agents. We believe that our emphasis on maintaining a local presence in our markets, coupled with investments in products, operating efficiency and technology, will enable us to compete effectively. Also, we seek to develop and maintain strong relationships with our agents. Our Property and Casualty group is not dependent on a single customer or even a few customers, for which the loss of any one or more would have an adverse effect upon the group s insurance operation.

In our Other Property and Casualty segment, AMGRO faces competition among providers of premium financing services, including from banks, finance companies and property and casualty insurance carriers that offer direct billing plans. Competition is based on price and quality of service. Our premium financing business is not dependent on a single customer or agency relationship for which the loss of any one would have an adverse affect on its operations. Also, in our Other Property and Casualty segment, Opus faces strong competition among providers of investment advisory services. In general, competition is based on a number of factors, including investment performance, pricing and client service. There are few barriers to entry by new investment advisory firms. Opus also earns advisory fees from other affiliated and unaffiliated separately managed accounts and we are dependent upon the relationships we maintain with them. In the event that any of these relationships are discontinued, the segment s financial results may be adversely affected.

CLAIMS

We utilize experienced claims adjusters, appraisers, medical specialists, managers and attorneys in order to manage our claims. Our Property and Casualty group has field claims adjusters strategically located throughout our operating territories. Claims staff members work closely with the agents and seek to settle claims rapidly, fairly and in a cost-effective manner.

Claims office adjusting staff is supported by general adjusters for large property and large casualty losses, by automobile and heavy equipment damage appraisers for automobile material damage losses, and by medical specialists whose principal concentration is on workers compensation and no-fault automobile injury cases. In addition, the claims offices are supported by staff attorneys who specialize in litigation defense and claim settlements. We also maintain a special investigative unit that investigates suspected insurance fraud and abuse.

We utilize claims processing technology which allows most of the smaller and more routine personal lines claims to be processed at centralized locations. In 2006, we invested in enhancements to our claims related technology and processes and in 2007 we plan to begin to implement new technology and reorganize our claims processes. We believe these enhancements and our centralization will help to increase efficiency and reduce costs, although there can be no assurance that we will achieve our objectives or that disruptions caused by such implementations will not adversely affect our operations or financial results.

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CATASTROPHES

Property and casualty insurers are subject to claims arising out of catastrophes, which may have a significant impact on their results of operations and financial condition. We may experience catastrophe losses in the future which could have a material adverse impact on us. Catastrophes can be caused by various events, including snow, ice storms, hurricanes, earthquakes, tornadoes, wind, hail, terrorism, fires and explosions. The incidence and severity of catastrophes are inherently unpredictable. We manage our catastrophe risks through underwriting procedures, including the use of deductibles and specific exclusions for floods and terrorism, as allowed, and other factors, through geographic exposure management and through reinsurance programs. The catastrophe reinsurance program is structured to protect us on a per-occurrence basis. We will monitor geographic location and coverage concentrations in order to manage corporate exposure to catastrophic events. Although catastrophes can cause losses in a variety of property and casualty lines, homeowners and commercial multiple peril insurance have, in the past, generated the majority of catastrophe-related claims.

TERRORISM

As a result of the Federal Terrorism Risk Insurance Act of 2002 (TRIA) and the Federal Terrorism Risk Insurance Extension Act of 2005, prior terrorism exclusions in insurance policies are void for certified terrorist events (as defined by TRIA). TRIA provides a federal reinsurance arrangement for insured losses resulting from certified terrorist events that exceed certain thresholds on an industry-wide basis. There can be no assurance that TRIA will be extended beyond its current expiration date of December 31, 2007.

As required, we have notified policyholders of their option to elect the terrorism coverage and the cost of this coverage. We seek to manage our exposures on an individual line of business basis and in the aggregate by zip code and, as available, street address. At this time, we have purchased no additional specific terrorism-only reinsurance coverage. However, we are reinsured for certain terrorism coverage within existing Catastrophe, Property per Risk and Casualty Excess of Loss corporate treaties (see Reinsurance on pages 14 to 17 of this Form 10-K). Our retention limit under TRIA in 2006 was $111.5 million, representing 9.2% of year-end 2005 statutory policyholder surplus, and is estimated to be $137.4 million in 2007, representing 9.4% of 2006 year-end statutory policyholder surplus. We were required to retain an additional 10% of any claims from a certified terrorist event in excess of our retention in 2006, and will be required to retain 15% of any claims from a certified terrorist event in excess of our retention in 2007. Coverage under TRIA is available for workers compensation, commercial multiple peril and certain other commercial lines policies.

STATE REGULATION

Our property and casualty insurance subsidiaries are subject to extensive regulation in the various states and jurisdictions in which they transact business and are also supervised by the individual state insurance departments. Numerous aspects of our business are subject to regulatory standards, including premium rates, mandatory risks that must be covered, prohibited exclusions, licensing of agents, investments, restrictions on the size of risks that may be insured under a single policy, reserves and provisions for unearned premiums, losses and other obligations, deposits of securities for the benefit of policyholders, policy forms, and other conduct, including the use of credit information in underwriting, as well as other underwriting and claims practices. States also regulate various aspects of the contractual relationships between insurers and independent agents.

In addition, as a condition to writing business in certain states, insurers are required to participate in various pools or risk sharing mechanisms or to accept certain classes of risk, regardless of whether such risks meet our underwriting requirements for voluntary business. Some states also limit or impose restrictions on the ability of an insurer to withdraw from certain classes of business. For example, Massachusetts, New Jersey, New York, Louisiana and Florida each impose material restrictions on a company s ability to withdraw from certain lines of business in their respective states. Furthermore, certain states prohibit an insurer from withdrawing one or more lines of insurance business from the state, except pursuant to a plan that is approved by the state insurance department. The state insurance departments can impose significant charges on a carrier in connection with a market withdrawal or refuse to approve these plans on the grounds that they could lead to market disruption. Laws and regulations that limit cancellation and non-renewal and that subject withdrawal plans to prior approval requirements may significantly restrict an insurer s ability to exit unprofitable markets.

Emergency Rule 23 (Rule 23), which was issued on December 30, 2005 by the Louisiana Insurance Commissioner, and which suspended the authority of insurance companies to cancel or non-renew certain personal and commercial property insurance policies covering properties in Louisiana that had been damaged by hurricanes Katrina and Rita, expired on December 31, 2006. Prior to the expiration of Rule 23, Advisory Letter 06-05 was issued by the Louisiana Insurance Department providing guidance on actions to be

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taken before insurers may send cancellation or non-renewal notices on properties previously covered by Rule 23. Legislation was enacted in Louisiana to extend the time period for Louisiana homeowners who have policy coverage claims arising out of hurricanes Katrina and Rita to take legal action against their insurance companies from the pre-existing 12 month period to 24 months from the date of loss. The Louisiana Supreme Court has determined that the legislation is constitutional. Legislation was also adopted which increased an insurer s potential exposure if it is determined to have acted in bad faith in the claim adjustment process.

In January 2007, the Governor of Florida signed into law significant changes affecting the property and casualty insurance market. The legislation reversed two recently approved rate increases for the residual market property insurer, Citizens Property Insurance Corporation, and mandated that private insurer rates be adjusted to reflect projected savings in reinsurance costs realized through purchases of catastrophe reinsurance from the Florida Hurricane Catastrophe Fund. Insurers are presently prohibited by an Emergency Rule from canceling, non-renewing or raising rates with very limited exceptions, until rate filings reflecting the reduced cost of reinsurance from the Florida Hurricane Catastrophe Fund have been filed with the Office of Insurance Regulation. For further discussion of this legislation, see Contingencies and Regulatory Matters Other Regulatory Matters on pages 65 and 66 in Management s Discussion and analysis of Financial Condition and Results of Operations of this Form 10-K.

The insurance laws of many states generally provide that property and casualty insurers doing business in those states belong to statutory property and casualty guaranty funds. The purpose of these guaranty funds is to protect policyholders by requiring that solvent property and casualty insurers pay certain insurance claims of insolvent insurers. These guaranty associations generally pay these claims by assessing solvent insurers proportionately based on the insurer s share of voluntary written premium in the state. While most guaranty associations provide for recovery of assessments through subsequent rate increases, surcharges or premium tax credits, there is no assurance that insurers will ultimately recover these assessments, which could be material particularly following a large catastrophe affecting us and the industry generally or in markets which become disrupted or where we have significant market share.

We are subject to periodic financial and market conduct examinations conducted by state insurance departments. We are also required to file annual and other reports relating to the financial condition of our insurance subsidiaries and other matters.

RESIDUAL MARKETS AND POOLING ARRANGEMENTS

As a condition of our license to do business in various states, we are required to participate in mandatory property and casualty shared market mechanisms or pooling arrangements which provide various insurance coverages to individuals or other entities that otherwise are unable to purchase such coverage. Such mechanisms include assigned risk plans, reinsurance facilities and pools, joint underwriting associations, fair access to insurance requirements plans, and commercial automobile insurance plans. For example, since most states compel the purchase of a minimal level of automobile liability insurance, states have developed shared market mechanisms to provide the required coverages and in many cases, optional coverages, to those drivers who, because of their driving records or other factors, cannot find insurers who will insure them voluntarily. Our participation in such shared markets or pooling mechanisms is generally proportional to our direct writings for the type of coverage written by the specific pooling mechanism in the applicable state. We experienced an underwriting profit (loss) from participation in these mechanisms, mandatory pools and underwriting associations of $9.7 million and ($43.1) million in 2006 and 2005, respectively, relating primarily to coverages for personal and commercial property, personal and commercial automobile, and workers compensation. The improvement in underwriting results in 2006, compared to 2005, is primarily the result of our participation in the Louisiana Fair Access to Insurance Requirements Plan (FAIR Plan), which incurred significant losses in 2005 due to Hurricane Katrina, and to our participation in the Massachusetts Commonwealth Automobile Reinsurers (CAR) pool.

Reinsurance Facilities and Pools

Reinsurance facilities are currently in operation in various states that require an insurer to write all applications submitted by an agent, regardless of its pricing or underwriting characteristics. As a result, insurers in that state may be writing policies for applicants with a higher risk of loss, or at a lower premium, than they would normally accept. The reinsurance facility allows the insurer to cede this high risk business to the reinsurance facility, thus sharing the underwriting experience with all other insurers in the state. If a claim is paid on a policy issued in this market, the facility will reimburse the insurer. Typically, reinsurance facilities operate at a deficit, which is then recouped by levying assessments against the same insurers.

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With respect to our Massachusetts business, we cede a portion of our personal and commercial automobile premiums to the CAR pool. Net premiums earned and losses and LAE ceded to CAR were $44.3 million and $29.5 million in 2006, $53.3 million and $37.1 million in 2005, and $46.6 million and $38.1 million in 2004, respectively. At December 31, 2006, CAR represented at least 10% of our reinsurance activity.

As part of the CAR plan, Massachusetts maintains an Exclusive Representative Producer (ERP) program. An ERP is an independent agency which cannot obtain a voluntary insurance market for automobile business from insurance companies in Massachusetts. For Personal Lines, CAR assigns an ERP agency to an individual insurance carrier, which is then required to write all personal automobile business produced by that agency (subject to any cessions to the CAR pool). We are required to maintain a level of ERPs consistent with other carriers in the state and proportionate to our overall market share of such business. Once an agency is assigned to an insurance carrier, it is difficult to terminate the relationship. ERPs generally produce underwriting results that are markedly poorer than our voluntary agents, although results vary significantly among ERPs. For Personal Lines, as of December 31, 2006, we had approximately 16 ERPs assigned to us with annual direct retained written premium of approximately $24.3 million. As described under Contingencies and Regulatory Matters - Other Regulatory Matters on pages 65 and 66 of Management s Discussion and Analysis of Financial Condition and Results of Operations included in this Form 10-K, the Massachusetts Commissioner of Insurance adopted rules to redistribute the residual market in 2006 and issued an Order in December 2006 directing the implementation of an assigned risk plan on a phased-in basis in April of 2007. In January 2007, the Commissioner of Insurance resigned and the Acting Commissioner issued an Order suspending the implementation of the assigned risk plan until a review could be completed by the administration of the newly elected Governor. For Commercial Lines, we act as one of six servicing carriers for commercial automobile business.

The Michigan Catastrophic Claims Association (MCCA) is a reinsurance mechanism that covers no-fault first party medical losses of retentions in excess of $400,000. All automobile insurers doing business in Michigan are required to participate in the MCCA. Insurers are reimbursed for their covered losses in excess of this threshold, which increased from $375,000 to $400,000 on July 1, 2006 and will continue to increase each July 1st in scheduled amounts until it reaches $500,000 in 2011. Funding for MCCA comes from assessments against automobile insurers based upon their proportionate market share of the state s automobile liability insurance market. Insurers are allowed to pass along this cost to Michigan automobile policyholders. We ceded to the MCCA premiums earned and losses and LAE of $74.3 million and $118.8 million in 2006, $68.9 million and $61.3 million in 2005, and $60.9 million and $12.4 million in 2004, respectively. At December 31, 2006, the MCCA represented at least 10% of our reinsurance activity.

At December 31, 2006 and 2005, we had reinsurance recoverables on paid and unpaid losses from CAR of $42.3 million and $47.2 million, respectively, and from the MCCA of $515.0 million and $436.5 million, respectively. We believe that we are unlikely to incur any material loss as a result of non-payment of amounts owed to us by CAR, because CAR is a mandated pool supported by all insurance companies licensed to write automobile insurance in Massachusetts. In addition, with respect to MCCA, we are unlikely to incur any material loss from this facility as a result of non-payment of amounts owed to us by MCCA because (i) the payment obligations of the MCCA are extended over many years, resulting in relatively small current payment obligations in terms of MCCA total assets, and (ii) the MCCA is supported by assessments permitted by statute.

Reference is made to Note 18 on pages 108 and 109 and Note 21 on pages 112 to 114 of the Notes to Consolidated Financial Statements included in Financial Statements and Supplementary Data of this Form 10-K.

FAIR Plans and Other Involuntary Pools

The principal shared market mechanisms for property insurance are FAIR Plans, the formation of which were required by the federal government as a condition to an insurer s ability to obtain federal riot reinsurance coverage following the riots and civil disorder that occurred during the 1960s. These plans, created as mechanisms similar to automobile assigned risk plans, were designed to increase the availability of property insurance in urban areas, but now cover other circumstances where homeowners are unable to obtain insurance, such as a result of hurricanes or other natural exposures. The federal government reinsures those insurers participating in FAIR Plans against excess losses sustained from riots and civil disorders. The individual state FAIR Plans are created pursuant to statute or regulation. The property shared market mechanisms provide insurance coverage protection for dwellings and certain commercial properties that could not be insured in the voluntary market. A few states also include a basic homeowners form of coverage in their shared market mechanism. Approximately 30 states have FAIR Plans, including Louisiana, Florida and Massachusetts.

In 2005, the Louisiana Citizens FAIR Plan experienced substantial losses primarily from Hurricane Katrina. We have estimated and recorded a liability related to Louisiana s FAIR Plan for accident year 2005 at approximately $2.4 million and $20.0 million at December 31, 2006 and 2005, respectively. The maximum annual FAIR Plan assessment that can be levied against an insurer operating in Louisiana is approximately 30% of the annual direct premium written by the insurer in the prior year, consisting of a regular FAIR Plan assessment of up to 10%, a regular Coastal Plan assessment of up to 10%, and an emergency assessment of up to 10%. Under the state s FAIR Plan, we are allowed to recover such losses from policyholders, subject to annual limitations. Under current regulations, we do not anticipate additional liabilities for the 2005 accident year. The availability of private homeowners insurance in the state is declining as carriers seek to exit or significantly reduce their exposure in the state. This will increase the number of insureds seeking coverage from the state s FAIR Plan and could result in increased losses to us through the FAIR Plan for future events.

The Florida FAIR Plan, Citizens Property Insurance Corporation, also experienced considerable losses during 2005 as a result of hurricanes. The Florida Plan has authority to assess insurers up to an aggregate amount of approximately 20% of direct premium written from the prior year in the form of a regular assessment, not to exceed 10%, and an emergency assessment that may not exceed 10%. In 2006, we received an assessment from Florida s FAIR Plan of $1.0 million. Florida s FAIR Plan has experienced significant growth and is expected to continue to grow. In January 2007, the Governor of Florida signed into law significant changes affecting the property and casualty industry, as well as Florida s FAIR Plan. For a further discussion of this legislation, see Contingencies and Regulatory Matters Other Regulatory Matters on pages 65 and 66 in Management s Discussion and Analysis of Financial Condition and Results of Operations of this Form 10-K.

We have recently seen significant growth in the Massachusetts FAIR Plan coastal exposures. We also anticipate the FAIR Plan to have significant hurricane exposures for 100 year or more events, which would likely be material to the FAIR Plan, as well as to participating companies.

It should also be noted that such an event would be subject to our reinsurance programs, as described in the Reinsurance section on pages 14 to 17 of this Form 10-K. Although it is difficult to accurately estimate such exposure, it would likely be material to our financial position and/or results of operations. Two other state FAIR Plans, where our participation is larger as compared to other states, are North Carolina and New York.

The New Jersey Department of Banking and Insurance has proposed establishing a mechanism to subsidize insurers for writing urban personal automobile policies. The Territorial Rating Equalization Exchange is intended to help to avoid future issues of high premiums and reduced availability in urban areas. The New Jersey Department of Banking and Insurance is presently seeking insurer comment and input to more fully develop and implement the proposal.

With respect to commercial automobile coverage, another pooling mechanism, a Commercial Auto Insurance Plan (CAIP), uses a limited number of servicing carriers to handle assignments from other insurers. The CAIP servicing carrier is paid a fee by the insurer who otherwise would be assigned the responsibility of handling the commercial automobile policy and paying claims. Approximately 40 states have CAIP mechanisms, including the states of New Jersey, New York, and Louisiana, where our participation is larger as compared to other states.

Assigned Risk Plans

Assigned risk plans are the most common type of shared market mechanism. Many states, including New Jersey and New York operate assigned risk plans. Such plans assign applications from drivers who are unable to obtain insurance in the voluntary market to insurers licensed in the applicant s state. Each insurer is required to accept a specific percentage of applications based on its market share of voluntary business in the state. Once an application has been assigned to an insurer, the insurer issues a policy under its own name and retains premiums and pays losses as if the policy was voluntarily written. With respect to New York s assigned risk plan, which is called The New York Automobile Insurance Plan (NYAIP), we have elected to transfer our assignments to a servicing carrier under a limited assignment distribution (LAD) agreement. Under this LAD agreement, the servicing carrier retains the assigned underwriting results of the NYAIP for which it receives a fee from us. In 2006 and 2005, we incurred expenses of $0.8 million and $4.3 million, respectively, related to this agreement.

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Voluntary Pools

We have terminated our participation in virtually all voluntary pool business; however, we continue to be subject to claims related to years in which we were a participant. The most significant of these pools is a voluntary excess and casualty reinsurance pool known as the Excess and Casualty Reinsurance Association (ECRA), in which we were a participant from 1950 to 1982. In 1982, the pool was dissolved and since that time the business has been in runoff. Our participation in this pool has resulted in average paid losses of approximately $2 million annually over the past ten years. Because of the inherent uncertainty regarding the types of claims in this pool, there can be no assurance that the reserves will be sufficient. Loss and LAE reserves for our voluntary pools were $74.8 million and $74.7 million at December 31, 2006 and 2005, respectively, including $53.3 million related to ECRA as of December 31, 2006 and 2005. Excluding the ECRA pool, the average annual paid losses and reserve balances at December 31, 2006 were not individually significant.

RESERVE FOR UNPAID LOSSES AND LOSS ADJUSTMENT EXPENSES

Reference is made to Property and Casualty Reserve for Losses and Loss Adjustment Expenses on pages 40 to 46 of Management s Discussion and Analysis of Financial Condition and Results of Operations of this Form 10-K.

Our property and casualty actuaries review the reserves each quarter and certify the reserves annually as required for statutory filings. Significant periods of time often elapse between the occurrence of an insured loss, the reporting of the loss to us and our settlement and payment of that loss. To recognize liabilities for unpaid losses, we establish reserves as balance sheet liabilities representing estimates of amounts needed to pay reported and unreported losses and LAE.

We regularly review our reserving techniques, our overall reserving position and our reinsurance. Based on (i) our review of historical data, legislative enactments, judicial decisions, legal developments in impositions of damages, changes in political attitudes and trends in general economic conditions, (ii) our review of per claim information, (iii) our historical loss experience and that of the industry, (iv) the relatively short-term nature of most policies written by us and (v) our internal estimates of required reserves, we believe that adequate provision has been made for loss reserves. However, establishment of appropriate reserves is an inherently uncertain process and there can be no certainty that current established reserves will prove adequate in light of subsequent actual experience. A significant change to the estimated reserves could have a material effect on our results of operations or financial position. An increase or decrease in reserve estimates would result in a corresponding decrease or increase in financial results. For example, each one percentage point change in the aggregate loss and LAE ratio resulting from a change in reserve estimation is currently projected to have an approximate $22 million impact on property and casualty segment income, based on 2006 full year premiums.

We do not use discounting techniques in establishing reserves for losses and LAE, nor have we participated in any loss portfolio transfers or other similar transactions.

The following table reconciles reserves determined in accordance with accounting principles and practices prescribed or permitted by insurance statutory authorities (Statutory) to reserves determined in accordance with generally accepted accounting principles (GAAP).

DECEMBER 31 ***(In millions)***	**2006**	**2005**	**2004**
Statutory reserve for losses and LAE	**$ 2,274.4**	$ 2,351.4	$ 2,162.6
GAAP adjustments:			
Reinsurance recoverable on unpaid losses	**889.5**	1,107.6	907.1
Other		(0.3)	(1.1)
GAAP reserve for losses and LAE	**$ 3,163.9**	$ 3,458.7	$ 3,068.6

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ANALYSIS OF LOSSES AND LOSS ADJUSTMENT EXPENSES RESERVE DEVELOPMENT

The following table sets forth the development of our GAAP reserves (net of reinsurance recoverables) for unpaid losses and LAE from 1996 through 2006.

DECEMBER 31 *(In millions)*	**2006**	**2005**	**2004**	**2003**	**2002**	**2001**	**2000**	**1999**	**1998**	**1997**	**1996**
Net reserve for losses and LAE[1]	$ 2,274.4	$ 2,351.1	$ 2,161.5	$ 2,078.9	$ 2,083.8	$ 2,056.9	$ 1,902.2	$ 1,924.5	$ 2,005.5	$ 2,038.7	$ 2,117.2
Cumulative amount paid as of[2]:											
One year later		729.5	622.0	658.3	784.5	763.6	780.3	703.8	638.0	643.0	732.1
Two years later			967.0	995.4	1,131.7	1,213.6	1,180.1	1,063.8	996.0	967.4	1,054.3
Three years later				1,217.1	1,339.5	1,423.9	1,458.3	1,298.2	1,203.0	1,180.7	1,235.0
Four years later					1,478.9	1,551.5	1,567.8	1,471.8	1,333.0	1,301.5	1,365.9
Five years later						1,636.9	1,636.9	1,524.4	1,446.0	1,375.5	1,439.8
Six years later							1,689.0	1,560.6	1,497.5	1,458.7	1,486.3
Seven years later								1,596.4	1,537.4	1,496.3	1,555.3
Eight years later									1,573.3	1,528.0	1,584.5
Nine years later										1,557.2	1,610.4
Ten years later											1,636.0
Net reserve re-estimated as of[3]:											
End of year	2,274.4	2,351.1	2,161.5	2,078.9	2,083.8	2,056.9	1,902.2	1,924.5	2,005.5	2,038.7	2,117.2
One year later		2,271.1	2,082.0	2,064.4	2,124.2	2,063.3	2,010.8	1,837.1	1,822.1	1,911.5	1,989.3
Two years later			1,989.6	2,017.4	2,115.3	2,122.5	2,028.2	1,863.3	1,781.4	1,796.8	1,902.8
Three years later				1,971.5	2,093.9	2,124.3	2,066.6	1,863.0	1,818.6	1,734.9	1,832.5
Four years later					2,074.0	2,121.6	2,071.1	1,893.6	1,823.5	1,762.9	1,783.7
Five years later						2,121.7	2,078.3	1,901.6	1,860.5	1,770.9	1,810.9
Six years later							2,084.1	1,913.4	1,871.0	1,806.8	1,824.4
Seven years later								1,925.4	1,883.1	1,818.3	1,856.9
Eight years later									1,897.6	1,834.7	1,867.9
Nine years later										1,851.0	1,886.3
Ten years later											1,904.4
Redundancy (deficiency), net [4,5]	$	$ 80.0	$ 171.9	$ 107.4	$ 9.8	$ (64.8)	$ (181.9)	$ (0.9)	$ 107.9	$ 187.7	$ 212.8

(1) Sets forth the estimated net liability for unpaid losses and LAE recorded at the balance sheet date for each of the indicated years; represents the estimated amount of net losses and LAE for claims arising in the current and all prior years that are unpaid at the balance sheet date, including incurred but not reported (IBNR) reserves.

(2) Cumulative loss and LAE payments made in succeeding years for losses incurred prior to the balance sheet date.

(3) Re-estimated amount of the previously recorded liability based on experience for each succeeding year; increased or decreased as payments are made and more information becomes known about the severity of remaining unpaid claims.

(4)

Cumulative redundancy or deficiency at December 31, 2006 of the net reserve amounts shown on the top line of the corresponding column. A redundancy in reserves means the reserves established in prior years exceeded actual losses and LAE or were re-evaluated at less than the original reserved amount. A deficiency in reserves means the reserves established in prior years were less than actual losses and LAE or were reevaluated at more than the original reserved amount.

(5) The following table sets forth the development of gross reserve for unpaid losses and LAE from 1997 through 2006:

DECEMBER 31 *(In millions)*	**2006**	**2005**	**2004**	**2003**	**2002**	**2001**	**2000**	**1999**	**1998**	**1997**
Reserve for losses and LAE:										
Gross liability	$ 3,163.9	$ 3,458.7	$ 3,068.6	$ 3,018.9	$ 2,961.7	$ 2,921.5	$ 2,719.1	$ 2,618.7	$ 2,597.2	$ 2,615.4
Reinsurance recoverable	889.5	1,107.6	907.1	940.0	877.9	864.6	816.9	694.2	591.7	576.7
Net liability	$ 2,274.4	$ 2,351.1	$ 2,161.5	$ 2,078.9	$ 2,083.8	$ 2,056.9	$ 1,902.2	$ 1,924.5	$ 2,005.5	$ 2,038.7
One year later:										
Gross re-estimated liability		$ 3,409.9	$ 3,005.9	$ 2,972.2	$ 3,118.6	$ 2,926.4	$ 2,882.0	$ 2,553.4	$ 2,432.9	$ 2,472.6
Re-estimated recoverable		1,138.8	923.9	907.8	994.4	863.1	871.2	716.3	610.8	561.1
Net re-estimated liability		$ 2,271.1	$ 2,082.0	$ 2,064.4	$ 2,124.2	$ 2,063.3	$ 2,010.8	$ 1,837.1	$ 1,822.1	$ 1,911.5
Two years later:										
Gross re-estimated liability			$ 2,941.5	$ 2,970.7	$ 3,113.5	$ 3,118.9	$ 2,913.0	$ 2,640.8	$ 2,379.6	$ 2,379.3
Re-estimated recoverable			951.9	953.3	998.2	996.4	884.8	777.5	598.2	582.5
Net re-estimated liability			$ 1,989.6	$ 2,017.4	$ 2,115.3	$ 2,122.5	$ 2,028.2	$ 1,863.3	$ 1,781.4	$ 1,796.8
Three years later:										
Gross re-estimated liability				$ 2,951.0	$ 3,129.4	$ 3,146.6	$ 3,063.9	$ 2,658.0	$ 2,439.7	$ 2,305.2
Re-estimated recoverable				979.5	1,035.5	1,022.3	997.3	795.0	621.1	570.3
Net re-estimated liability				$ 1,971.5	$ 2,093.9	$ 2,124.3	$ 2,066.6	$ 1,863.0	$ 1,818.6	$ 1,734.9
Four years later:										
Gross re-estimated liability					$ 3,128.6	$ 3,178.8	$ 3,088.5	$ 2,782.4	$ 2,458.4	$ 2,351.0
Re-estimated recoverable					1,054.6	1,057.2	1,017.4	888.8	634.9	588.1
Net re-estimated liability					$ 2,074.0	$ 2,121.6	$ 2,071.1	$ 1,893.6	$ 1,823.5	$ 1,762.9
Five years later:										
Gross re-estimated liability						$ 3,197.0	$ 3,126.1	$ 2,814.1	$ 2,576.4	$ 2,368.2
Re-estimated recoverable						1,075.3	1,047.8	912.5	715.9	597.3
Net re-estimated liability						$ 2,121.7	$ 2,078.3	$ 1,901.6	$ 1,860.5	$ 1,770.9
Six years later:										
Gross re-estimated liability							$ 3,148.7	$ 2,848.1	$ 2,619.0	$ 2,483.4
Re-estimated recoverable							1,064.6	934.7	748.0	676.6
Net re-estimated liability							$ 2,084.1	$ 1,913.4	$ 1,871.0	$ 1,806.8
Seven years later:										
Gross re-estimated liability								$ 2,871.6	$ 2,649.2	$ 2,523.8
Re-estimated recoverable								946.2	766.1	705.5
Net re-estimated liability								$ 1,925.4	$ 1,883.1	$ 1,818.3
Eight years later:										
Gross re-estimated liability									$ 2,672.9	$ 2,552.1
Re-estimated recoverable									775.3	717.4
Net re-estimated liability									$ 1,897.6	$ 1,834.7

Nine years later:	
Gross re-estimated liability	$ 2,576.0
Re-estimated recoverable	725.0
Net re-estimated liability	$ 1,851.0

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Reinsurance

We maintain a reinsurance program designed to protect against large or unusual losses and LAE activity. We utilize a variety of reinsurance agreements, which are intended to control our exposure to large property and casualty losses, stabilize earnings and protect capital resources, including facultative reinsurance, excess of loss reinsurance and catastrophe reinsurance. Catastrophe reinsurance serves to protect us, as the ceding insurer, from significant aggregate losses arising from a single event such as snow, ice storm, windstorm, hail, hurricane, tornado, riot or other extraordinary event. We determine the appropriate amount of reinsurance based upon our evaluation of the risks insured, exposure analyses prepared by consultants and/or reinsurers and on market conditions, including the availability and pricing of reinsurance.

We cede to reinsurers a portion of our risk based upon policy premiums subject to such reinsurance. Reinsurance contracts do not relieve us from our obligations to policyholders. Failure of reinsurers to honor their obligations could result in losses to us. We believe that the terms of our reinsurance contracts are consistent with industry practice in that they contain standard terms with respect to lines of business covered, limit and retention, arbitration and occurrence. Based upon reported financial strength ratings from rating agencies, ongoing review of our reinsurers financial statements and reputations in the reinsurance marketplace and the analysis and guidance of our reinsurance intermediaries, we believe that our reinsurers are financially sound.

As described above under Residual Markets and Pooling Arrangements Reinsurance Facilities and Pools , we are subject to concentration of risk with respect to reinsurance ceded to various mandatory residual market mechanisms.

Reference is made to Reinsurance in Note 18 on pages 108 and 109 of the Notes to Consolidated Financial Statements included in Financial Statements and Supplementary Data of this Form 10-K.

Reference is also made to Reinsurance Facilities and Pools on pages 8 and 9 of this Form 10-K.

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The following tables summarize our reinsurance programs:

2006
(in millions)

Treaty	*Loss Amount*	*Loss Retention*	*Reinsurance Coverage, Including Non-Certified Terrorism*	*Certified Terrorism Coverage (as defined by TRIA)*
Property catastrophe occurrence treaty				
All perils, per occurrence	< $60.0	100%	NA	NA
	$60.0 to $500.0	16%	84%	84%; Personal lines only
	> $500.0	100%	NA	NA
Property catastrophe aggregate treaty [1]				
All perils	< $90.0	100%	NA	NA
	$90.0 to $140.0	10%	90%	90%; Personal lines only
	> $140.0	100%	NA	NA
Property per risk treaty [2]				
All perils, per risk	< $2.0	100%	NA	NA
	$2.0 to $50.0	NA	100%	100%
	> $50.0	100%	NA	NA
Casualty reinsurance [3]				
Each loss, per occurrence for general liability, automobile liability and workers compensation	< $0.5	100%	NA	NA
	$0.5 to $1.25	35%	65%	65%; subject to annual aggregate limit
	$1.25 to $30.0	NA	100%	100%; subject to annual aggregate limit
	> $30.0	100%	NA	NA
Umbrella reinsurance [2]				
Excess of loss treaty on umbrella liability coverages	< $1.0	100%	NA	NA
	$1.0 to $15.0	NA	100%	100%; non-target risks only
	> $15.0	100%	NA	NA
Commercial marine reinsurance [2]				
All inland and ocean marine, each occurrence	< $1.0	100%	NA	NA
	$1.0 to $6.0	NA	100%	100%; inland marine only
	> $6.0	100%	NA	NA
Surety/fidelity bond reinsurance [2]				
Excess of loss treaty on bond business	< $2.0	100%	NA	NA
	$2.0 to $30.0	15%	85%	NA
	> $30.0	100%	NA	NA

NA Not applicable

(1) Retention and loss amounts were variable, ranging from $90.0 million to $93.0 million and $140.0 million to $143.0 million, respectively. The property catastrophe aggregate treaty included a per occurrence limit of $30.0 million.

(2) The property per risk, commercial marine and bond treaties have an annual effective date of July 1st, and the excess of loss on umbrella liability coverage is continuous. All other treaties have January 1st effective dates.

(3) The casualty reinsurance treaty includes $5 million of coverage for nuclear, chemical or biological events, whether or not such events are terrorism related. Certified terrorism losses, as defined by TRIA, which are not related to nuclear, chemical or biological events are subject to an annual aggregate limit of $30 million.

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2007
(in millions)

Treaty	*Loss Amount*	*Loss Retention*	*Reinsurance Coverage, including non-certified terrorism*	*Certified Terrorism Coverage (as defined by TRIA)*
Property catastrophe occurrence treaty				
All perils, per occurrence	< $90.0	100%	NA	NA
	$90.0 to $600.0	15%	85%	85%; Personal lines only
	> $600.0	100%	NA	NA
Property per risk treaty [(1)]				
All perils, per risk	< $2.0	100%	NA	NA
	$2.0 to $50.0	NA	100%	100%
	> $50.0	100%	NA	NA
Casualty reinsurance [(2)]				
Each loss, per occurrence for general liability, automobile liability and workers compensation	< $.5	100%	NA	NA
	$0.5 to $1.25	60%	40%	40%; subject to annual aggregate limit
	$1.25 to $30.0	NA	100%	100%; subject to annual aggregate limit
	> $30.0	100%	NA	NA
Umbrella reinsurance [(1)]				
Excess of loss treaty on umbrella liability coverages	< $1.0	100%	NA	NA
	$1.0 to $15.0	NA	100%	100%; non-target risks only
	> $15.0	100%	NA	NA
Commercial marine reinsurance [(1)]				
All inland and ocean marine, each occurrence	< $1.0	100%	NA	NA
	$1.0 excess $1.0 annual aggregate deductible	16%	84%	84%; inland marine only
	$2.0 to $6.0	NA	100%	100%; inland marine only
	> $6.0	100%	NA	NA
Surety/fidelity bond reinsurance [(1)]				
Excess of loss treaty on bond business	< $2.0	100%	NA	NA
	$3.0 excess $1.0 annual aggregate deductible	17.5%	82.5%	NA
	$5.0 to $35.0			

>$35.0	10%	90%	NA
	100%	NA	NA

NA Not applicable

(1) The property per risk, commercial marine and bond treaties have an annual effective date of July 1st and the excess of loss on umbrella liability coverage is continuous. All other treaties have January 1st effective dates.

(2) The casualty reinsurance treaty includes $5 million of coverage for nuclear, chemical or biological events, whether or not such events are terrorism related. Certified terrorism losses, as defined by TRIA, which are not related to nuclear, chemical or biological events are subject to an annual aggregate limit of $30 million.

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We renewed our property catastrophe occurrence reinsurance treaty for approximately $48 million in 2007 and did not purchase the property catastrophe aggregate treaty. The cost of these treaties was approximately $52 million in 2006. For 2007, we increased our property catastrophe occurrence treaty coverage from $500 million to $600 million and raised our retention from $60 million to $90 million. There continues to be one mandatory reinstatement premium provision in the 2007 property catastrophe occurrence reinsurance treaty, consistent with a similar provision in the 2006 treaty. We believe the increase in retention for 2007 is appropriate given our increased surplus and the current reinsurance pricing environment.

While we exclude coverage of nuclear, chemical or biological events from the personal and commercial policies we write, we are required by law to offer this coverage in our workers compensation policies. We have reinsurance coverage under our casualty reinsurance treaty for losses that result from nuclear, chemical or biological events of approximately $5 million. All other treaties exclude such coverage. Further, under TRIA, our retention of losses from such events, if deemed certified terrorist events, is limited to $137.4 million and 15% of losses in excess of this limit in 2007. However, there can be no assurance that such events would not be material to our financial position or results of operations.

LIFE COMPANIES

OVERVIEW

Our Life Companies segment consists of two major components: Continuing Operations and Discontinued Operations. Our Continuing Operations business includes the run-off blocks of traditional life insurance products (principally the Closed Block), our discontinued group life and health business (including group life and health involuntary pools), certain group retirement products, and our guaranteed investment contract (GIC) business, as well as certain non-insurance subsidiaries. For the year ended December 31, 2006, our Continuing Operations segment accounted for $142.5 million, or 5.4%, of consolidated segment revenues, and a segment loss of $3.9 million before federal income taxes.

Our Discontinued Operations business includes additional costs associated with the loss on the sale of AFLIAC, including indemnification costs, operations conversion expenses, employee severance costs and the net cost of transitional services. Reference is made to Segment Results Life Companies on pages 46 to 49 of Management s Discussion and Analysis of Financial Condition and Results of Operations of this Form 10-K.

PRODUCTS

The following table reflects total reserves held, both gross and net of reinsurance recoverable, for the segment s major product lines, including the Closed Block (see Note 1 - Summary of Significant Accounting Policies, Closed Block on page 77 of the Notes to the Consolidated Financial Statements included in Financial Statements and Supplementary Data of this Form 10-K), for the years ended December 31, 2006 and 2005.

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DECEMBER 31 *(In millions)*	Gross 2006	Gross 2005	Net of Reinsurance Recoverable 2006	Net of Reinsurance Recoverable 2005
General Account Reserves:				
Insurance				
Traditional life	**$ 723.8**	$ 760.2	**$ 723.7**	$ 760.0
Group life and health insurance	**287.3**	322.2	**77.5**	86.8
Other life and health insurance	**34.1**	52.6	**1.2**	0.4
Total insurance	**1,045.2**	1,135.0	**802.4**	847.2
Annuities				
Individual annuities	**97.6**	113.5	**7.2**	15.7
Group annuities	**374.7**	400.7	**369.5**	395.5
Total annuities	**472.3**	514.2	**376.7**	411.2
Guaranteed investment contracts		30.3		30.3
Total general account reserves [1]	**$ 1,517.5**	$ 1,679.5	**$ 1,179.1**	$ 1,288.7
Trust instruments supported by funding obligations	**$ 38.5**	$ 294.3	**$ 38.5**	$ 294.3
Separate Account Liabilities:				
Insurance - Variable universal life	**$ 85.3**	$ 70.2	**$ 85.3**	$ 70.2
Annuities				
Variable individual annuities	**362.0**	405.5	**362.0**	405.5
Group annuities	**96.3**	96.2	**96.3**	96.2
Total annuities	**458.3**	501.7	**458.3**	501.7
Total separate account liabilities [2]	**$ 543.6**	$ 571.9	**$ 543.6**	$ 571.9

[1] Excludes reserves of $49.5 million and $45.2 million as of December 31, 2006 and 2005, respectively, related to projected future gross losses in the runoff of our former CRMS segment, in accordance with Accounting Principles Board Opinion No. 30, *Reporting the Results of Operations Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions* (see Discontinued Operations Group Life and Health in Note 16 - Segment Information on pages 106 to 108 of the Notes to the Consolidated Financial Statements and Supplementary Data of this Form 10-K).

[2] Includes separate account liabilities subject to a modified coinsurance agreement with a former subsidiary, AFLIAC, of $437.3 million and $465.7 million as of December 31, 2006 and 2005, respectively.

We no longer issue new business. The primary insurance products in this run-off segment are participating, whole life insurance products and fixed individual annuities. Additionally, we continue to manage group annuity accounts for participants of defined benefit plans whose retirement benefits were purchased for them by their defined benefit plan sponsor. Finally, we have stable value products, which currently consist of non-qualified GICs, often referred to as funding agreements. These funding agreements were issued to non-ERISA institutional buyers and have either fixed or variable interest rates. They are denominated in either U.S. dollars or foreign currencies.

We previously participated in approximately 40 assumed accident and health reinsurance pools and arrangements. We ceased writing new premiums in this business in 1998, subject to certain contractual obligations. This reinsurance business was included in our former Corporate Risk Management Services segment, which was discontinued in 1999. The reinsurance pool business consisted primarily of direct and assumed medical stop loss, the medical and disability portions of workers compensation risks, small group managed care, long-term disability and

long-term care pools, student accident and special risk business. We are currently monitoring and managing the run-off of our related participation in the 23 pools with remaining liabilities.

We reinsured business from these pools and arrangements, and ceded business to other reinsurers that we assumed from these pools and arrangements. Accordingly, we have established reserves for claims and expenses related to this discontinued accident and health assumed reinsurance pool business. Our total reserves were $227.1 million at December 31, 2006. Our total amount recoverable from third party reinsurers was $165.9 million at December 31, 2006. These amounts are included in the table above under Group Life and Health Insurance . Although there have been no results in our Consolidated Statements of Income relating to our accident and health assumed reinsurance pools business since we discontinued this business in 1999, should we incur any additional losses from these pools, they would be reflected in discontinued operations.

COMPETITION AND DISTRIBUTION

We are no longer competing for new business or distributing life insurance products. Our focus is now on managing our existing portfolio of insurance contracts.

GENERAL ACCOUNT RESERVES

We have established liabilities for policyholders account balances and future policy benefits, included in the Consolidated Balance Sheets, to meet obligations on various policies and contracts. Reserves for policyholders account balances for universal life and investment-type policies are equal to cumulative account balances consisting of deposits plus credited interest, less expense and mortality charges and withdrawals. Future policy benefits for traditional contracts are computed on the net level premium method, which utilizes assumed investment yields, mortality, persistency, morbidity and expenses (including a margin for adverse deviation). These reserves were established at the time of issuance of a policy and generally vary by product, year of issue and policy duration. We periodically review both reserve assumptions and policyholder liabilities. Additionally, in regards to reserves established for pool liabilities, we are provided loss estimates by managers of each pool. We adopt reserve estimates for the pools that consider this information and other facts.

REGULATION OF LIFE INSURANCE AND BROKER-DEALER SUBSIDIARIES

Our life insurance subsidiary is subject to the laws and regulations of Massachusetts governing insurance companies and to the insurance laws and regulations of the various jurisdictions where we are licensed to operate. The extent of regulation varies, although most jurisdictions have laws and regulations governing the financial aspects of insurers, including standards of solvency, reserves, reinsurance and capital adequacy, and the business conduct of insurers. Any distributions from FAFLIC to the holding company require prior regulatory approval from the Massachusetts Commissioner of Insurance. Reference is made to Liquidity and Capital Resources on pages 61 to 63 of Management s Discussion and Analysis of Financial Condition and Results of Operations and to Note 15 - Dividend Restrictions on page 106 of the Notes to the Consolidated Financial Statements included in Financial Statements and Supplementary Data of this Form 10-K.

Although the variable life insurance and annuity business of our life insurance operations are subject to a modified coinsurance agreement with an unaffiliated company, FAFLIC and the separate accounts remain subject to extensive regulation under federal and state law. In addition, we may be involved, from time to time, in investigations and proceedings by governmental and self-regulatory agencies, including with respect to operations which have been sold, discontinued or reinsured. Reference is made to Contingencies and Regulatory Matters on pages 64 to 66 of Management s Discussion and Analysis of Financial Condition and Results of Operations and to Note 21 Commitments and Contingencies on pages 112 to 114 of the Notes to the Consolidated Financial Statements included in Financial Statements and Supplementary Data of this Form 10-K.

REINSURANCE

Our reinsurance program consists of coinsurance and modified coinsurance agreements that reinsure substantially all of our variable life insurance and annuity business, universal life, individual disability income business and yearly renewable term business. Although reinsurance does not legally discharge the ceding insurer from its primary liability for the full amount of policies reinsured, it does make the reinsurers liable to the insurer to the extent of the reinsurance ceded. We maintain a gross reserve for reinsurance liabilities. We ceded 17% of our statutory individual life insurance premiums in 2006. Based on a review of our reinsurers financial positions and reputations in the marketplace, we believe that our reinsurers are financially sound.

INVESTMENT PORTFOLIO

We held $6.2 billion of investment assets at December 31, 2006. Approximately 90% of our investment assets are comprised of fixed maturities, which includes both investment grade and below investment grade public and private debt securities. An additional 6% of our investment assets are comprised of cash and cash equivalents, while the remaining 4% includes our policy loans; mortgage loans, principally on commercial properties; equity securities; and other long-term investments. These investments are generally of high quality and our fixed maturities are broadly diversified across sectors of the fixed income market.

We determine the appropriate asset allocation (the selection of broad investment categories such as fixed maturities, equity securities and mortgage loans) by a process that focuses overall on our types of businesses and the level of surplus (net worth) required to support these businesses. For our Property and Casualty business, we develop an investment strategy that maximizes income balanced with driving long-term growth of shareholders equity and book value. Through extensive fundamental research and credit analysis, our investment professionals seek to identify a combination of undervalued securities in the credit markets and stable income producing higher quality US Agency, corporate and

mortgage-backed securities. For our Life business, our strategy is to generate investment income while maintaining stability of investment values and preserving capital. We believe that our approaches achieve the separate investment objectives of our Property and Casualty and Life businesses.

We develop investment guidelines for each portfolio consistent with the return objectives, risk tolerance, liquidity, time horizon, tax and regulatory requirements of the related product or business. Specific investments frequently meet the requirements of, and are acquired by, more than one investment portfolio. We have a general policy of diversifying investments both within and across all portfolios. We monitor the credit quality of our investments and our exposure to individual markets, borrowers, industries, sectors and in the case of mortgages, property types and geographic locations. All investments held by our insurance subsidiaries are subject to diversification requirements under insurance laws.

Reference is made to Investment Portfolio on pages 49 to 51 and Derivative Instruments on pages 51 and 52 of Management s Discussion and Analysis of Financial Condition and Results of Operations of this Form 10-K.

RATING AGENCIES

Insurance companies are rated by rating agencies to provide both industry participants and insurance consumers information on specific insurance companies. Higher ratings generally indicate the rating agencies opinion regarding financial stability and a stronger ability to pay claims.

We believe that strong ratings are important factors in marketing our products to our agents and customers, since rating information is broadly disseminated and generally used throughout the industry. We believe that a rating of A- or higher from A.M. Best Co. is particularly important for our business. Insurance company financial strength ratings are assigned to an insurer based upon factors deemed by the rating agencies to be relevant to policyholders and are not directed toward protection of investors. Such ratings are neither a rating of securities nor a recommendation to buy, hold or sell any security.

See Rating Agency Actions on pages 66 and 67 in Management s Discussion and Analysis of Financial Condition and Results of Operations of this Form 10-K.

EMPLOYEES

We have approximately 4,000 employees located throughout the United States as of December 31, 2006. We believe our relations with employees and agents are good.

EXECUTIVE OFFICERS OF THE REGISTRANT

Reference is made to Directors and Executive Officers of the Registrant in Part III, Item 10 on page 117 of this Form 10-K.

AVAILABLE INFORMATION

We file our annual report on Form 10-K, quarterly reports on Form 10-Q, periodic information on Form 8-K, our proxy statement, and other required information with the SEC. Shareholders may read and copy any materials on file with the SEC at the SEC s Public Reference Room at 450 Fifth Street, NW, Washington, DC 20549. Shareholders may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. In addition, the SEC maintains an Internet website, http://www.sec.gov, which contains reports, proxy and information statements and other information with respect to our filings.

Our website address is http://www.hanover.com. We make available free of charge on or through our website, our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as soon as reasonably practicable after we electronically file such material with, or furnish it to, the SEC. Additionally, our Code of Conduct is also available, free of charge, on our website. The Code of Conduct applies to our directors, officers and employees, including our Chief Executive Officer, Chief Financial Officer and Controller. While we do not expect to grant waivers to our Code of Conduct, any such waivers granted to our Chief Executive Officer, Chief Financial Officer or Controller, or any amendments to our Code will be posted on our website as required by law or rules of the New York Stock Exchange. Our Corporate Governance Guidelines and the charters of our Audit Committee, Compensation Committee, Committee of Independent Directors and Nominating and Corporate Governance Committee are available on our website. All documents are also available in print to any shareholder who requests them.

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ITEM 1A RISK FACTORS

We wish to caution readers that the following important factors, among others, in some cases have affected and in the future could affect our actual results and could cause our actual results for 2007 and beyond to differ materially from historical results and from those expressed in any of our forward-looking statements. When used in this Form 10-K, the words believes , anticipates , expects , projections , outlook , should , guidance and similar expressions are intended to identify forward looking statements. See Important Factors Regarding Forward-Looking Statements filed as Exhibit 99.2 to our Annual Report on Form 10-K for the period ended December 31, 2006. While any of these factors could affect our business as a whole, we have grouped certain factors by the business segment to which we believe they are most likely to apply.

RISKS RELATING TO OUR PROPERTY AND CASUALTY INSURANCE BUSINESS

We generate most of our total revenues and earnings through our property and casualty insurance subsidiaries. The results of companies in the property and casualty insurance industry historically have been subject to significant fluctuations and uncertainties. Our profitability could be affected significantly by (i) adverse loss development or loss adjustment expense for events we have insured in either the current or in prior years, including risks indirectly insured through various mandatory market mechanisms or through discontinued pools which are included in the Other Property and Casualty segment (our retained Life Companies business also includes discontinued pools which present similar risks); (ii) an inability to retain profitable policies in force and attract profitable policies in our Personal Lines and Commercial Lines segments, whether as the result of an increasingly competitive product pricing environment, the adoption by competitors of strategies to increase agency appointments and commissions, as well as marketing and advertising expenditures, or otherwise; (iii) heightened competition, including the recent intensification of price competition and increased marketing efforts by our competitors, the entry of new competitors and the introduction of new products by new and existing competitors, or as the result of consolidation within the financial services industry and the entry of additional financial institutions into the insurance industry; (iv) failure to obtain new customers, retain existing customers or reductions of policies in force by existing customers, whether as a result of recent competition or otherwise; (v) increases in costs, particularly those occurring after the time our products are priced and including construction, automobile, and medical and rehabilitation costs; (vi) restrictions on insurance underwriting; (vii) adverse state and federal legislation or regulation, including decreases in rates, the inability to obtain further rate increases, limitations on premium levels, increases in minimum capital and reserve requirements, benefit mandates, limitations on the ability to manage care and utilization, requirements to write certain classes of business, limitations on the use of credit scoring, such as the proposal to ban the use of credit scores with respect to personal lines in Michigan or arising out of the pending report on credit scores to be issued by the U.S Fair Trade Commission or interpretations of the Fair Credit Reporting Act such as are currently under review by the United States Supreme Court (see, for example, Safeco Insurance Company of America v. Charles Burr, et al. No. 06-84), restrictions on the use of certain compensation arrangements with agents and brokers, as well as continued compliance with state and federal regulations; (viii) adverse changes in the ratings obtained from independent rating agencies, such as Moody s, Standard and Poor s and A.M. Best; (ix) industry-wide change resulting from investigations and inquiries relating to compensation arrangements with insurance brokers and agents; (x) disruptions caused by the introduction of new personal lines products, such as our multivariate auto product, and related technology changes and new personal and commercial lines operating models; and (xi) disruptions caused by the implementation of a new claims system for both the personal and commercial automobile lines. Additionally, our profitability could be affected by adverse catastrophe experience, severe weather or other unanticipated significant losses. Further, certain new catastrophe models assume an increased frequency and severity of certain weather events, and financial strength rating agencies are placing increased emphasis on capital and reinsurance adequacy for insurers with certain geographic concentrations of risk. This factor, along with the increased cost of reinsurance, may result in insurers seeking to diversify their geographic exposure which could result in increased regulatory restrictions in those markets where insurers seek to exit or reduce coverage, as well as an increase in competitive pressures in non-coastal markets such as the Midwest. We have significant concentration of exposures in certain areas, including portions of the Northeast and Southeast and derive a material amount of profits from operations in the Midwest.

Specifically, underwriting results and segment income could be adversely affected by further changes in our net loss and LAE estimates related to hurricanes Katrina and Rita. The risks and uncertainties in our business that may affect such estimates and future

performance, including the difficulties in arriving at such estimates, should be considered. Estimating losses following any major catastrophe is an inherently uncertain process, which is made more difficult by the unprecedented nature of this event. Factors that add to the complexity in this event include the legal and regulatory uncertainty (including legislative changes in Louisiana to the statute of limitations for reporting certain claims and to sanctions for bad faith claims handling, as well as certain legal developments related to flood exclusion language in policy contracts and the interpretation of Louisiana Valued Policy Law), difficulty in accessing portions of the affected areas, the complexity of factors contributing to the losses, delays in claim reporting, the exacerbating circumstances of Hurricane Rita and a slower pace of recovery resulting from the extent of damage sustained in the affected areas due in part to the availability and cost of resources to effect repairs. As a result, there can be no assurance that our ultimate costs associated with this event will not be substantially different from current estimates. In addition, there can be no assurance that, in light of the devastation in the areas affected by Hurricane Katrina, our ability to obtain and retain policyholders will not be adversely affected.

Hurricane Katrina has also contributed to uncertainty regarding the reinsurance marketplace, which also experienced significant losses related to this catastrophe. We anticipate that the cost of and ability to obtain reinsurance coverages similar to our current programs will be adversely affected by these factors. Changes in the reinsurance marketplace in 2006 have resulted in the renewal of our property catastrophe occurrence treaty at higher retention levels with slightly higher coverage, as well as the non-renewal of our property catastrophe aggregate treaty. Changes in our reinsurance program, although dependent on the nature and number of catastrophes, may result in our incurring additional losses and ultimately decreased profits in future periods.

Additionally, future operating results as compared to prior years and forward-looking information regarding Personal Lines and Commercial Lines segment information on written and earned premiums, policies in force, underwriting results and segment income currently are expected to be adversely affected by competitive and regulatory pressures affecting rates. In addition, underwriting results and segment income could be adversely affected by changes in the current favorable frequency and loss trends generally being experienced industry-wide. Results in personal lines business may also be adversely affected by pricing decreases and market disruptions (including any caused by the current economic environment in Michigan, proposals in Michigan to reduce rates or the Michigan Commissioner of Insurance s proposed ban on the use of credit scores), by unfavorable loss trends that may result in New Jersey due to that state s supreme court ruling relating to the no-fault tort threshold, and by disruptions caused by judicial and potential legislative and executive branch intervention related to rules proposed by the former Massachusetts Commissioner of Insurance to reform the distribution of losses from the Massachusetts personal automobile residual market, as well as the 2006 reduction in personal automobile rates and significant rate reductions approved for 2007.

Also, our personal lines business production and earnings may be unfavorably affected by the introduction of our multivariate auto product should we experience adverse selection because of our pricing, operational difficulties or implementation impediments with independent agents, or the inability to grow new markets after the introduction of new products or the appointment of new agents. In addition, there are increased underwriting risks associated with premium growth and the introduction of new products or programs in both our personal and commercial lines businesses, as well as the appointment of new agencies and the expansion into new geographical areas, and we have experienced increased loss ratios with respect to our new personal automobile business, which is written through our ***Connections Auto*** product, particularly in certain states where we have less experience and data.

Additionally, during the past few years, we have made and our current plans are to continue to make, significant investments in our personal lines and commercial lines businesses to, among other things, strengthen our product offerings and service capabilities, improve technology and our operating models, build expertise in our personnel, and expand our distribution capabilities, with the ultimate goal of achieving significant and sustained profitable growth and obtaining favorable returns on these investments. In order for these investment strategies to be profitable, we must achieve both profitable premium growth and the successful implementation of our operating models so that our expenses do not increase proportionately with growth. The ability to grow profitably throughout the property and casualty cycle is crucial to our current strategy. There can be no assurance that we will be successful in profitably growing our business, or that we will not alter our current strategy due to changes in our markets or an inability to successfully maintain acceptable margins on new business or for other reasons, in which case written and earned premium, property and casualty segment income and net book value could be adversely affected.

Recent significant increases and expected further increases in the number of participants or insureds in state-sponsored reinsurance pools or FAIR Plans, particularly in the states of Massachusetts, Louisiana and Florida, combined with regulatory restrictions on the ability to adequately price, underwrite, or non-renew business, could expose us to significant exposures and assessment risks.

RISKS RELATING TO OUR LIFE COMPANIES

Our businesses may be affected by (i) adverse actions related to legal and regulatory actions described under Contingencies and Regulatory Matters on pages 64 to 66 of Management s Discussion and Analysis of Financial Condition and Results of Operations of this Form 10-K which are subject to the FIN 45 reserve described under Life Companies Discontinued Operations Loss on Sale of AFLIAC Variable Life Insurance and Annuity Business on page 48 of Management s Discussion and Analysis of Financial Condition and Results of Operations of this Form 10-K; (ii) adverse loss and expense development related to our discontinued assumed accident and health reinsurance pool business or failures of our reinsurers to timely pay their obligations (especially in light of the fact that historically these pools sometimes involved multiple layers of overlapping reinsurers, or so called spirals); (iii) possible claims relating to sales practices for insurance and investment products or our historical administration of such products; (iv) adverse trends in mortality and morbidity; and (v) lower appreciation or decline in value of our managed investments or the investment markets in general.

In particular, we have provided forward-looking information relating to the sale of our variable life insurance and annuity business and its effect on our results of operations and financial position. There are certain factors that could cause actual results to differ materially from those anticipated herein. These include (i) the impact of contingent liabilities, including litigation and regulatory matters, assumed or retained by THG in connection with the transaction and the impact of other indemnification obligations owed from THG to Goldman Sachs (including with respect to existing and potential litigation and regulatory actions and the remediation of certain processing errors in connection with tax reporting); (ii) the ability to outsource the administration of the retained FAFLIC businesses at projected rates and within a reasonable time frame in 2007; and (iii) future statutory operating results of FAFLIC, which will affect its projected statutory adjusted capital and ability to obtain future regulatory approval for dividends.

RISKS RELATING TO OUR BUSINESS GENERALLY

Other market fluctuations and general economic, market and political conditions also may negatively affect our business and profitability. These conditions include (i) changes in interest rates causing a reduction of investment income or in the market value of interest rate sensitive investments; (ii) higher service, administrative or general expense due to the need for additional advertising, marketing, administrative or management information systems expenditures; (iii) the inability to attract, or the loss or retirement of key executives or other key employees, and increased costs associated with the replacement of key executives or employees; (iv) changes in our liquidity due to changes in asset and liability matching, including the effect of defaults of debt securities; (v) failure of a reinsurer of our policies to pay its liabilities under reinsurance or coinsurance contracts or adverse effects on the cost and availability of reinsurance; (vi) changes in the mix of assets comprising our investment portfolios and changes in general market conditions that may cause the market value of our investment portfolio to fluctuate; (vii) losses resulting from our participation in certain reinsurance pools, including pools in which we no longer participate but may have unquantified potential liabilities relating to asbestos and other matters, or from fronting arrangements where the reinsurer does not meet all of its reinsurance obligations; (viii) defaults or impairments of debt securities held by us; (ix) higher employee benefit costs due to changes in market values of plan assets, interest rates, regulatory requirements or judicial interpretations of benefits; (x) the effects of our restructuring actions, including any resulting from our review of operational matters related to our business, including a review of our markets, products, organization, financial capabilities, agency management, regulatory environment, ancillary businesses and service processes; (xi) errors or omissions in connection with the administration of any of our products; and (xii) interruptions in our ability to conduct business as a result of terrorist actions, catastrophes or other significant events affecting infrastructure, and delays in recovery of our operating capabilities.

ITEM 1B UNRESOLVED STAFF COMMENTS

None.

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ITEM 2 PROPERTIES

We own our headquarters, located at 440 Lincoln Street, Worcester, Massachusetts, which consist primarily of approximately 758,000 square feet of office and conference space.

Citizens owns its home office, located at 645 W. Grand River, Howell, Michigan, which is approximately 104,000 square feet. Citizens also owns a three-building complex located at 808 North Highlander Way, Howell, Michigan, with approximately 157,000 square feet, where various business operations are conducted.

Hanover and Citizens lease offices throughout the country for branch sales, underwriting and claims processing functions.

We believe that our facilities are adequate for our present needs in all material respects. Certain of our properties may be made available for lease.

ITEM 3 LEGAL PROCEEDINGS

EMERALD LITIGATION

On July 24, 2002, an action captioned American National Bank and Trust Company of Chicago, as Trustee f/b/o Emerald Investments Limited Partnership, and Emerald Investments Limited Partnership v. Allmerica Financial Life Insurance and Annuity Company was commenced in the United States District Court for the Northern District of Illinois, Eastern Division. In 1999, plaintiffs purchased two variable annuity contracts with initial premiums aggregating $5 million. Plaintiffs, who AFLIAC subsequently identified as engaging in frequent transfers of significant sums between sub-accounts that in our opinion constituted market timing , were subject to restrictions upon such trading that AFLIAC imposed in December 2001. Plaintiffs allege that such restrictions constituted a breach of the terms of the annuity contracts. In December 2003, the court granted partial summary judgment to the plaintiffs, holding that at least certain restrictions imposed on their trading activities violated the terms of the annuity contracts.

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

A jury trial on plaintiffs damage claim was held in December 2006, which resulted in an aggregate award to plaintiffs of $1.3 million for lost profits and reimbursement of surrender charges. Plaintiffs motion for a new trial was subsequently denied. Plaintiffs currently have until March 2007 to file a Notice of Appeal to the United States Court of Appeals, Seventh Circuit.

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

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

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HURRICANE KATRINA LITIGATION

We have been named as a defendant in various litigation, including putative class actions, relating to disputes arising from damages which occurred as a result of Hurricane Katrina in 2005. As of December 31, 2006, there were in excess of 200 such cases, six of which were styled as class actions. These cases have been filed in both Louisiana state courts and federal district courts. These cases involve, among other claims, disputes as to the amount of reimbursable claims in particular cases, as well as the scope of insurance coverage under homeowners and commercial property policies due to flooding, civil authority actions, loss of landscaping, business interruption and other matters. Certain of these cases claim a breach of duty of good faith or violations of Louisiana insurance claims handling laws or regulations and involve claims for punitive or exemplary damages. Certain of the cases claim that under Louisiana s so-called Valued Policy Law , the insurers must pay the total insured value of a home which is totally destroyed if any portion of such damage was caused by a covered peril, even if the principal cause of the loss was an excluded peril. Other cases challenge the scope or enforceability of the water damage exclusion in the policies.

Several actions pending against various insurers, including us, were consolidated for purposes of pretrial discovery and motion practice under the caption In re Katrina Canal Breaches Consolidated Litigation, Civil Action No. 05-4182 in the United States District Court, Eastern District of Louisiana. On November 27, 2006, the Federal District Court issued an Order in these consolidated cases denying our motion to dismiss. The Court held that the flood exclusions utilized in the forms of homeowners and commercial lines policies issued by us and a number of other insurance carriers were ambiguous because such exclusions did not specify that they applied to flooding caused by negligent acts or omissions as well as to flooding caused by natural incidents such as Acts of God. The plaintiffs in these cases claim, among other things, that the efficient proximate cause of their losses was the third-party negligence of Orleans Levee District in the maintenance of the canal walls or in its failure to warn the plaintiffs and others of the impending water intrusion. The Federal District Court ordered that discovery proceed on the questions of whether there was such negligence and whether such negligence was in fact the efficient proximate cause of such losses.

On February 2, 2007, the United States Court of Appeals, Fifth Circuit, issued an Order granting our and the other defendant s motion for leave to appeal.

We continue to vigorously defend this matter and other cases related to losses incurred in connection with Hurricane Katrina. We believe that the flood exclusions at issue are unambiguous and enforceable. However, a final non-appealable order that our flood exclusions do not exclude losses from flooding caused by third-party negligence and a determination that such negligence was the efficient proximate cause of such flooding, or that such an exclusion is inapplicable where any portion of a loss is attributable to a covered peril, would likely have a material adverse effect on our financial position, as well as on our results of operations. We have established our loss and LAE reserves on the assumption that the flood exclusion will be found to be enforceable and effective to exclude losses caused by third-party negligence, as well as by Acts of God, and that the application of the Valued Policy Law will not result in our having to pay damages for perils not otherwise covered.

ITEM 4 SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matters were submitted to a vote of security holders in the fourth quarter of the fiscal year covered by this Annual Report on Form 10-K.

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PART II

ITEM 5 MARKET FOR REGISTRANT S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

COMMON STOCK AND STOCKHOLDER OWNERSHIP

Our common stock is traded on the New York Stock Exchange under the symbol THG . Prior to December 1, 2005, our common stock was traded on the New York Stock Exchange under the symbol AFC . On February 16, 2007, we had 32,842 shareholders of record and 51,271,040 shares outstanding. On the same date, the trading price of our common stock was $48.52 per share.

COMMON STOCK PRICES AND DIVIDENDS

	High	Low	Dividends
2006			
First Quarter	**$ 53.12**	**$ 42.98**	
Second Quarter	**$ 54.11**	**$ 43.17**	
Third Quarter	**$ 48.49**	**$ 41.17**	
Fourth Quarter	**$ 50.25**	**$ 43.95**	**$ 0.30**
2005			
First Quarter	$ 36.50	$ 30.27	
Second Quarter	$ 37.29	$ 32.85	
Third Quarter	$ 42.11	$ 37.13	
Fourth Quarter	$ 42.03	$ 37.20	$ 0.25

2006 DIVIDEND SCHEDULE

On October 17, 2006, the Board of Directors declared a $0.30 cash dividend, which was paid on December 12, 2006 to shareholders of record as of November 28, 2006. The payment of future dividends on our common stock will be a business decision made by the Board of Directors from time to time based upon our results of operations and financial condition and such other factors as the Board of Directors considers relevant.

Dividends to shareholders may be funded from dividends paid to us from our subsidiaries. Dividends from insurance subsidiaries are subject to restrictions imposed by state insurance laws and regulations. See Liquidity and Capital Resources on pages 61 to 63 of Management s Discussion and Analysis of Financial Condition and Results of Operations and Note 15 - Dividend Restrictions on page 106 of the Notes to Consolidated Financial Statements included in Financial Statements and Supplementary Data of this Form 10-K.

ISSUER PURCHASES OF EQUITY SECURITIES

Period	*Total Number of Shares Purchased*	*Average Price Paid per Share*	*Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs*	*Maximum Number of Shares That May Yet be Purchased Under the Plans or Programs*
October 1 31, 2006		$		
November 1 30, 2006				
December 1 31, 2006[1]	1,085	49.17		
Total	1,085	$ 49.17		

[1] Shares repurchased to satisfy tax withholding amounts due from the employee upon their receipt of previously deferred shares.

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ITEM 6-SELECTED FINANCIAL DATA

Five Year Summary of Selected Financial Highlights

For the Years Ended December 31

(In millions, except per share data)	**2006**	**2005**	**2004**	**2003**	**2002**
Statements of Income					
Revenues					
Premiums	**$ 2,254.6**	$ 2,198.2	$ 2,288.6	$ 2,282.3	$ 2,320.1
Fees and other income	**74.9**	80.9	83.1	169.2	207.1
Net investment income	**318.9**	321.4	329.3	363.9	502.4
Net realized investment (losses) gains	**(4.3)**	23.8	16.1	15.1	(126.1)
Total revenues	**2,644.1**	2,624.3	2,717.1	2,830.5	2,903.5
Benefits, Losses and Expenses					
Policy benefits, claims, losses and loss adjustment expenses	**1,471.8**	1,703.1	1,646.7	1,783.2	1,941.0
Policy acquisition expenses	**477.5**	465.2	477.0	467.7	463.9
Losses (gains) from retirement of funding agreements and trust instruments supported by funding obligations			0.2	(5.7)	(102.6)
(Income) loss from sale of universal life business				(5.5)	31.3
Restructuring costs	**1.6**	2.1	8.5	28.7	14.8
Losses (gains) on derivative instruments	**0.6**	2.3	0.6	1.9	(40.3)
Other operating expenses	**413.2**	380.3	439.6	500.0	465.4
Total benefits, losses and expenses	**2,364.7**	2,553.0	2,572.6	2,770.3	2,773.5
Income from continuing operations before federal income taxes	**279.4**	71.3	144.5	60.2	130.0
Federal income tax expense (benefit)	**87.7**	(5.2)	(0.8)	3.9	(1.4)
Income from continuing operations before minority interest	**191.7**	76.5	145.3	56.3	131.4
Minority interest (2)					(16.0)
Income from continuing operations	**191.7**	76.5	145.3	56.3	115.4
Discontinued Operations:					
Income (loss) from operations of discontinued variable life insurance and annuity business, net of taxes		42.7	37.2	30.6	(417.8)
Loss on disposal of variable life insurance and annuity business, net of taxes	**(29.8)**	(444.4)			
Gain on sale of Financial Profiles, Inc., net of taxes	**7.8**				
(Loss) income from discontinued operations	**(22.0)**	(401.7)	37.2	30.6	(417.8)
Income (loss) before cumulative effect of change in accounting principle	**169.7**	(325.2)	182.5	86.9	(302.4)
Cumulative effect of change in accounting principle	**0.6**		(57.2)		(3.7)
Net income (loss)	**$ 170.3**	$ (325.2)	$ 125.3	$ 86.9	$ (306.1)
Earnings (loss) per common share (diluted) (1)	**$ 3.27**	$ (6.02)	$ 2.34	$ 1.63	$ (5.79)
Dividends declared per common share (diluted)	**$ 0.30**	$ 0.25	$	$	$

Balance Sheets (at December 31)					
Total assets	**$ 9,856.6**	$ 10,634.0	$ 23,810.1	$ 25,510.1	$ 26,627.0
Long-term debt (2)	**508.8**	508.8	508.8	499.5	199.5
Total liabilities	**7,857.4**	8,682.7	21,470.6	23,289.9	24,254.8
Minority interest (2)					300.0
Shareholders equity	**1,999.2**	1,951.3	2,339.5	2,220.2	2,072.2

(1) Per share data for the year ended December 31, 2002 represents basic loss per share due to antidilution.

(2) For periods subsequent to 2002, long-term debt includes the mandatorily redeemable preferred securities of a subsidiary trust (minority interest) in accordance with Statement of Financial Accounting Standards No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity* (Statement No. 150). Preferred dividends associated with these instruments have been reflected in interest expense, which is included in other operating expenses in periods subsequent to 2002. Reclassification of prior year amounts was not permitted under Statement No. 150.

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ITEM 7

MANAGEMENT S DISCUSSION AND ANALYSIS OF

FINANCIAL CONDITION AND RESULTS OF OPERATIONS

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INTRODUCTION

The following Management s Discussion and Analysis of Financial Condition and Results of Operations of The Hanover Insurance Group, Inc., (the holding company) and subsidiaries (THG) should be read in conjunction with the Consolidated Financial Statements and related footnotes included elsewhere herein.

Our results of operations include the accounts of The Hanover Insurance Company (Hanover Insurance) and Citizens Insurance Company of America (Citizens), our principal property and casualty companies; First Allmerica Financial Life Insurance Company (FAFLIC), our life insurance and annuity company; and certain other insurance and non-insurance subsidiaries. Our results of operations also include the accounts of Allmerica Financial Life Insurance and Annuity Company (AFLIAC) through December 30, 2005. On December 30, 2005, we completed the sale of AFLIAC to The Goldman Sachs Group, Inc. and its subsidiaries (Goldman Sachs). In addition, we have reinsured 100% of the variable life insurance and annuity business of FAFLIC (see Significant Transactions on pages 59 and 60 of this Form 10-K for further information). The results of AFLIAC s variable life insurance and annuity operations are reported as discontinued operations. Hanover Insurance and Citizens are domiciled in the states of New Hampshire and Michigan, respectively, while FAFLIC is domiciled in Massachusetts.

EXECUTIVE OVERVIEW

As a result of the sale of the variable life insurance and annuity business in December 2005, the property and casualty business constitutes our primary ongoing operations. Our property and casualty business includes personal lines business, commercial lines business and other property and casualty business.

In our personal lines business, we are focused on making investments that are intended to help us maintain profitability, build a distinctive position in the market and continue to provide us with profitable growth opportunities. We expect that our focus will be on the expansion of our distribution capabilities by actively seeking to write more business with our best agents, and the development of new relationships with agents in the states where we conduct business. At the same time, we expect continued growth from the significant investments made during the past several years to strengthen our product offerings, including from ***Connections Auto***, our multivariate auto product, which is now available in seventeen states and accounts for most of our new personal automobile business. Part of our strategy is to broaden our product portfolio offerings and write whole accounts , which are accounts that include multiple personal line coverages for the same customer. As such, we have made investments in our homeowners product, including an upgrade to our homeowners product released in September 2006 that enhanced our agents ease of doing business and decreased quote times. We expect to introduce further homeowners product enhancements through a new homeowners product, to be branded ***Connections Home***, in several states during the first half of 2007. Additionally, we are making investments in and looking to grow our umbrella product throughout 2007. During 2006, we generated growth in written premium primarily due to our ***Connections Auto*** product and from the appointment of new agents in several states.

During 2006, we continued to focus on growing our commercial lines business by continuing to develop our product portfolio and specialty lines expertise in commercial lines in order to target small and first-tier middle market accounts, which encompass clients whose annual premiums are generally below $200,000, through mid-sized agents. We continued to expand our business owner s policy to accommodate a broader spectrum of risks, and continued to enhance our inland marine, bond and umbrella programs, which on average are expected to offer higher margins over time and enable us to deliver a more complete product portfolio to our agents and policyholders in our target markets. In 2006, we experienced strong growth in both our inland marine and bond businesses, as well as growth in our more traditional products. During 2007, our objective is to increase the number of our partner agents and continue to achieve profitable growth in several lines of business, particularly in our inland marine, bond and other niche businesses.

Our property and casualty group s earnings increased in 2006 as compared to the prior year due primarily to improved catastrophe losses in both Commercial Lines and Personal Lines. Catastrophe losses were unusually high in 2005 primarily due to Hurricane Katrina. The improved earnings also resulted from increased favorable development of prior years reserves and improved current accident year results, primarily in Commercial Lines. Partially offsetting these improved earnings was an increase in underwriting and loss adjustment expenses. Over the past several years, we have made significant investments and increased expenses in order to, among other things, strengthen our product offerings and service capabilities, improve technology and our operating models, build expertise in our personnel and expand our distribution capabilities. The ability to achieve profitable premium growth in 2007 and later years in order to earn adequate returns on such investments and expenses, and to grow further without proportionate increases in expenses, is key to our current strategy.

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In the third quarter of 2005, the property and casualty industry was significantly and adversely affected by the damage caused by Hurricane Katrina. This catastrophe placed unprecedented demands on both the industry and Hanover Insurance, one of our primary property and casualty companies. In 2005, the estimated impact of this catastrophe, on a gross, pre-tax basis was $562.0 million. The estimated impact, net of reinsurance, of this catastrophe was approximately $250 million on a pre-tax basis, or $162 million on an after-tax basis. Recent trends in claims activity observed during 2006 led us to re-evaluate and increase our estimate of Hurricane Katrina loss and loss adjustment expense (LAE) reserves. In 2006, we increased our Hurricane Katrina gross reserves by approximately $59 million on a pre-tax basis. Our increase in this reserve, net of reinsurance, totaled $48 million on a pre-tax basis, or $32 million on an after-tax basis. This results in an inception-to-date gross impact from this event of approximately $621 million on a gross, pre-tax basis. Our net of reinsurance impact from this catastrophe was approximately $298 million on a pre-tax basis, or approximately $194 million on an after-tax basis. Although we believe our current Hurricane Katrina reserves are adequate, there can be no assurance that our ultimate costs associated with this event will not substantially exceed these estimates.

DESCRIPTION OF OPERATING SEGMENTS

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

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

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

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

RESULTS OF OPERATIONS

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

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operations by highlighting net income attributable to the core operations of the business. However, segment income should not be construed as a substitute for net income determined in accordance with generally accepted accounting principles (GAAP).

Catastrophe losses are a significant component in understanding and assessing the financial performance of our property and casualty insurance business. However, catastrophic events, such as Hurricane Katrina, make it difficult to assess the underlying trends in this business. Management believes that providing certain financial metrics and trends excluding the effects of catastrophes helps investors to understand the variability in periodic earnings and to evaluate the underlying performance of our operations.

Our consolidated net income was $170.3 million in 2006, compared to a net loss of $325.2 million in 2005. The increase in 2006 of $495.5 million is primarily the result of the absence in 2006 of the $444.4 million loss on the disposal of our variable life insurance and annuity business recorded in 2005, as well as an increase in segment results from our property and casualty business. This improvement in property and casualty segment results primarily reflects lower after-tax catastrophe losses in 2006. We experienced unusually high catastrophe losses in 2005 from Hurricane Katrina, and to a lesser extent, Hurricane Rita.

Our consolidated net loss was $325.2 million in 2005, compared to net income of $125.3 million in 2004. The decrease in 2005 of $450.5 million resulted primarily from the aforementioned loss on the disposal of our variable life insurance and annuity business, as well as a decrease in segment results in our property and casualty business, primarily due to increased catastrophe losses from Hurricane Katrina, and to a lesser extent, Hurricane Rita. Net income in 2004 included the effect of the implementation of Statement of Position 03-1, *Accounting and Reporting by Insurance Enterprises for Certain Nontraditional Long-Duration Contracts and for Separate Accounts* (SOP 03-1), which resulted in an after-tax charge of $57.2 million, as well as a $30.4 million favorable federal income tax settlement.

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

For the Years Ended December 31 *(In millions)*	**2006**	**2005**	**2004**
Segment income (loss) before federal income taxes:			
Property and Casualty			
Personal Lines	**$ 186.7**	$ 143.2	$ 134.6
Commercial Lines	**120.3**	(35.0)	58.0
Other Property and Casualty	**21.1**	5.5	5.4
Total Property and Casualty	**328.1**	113.7	198.0
Life Companies	**(3.9)**	(18.7)	(22.3)
Interest expense on corporate debt	**(39.9)**	(39.9)	(39.9)
Total segment income before federal income taxes	**284.3**	55.1	135.8
Federal income tax expense on segment income	**(88.2)**	(1.0)	(26.6)
Change in prior years tax reserves	**3.3**	2.3	
Federal income tax settlement		9.5	30.4
Net realized investment (losses) gains, net of deferred acquisition cost and amortization	**(3.5)**	18.6	16.1
Gains (losses) on derivative instruments	**0.2**	(0.3)	1.3
(Losses) gains from retirement of funding agreements and trust instruments supported by funding obligations			(0.2)
Restructuring costs	**(1.6)**	(2.1)	(8.5)
Federal income tax expense on non-segment items	**(2.8)**	(5.6)	(3.0)
Income from continuing operations, net of taxes	**191.7**	76.5	145.3
Discontinued operations:			
Income from discontinued variable life insurance and annuity business, net of taxes		42.7	37.2
Loss from disposal of variable life insurance and annuity business, net of taxes	**(29.8)**	(444.4)	
Gain on sale of Financial Profiles, Inc., net of taxes	**7.8**		
Income (loss) before cumulative effect of change in accounting principle	**169.7**	(325.2)	182.5
Cumulative effect of change in accounting principle, net of taxes	**0.6**		(57.2)

Net income (loss)	**$ 170.3**	$ (325.2)	$ 125.3

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SEGMENT INCOME

2006 Compared to 2005

The Property and Casualty group s segment income increased $214.4 million, to $328.1 million for the year ended December 31, 2006, compared to $113.7 million in 2005, primarily due to a decrease in catastrophe related activity of $196.7 million in 2006. In 2005, we experienced significant catastrophe related activity primarily due to Hurricane Katrina, and to a lesser extent, Hurricane Rita. In 2006, we increased our catastrophe reserves for Hurricane Katrina by $48.6 million. Segment income was also positively affected by a litigation settlement which resulted in a $7.0 million benefit for 2006.

Excluding the impact of all catastrophe related activity and the litigation settlement, our Property and Casualty group s segment income would have increased $10.7 million for the year ended December 31, 2006, as compared to 2005. Segment income was positively affected by an increase of $49.1 million of favorable development on prior years loss and LAE reserves excluding Hurricane Katrina activity. Also, positively affecting segment income was improved current accident year underwriting results of an estimated $28 million, primarily due to earned premium growth in our inland marine and bond lines of business and favorable loss performance in most of our Commercial lines of business. Net investment income increased by $18.3 million, primarily due to improved operational cash flows, and other income increased by approximately $7 million. These items were partially offset by increased underwriting and LAE expenses of $94.3 million, primarily attributable to a $23.6 million increase in variable compensation costs (primarily a result of improved 2006 Property and Casualty group segment results), a $13.9 million increase in stock-based compensation primarily due to the impact of the new accounting for stock-based compensation in 2006, a $16.4 million increase in investments in technology and $6.5 million of higher expenses in support of our inland marine and bond business. In addition, there was a $17.8 million increase in the proportion of the corporate overhead expenses assigned to the Property and Casualty group as a result of the disposal of the variable life insurance and annuity business in December 2005.

Life Companies segment loss was $3.9 million for the year ended December 31, 2006, compared to a loss of $18.7 million during the same period in 2005. This improvement was primarily due to lower expenses resulting from the run-off of our continuing life business and due to lower losses in our GIC business. This improvement is partially offset by the absence, in 2006, of earnings from FAFLIC variable products that were 100% coinsured at December 30, 2005.

Our federal income tax expense on segment income was $88.2 million in 2006 compared to an expense of $1.0 million in 2005. The increase in federal income tax expense is primarily due to higher segment income in 2006, as well as by a reduced level of tax-exempt interest income.

2005 Compared to 2004

The Property and Casualty group s segment income decreased $84.3 million, or 42.6%, to $113.7 million for the year ended December 31, 2005, compared to $198.0 million in 2004. In 2005, we experienced significant catastrophe losses due primarily to Hurricane Katrina, and to a lesser extent, Hurricane Rita. As a result, segment income was negatively impacted by $303.9 million of catastrophe related activity, which includes $27.0 million of reinsurance reinstatement premiums resulting from Hurricane Katrina, in 2005. Catastrophe losses for the year ended December 31, 2004 were $99.3 million, primarily resulting from several hurricanes in the Southeast.

Excluding the impact of all catastrophe related activity, our Property and Casualty group s segment income would have increased $120.3 million for the year ended December 31, 2005, compared to 2004. Segment income was positively affected, as compared to 2004, by an increase of $65.0 million of favorable development on prior years loss and LAE reserves. Also positively affecting segment income in 2005 was an estimated $29 million of improved current accident year underwriting results. Underwriting expenses decreased $27.4 million in 2005 compared to 2004, primarily due to lower contingent commissions, to lower employee related expenses and to a reduction in expenses due to a premium tax credit associated with our participation in an involuntary pool.

Life Companies segment loss was $18.7 million for the year ended December 31, 2005, compared to a loss of $22.3 million during the same period in 2004. This improvement of $3.6 million was primarily the result of lower expenses due to the run-off of our continuing life business, partially offset by a $4.3 million provision related to a regulatory matter.

Our federal income tax expense on segment income was $1.0 million in 2005 compared to an expense of $26.6 million in 2004. The change in federal income tax expense is primarily due to lower segment income in 2005, offset, in part, by a reduced level of tax-exempt interest income in 2005.

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OTHER ITEMS

In 2006 and 2005, we recorded benefits of $3.3 million and $2.3 million, respectively, due to a reduction in our federal income tax reserves resulting from ongoing Internal Revenue Service audits. In 2005 and 2004, we recorded income tax benefits of $9.5 million and $30.4 million, respectively, relating to federal income tax settlements for prior years (see Income Taxes on pages 56 and 57 of this Form 10-K for further information).

Net realized investment losses were $3.5 million in 2006, primarily related to $11.3 million of charges resulting from impairments. Partially offsetting these losses were $11.0 million of gains recognized primarily from the sale of $611.7 million of fixed maturities. Also, we incurred $4.6 million in partnership losses in 2006. During 2005, net realized investment gains were $18.6 million, primarily due to $33.4 million of gains recognized from the sale of approximately $1.2 billion of fixed maturities. Partially offsetting these gains were $9.3 million of impairments, primarily related to fixed maturities, and $1.0 million of losses related to the termination of certain derivative instruments. During 2004, net realized investment gains were $16.1 million, primarily due to $29.1 million of gains from the sale of $735.3 million of fixed maturities. Partially offsetting these gains were losses of $9.7 million related to the termination of certain derivative instruments and $6.3 million of impairments primarily of fixed maturities.

Gains on derivative instruments were $0.2 million in 2006 as compared to losses on derivative instruments of $0.3 million in 2005 and gains of $1.3 million in 2004. The changes in net gains on derivative instruments in 2006, 2005 and 2004 resulted from derivative activity that does not meet the requirements of hedge accounting.

In 2006, 2005 and 2004, we recognized expenses of $1.6 million, $2.1 million and $5.3 million, respectively, primarily as a result of a 2003 restructuring effort related to our broker/dealer in our Life Companies segment. These restructuring costs consisted of severance and other employee-related expenses, as well as the cancellation of certain lease agreements and contracted services. Additionally, in 2004, we ceased certain employee and affinity group businesses and restructured certain commercial lines operations in our Property and Casualty group and recognized $3.2 million in expenses related to this effort.

In 2005, we sold our variable life insurance and annuity business (see Significant Transactions on pages 59 and 60 of this Form 10-K for further information). In accordance with Statement of Financial Accounting Standards No. 144, *Accounting for the Impairment or Disposal of Long-lived Assets* (Statement No. 144), we reflected the 2005 results of AFLIAC variable life insurance and annuity business as a discontinued operation. As such, we have restated prior year balances related to this business as discontinued operations. We recognized income of $42.7 million from the discontinued variable life insurance and annuity business in 2005, compared to $37.2 million in 2004.

In 2005, we recorded a loss of $444.4 million related to the aforementioned sale of our variable life insurance and annuity business (see Life Companies Discontinued Operations on pages 47 and 48 of this Form 10-K for a further discussion of this business). Additionally, in 2006, we recorded losses of $29.8 million, net of taxes, related to these discontinued operations. The losses in 2006 relate to both a $15.0 million increase to the existing provision for our estimated potential liability for certain contractual indemnities to Goldman Sachs relating to the pre-sale activities of the business sold, as well as a $14.8 million loss related to costs associated with the transition of this business to Goldman Sachs. The additional $15.0 million provision was recorded under FASB Interpretation No. 45, *Guarantor s Accounting and Disclosure Requirements for Guarantees*, *Including Indirect Guarantees of Indebtedness of Others* (FIN 45). This additional provision relates to preliminary estimated expenses, reimbursements, penalties and other costs of remediating certain pre-closing processing errors relating to tax reporting to certain policyholders and others in connection with distributions under a subset of our former variable annuity business.

On August 31, 2006, we sold all of the outstanding shares of Financial Profiles, Inc., a wholly-owned subsidiary, to Emerging Information Systems Incorporated and recognized a $7.8 million after-tax gain on the sale during the third quarter of 2006 (see Significant Transactions on pages 59 and 60 of this Form 10-K).

Effective January 1, 2006, we adopted Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment* (Statement No. 123(R)), which resulted in a cumulative effect benefit of $0.6 million. This adjustment was the result of remeasuring the value of certain stock-based awards at grant-date fair value that had previously been measured at intrinsic value. During 2004, we adopted SOP 03-1, which resulted in a cumulative effect charge of $57.2 million, net of taxes. The charge resulted from new requirements for recognizing guaranteed minimum death benefit and guaranteed minimum income benefit reserves based on various assumptions, including estimates of future market returns and expected contract persistency.

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Net income (loss) includes the following items by segment:

	2006				
	Property and Casualty				
(In millions)	**Personal Lines**	**Commercial Lines**	**Other Property and Casualty (2)**	**Life Companies**	**Total**
Change in prior years tax reserves	**$ (1.3)**	**$ (1.4)**	**$ 4.1**	**$ 1.9**	**$ 3.3**
Net realized investment gains (losses) (1)	**1.9**	**2.0**	**(4.1)**	**(3.3)**	**(3.5)**
Gains on derivative instruments				**0.2**	**0.2**
Restructuring costs				**(1.6)**	**(1.6)**
Loss on disposal of variable life insurance and annuity business, net of taxes				**(29.8)**	**(29.8)**
Gain on sale of Financial Profiles, Inc., net of taxes				**7.8**	**7.8**
Cumulative effect of change in accounting principle, net of taxes	**0.2**	**0.3**		**0.1**	**0.6**

	2005				
	Property and Casualty				
(In millions)	**Personal Lines**	**Commercial Lines**	**Other Property and Casualty (2)**	**Life Companies**	**Total**
Change in prior years tax reserves	$	$	$	$ 2.3	$ 2.3
Federal income tax settlement				9.5	9.5
Net realized investment gains (1)	2.6	2.6	2.4	11.0	18.6
Losses on derivative instruments				(0.3)	(0.3)
Restructuring costs				(2.1)	(2.1)
Income from discontinued variable life insurance and annuity business, net of taxes				42.7	42.7
Loss on disposal of variable life insurance and annuity business, net of taxes				(444.4)	(444.4)

2004