

COMMERCE GROUP INC /MA
Form 10-Q
November 09, 2007

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2007

or

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

For the transition period from _____ to _____.

Commission File Number 001-13672

The Commerce Group, Inc.

(Exact name of registrant as specified in its charter)

Massachusetts

(State or other jurisdiction of incorporation or organization)

04-2599931

(IRS Employer Identification No.)

211 Main Street, Webster, Massachusetts

(Address of principal executive offices)

01570

(Zip Code)

Registrant's telephone number, including area code: (508) 943-9000

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 and Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant 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

Accelerated filer

Non-accelerated filer

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

As of October 31, 2007, the number of shares outstanding of the Registrant's common stock (excluding Treasury Shares) was 60,126,578.

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The Commerce Group, Inc.

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Part I - Financial Information

Item 1. Financial Statements

The Commerce Group, Inc. and Subsidiaries
Consolidated Balance Sheets
September 30, 2007 and December 31, 2006

| | 2007 | 2006 |
|--|--------------------|--------------------|
| | (Unaudited) | |
| ASSETS | | |
| (Thousands of dollars, except per share data) | | |
| Investments and cash (Note 4): | \$1,906,047 | \$1,993,106 |
| Fixed maturities, at market (amortized cost: \$1,923,163 and \$1,961,080) | | |
| Preferred stocks, at market (amortized cost: \$584,362 and \$597,366) | 544,580 | 606,222 |
| Common stocks, at market (cost: \$36,038 and \$97,776) | 36,176 | 109,752 |
| Preferred stock mutual funds, at equity (cost: \$147,473 and \$120,990) | 165,190 | 141,654 |
| Mortgage loans on real estate and collateral notes receivable (less allowance for possible loan losses of \$61 and \$58) | 19,520 | 19,417 |
| Cash and cash equivalents | 114,789 | 141,367 |
| Short-term investments | 2,500 | 13,414 |
| Other investments (cost: \$48,962 and \$43,001) | 57,778 | 45,910 |
| Total investments and cash | 2,846,580 | 3,070,842 |
| Accrued investment income | 24,010 | 23,094 |
| Premiums receivable (less allowance for doubtful receivables of \$2,720 and \$2,454) | 497,940 | 480,605 |
| Deferred policy acquisition costs | 194,488 | 177,852 |
| Property and equipment, net of accumulated depreciation | 70,791 | 68,383 |
| Residual market receivable | 153,531 | 157,227 |
| Due from reinsurers | 58,846 | 53,679 |
| Deferred income taxes (Note 11) | 68,798 | 31,420 |
| Current income taxes (Note 11) | 13,212 | 7,796 |
| Other assets | 51,532 | 39,971 |
| Total assets | \$3,979,728 | \$4,110,869 |
| Liabilities: | | |
| Unpaid losses and loss adjustment expenses (Note 5) | \$1,011,865 | \$ 971,949 |
| Unearned premiums | 989,932 | 935,385 |
| Bonds payable (\$300,000 face less discount) (Note 6) | 298,740 | 298,589 |
| Deferred income | 8,435 | 10,913 |
| Accrued agents' profit sharing | 181,827 | 232,440 |
| Other liabilities and accrued expenses | 135,064 | 151,363 |
| Total liabilities | 2,625,863 | 2,600,639 |

| | | |
|--|------------------|------------------|
| Minority interest | 13,987 | 6,959 |
| Commitments and contingencies (Note 8) | - | - |
| Stockholders' equity (Note 12): | | |
| Preferred stock, authorized 5,000,000 shares at \$1.00 par value, none issued | - | - |
| Common stock, authorized 100,000,000 shares at \$.50 par value, 81,831,546 and 81,927,916 shares issued | 40,915 | 40,964 |
| Paid-in capital | 142,391 | 135,033 |
| Net accumulated other comprehensive income (loss), net of income taxes (benefits) of \$(19,728) and \$18,455 | (36,642) | 34,273 |
| Retained earnings | 1,652,490 | 1,539,056 |
| Total stockholders' equity before treasury stock | 1,799,154 | 1,749,326 |
| Treasury stock, 21,704,968 and 15,200,437 shares, at cost | (459,276) | (246,055) |
| Total stockholders' equity | 1,339,878 | 1,503,271 |
| Total liabilities, minority interest and stockholders' equity | \$3,979,728 | \$4,110,869 |

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

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The Commerce Group, Inc. and Subsidiaries
Consolidated Statements of Earnings and Comprehensive Income
Three and Nine Months Ended September 30, 2007 and 2006
(Unaudited)

| (Thousands of dollars, except per share data) | Three Months | | Nine Months | |
|---|----------------|----------------|------------------|------------------|
| | 2007 | 2006 | 2007 | 2006 |
| Revenues: | | | | |
| Direct premiums written | \$466,499 | \$479,156 | \$1,447,729 | \$1,444,956 |
| Assumed premiums | 20,666 | 32,645 | 78,621 | 78,377 |
| Ceded premiums | (35,556) | 37,776 | (125,817) | (94,716) |
| Net premiums written | 451,609 | 549,577 | 1,400,533 | 1,428,617 |
| (Increase) decrease in unearned premiums | 6,539 | (89,629) | (36,949) | (125,728) |
| Earned premiums | 458,148 | 459,948 | 1,363,584 | 1,302,889 |
| Net investment income | 40,310 | 34,417 | 119,762 | 104,065 |

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| | | | | |
|---|-------------------|-------------------|-------------------|-------------------|
| Premium finance and service fees | 8,427 | 7,282 | 23,459 | 21,353 |
| Net realized investment gains (losses) (Note 4) | (3,166) | 7,830 | 28,945 | 7,665 |
| Total revenues | 503,719 | 509,477 | 1,535,750 | 1,435,972 |
| Expenses: | | | | |
| Losses and loss adjustment expenses (Note 5) | 281,706 | 272,511 | 885,180 | 778,912 |
| Policy acquisition costs | 139,312 | 151,811 | 394,997 | 381,434 |
| Interest expense and amortization of bond fees | 4,583 | 4,584 | 13,745 | 13,746 |
| Total expenses | 425,601 | 428,906 | 1,293,922 | 1,174,092 |
| Earnings before income taxes and minority interest | 78,118 | 80,571 | 241,828 | 261,880 |
| Income taxes (Note 11) | 22,170 | 23,819 | 69,241 | 79,088 |
| Earnings before minority interest | 55,948 | 56,752 | 172,587 | 182,792 |
| Minority interest in net earnings of subsidiary | (448) | (217) | (1,237) | (683) |
| Net earnings | \$ 55,500 | \$ 56,535 | \$ 171,350 | \$ 182,109 |
| Comprehensive income (Note 2) | \$ 33,860 | \$104,925 | \$ 100,435 | \$ 207,768 |
| Net earnings per common share (Note 3): | | | | |
| Basic | \$ 0.89 | \$ 0.83 | \$ 2.66 | \$ 2.69 |
| Diluted | \$ 0.88 | \$ 0.83 | \$ 2.63 | \$ 2.68 |
| Cash dividends paid per common share | \$ 0.30 | \$ 0.25 | \$ 0.90 | \$ 0.725 |
| Weighted average number of common shares outstanding (Note 3): | | | | |
| Basic | 62,108,082 | 67,754,791 | 64,489,422 | 67,675,649 |
| Diluted | 62,830,662 | 68,182,710 | 65,260,028 | 68,036,253 |

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

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The Commerce Group, Inc. and Subsidiaries
 Consolidated Statements of Cash Flows
 Nine Months Ended September 30, 2007 and 2006
 (Unaudited)

| (Thousands of Dollars) | 2007 | 2006 |
|---|------------------|------------------|
| Operating activities: | | |
| Premiums collected | \$1,355,449 | \$1,334,379 |
| Net investment income received | 116,208 | 103,911 |
| Premium finance and service fees received | 23,459 | 21,353 |
| Losses and loss adjustment expenses paid | (871,286) | (758,588) |
| Policy acquisition costs paid | (452,854) | (380,379) |
| Federal income taxes | (70,351) | (91,253) |
| Interest paid | (8,925) | (8,925) |
| | 91,700 | 220,498 |
| Investing activities: | | |
| Investment sales, repayments and maturities | 1,790,547 | 1,487,622 |
| Mortgage loans and collateral notes receipts | 2,957 | 3,193 |
| Proceeds from sale of agency assets | 1,648 | - |
| Proceeds from sale of minority interest in subsidiary | 4,867 | - |
| Net cash paid for acquisition | (50,501) | - |
| Investment purchases | (1,589,200) | (1,616,855) |
| Mortgage loans and collateral notes originated | (3,063) | (3,853) |
| Net activity in short-term investments | 10,903 | - |
| Property and equipment purchases | (8,077) | (11,975) |
| Other investing activities | 692 | 1,846 |
| | 160,773 | (140,022) |
| Financing activities: | | |
| Dividends paid to stockholders | (57,916) | (49,101) |
| Treasury stock purchases | (223,366) | - |
| Capital stock issued | - | 130 |
| Capital infusion by minority interest | 2,732 | - |
| Outstanding checks payable | (501) | (920) |
| | (279,051) | (49,891) |
| (Decrease) increase in cash and cash equivalents | (26,578) | 30,585 |
| Cash and cash equivalents at beginning of period | 141,367 | 97,942 |

| | | |
|--|------------|------------|
| Cash and cash equivalents at end of period | \$ 114,789 | \$ 128,527 |
|--|------------|------------|

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

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The Commerce Group, Inc. and Subsidiaries
Consolidated Statements of Cash Flows
Nine Months Ended September 30, 2007 and 2006
(Unaudited)
(continued)

| | 2007 | 2006 |
|---|------------------|-------------------|
| Reconciliation of net earnings to cash from operating activities: | | |
| Net earnings | \$ 171,350 | \$ 182,109 |
| Adjustments to reconcile net earnings to cash from operating activities: | | |
| Premiums receivable | (8,535) | (36,466) |
| Deferred policy acquisition costs | (13,058) | (11,617) |
| Residual market receivable | 3,696 | 25,051 |
| Due from reinsurers | (5,167) | 93,768 |
| Unpaid losses and loss adjustment expenses | (3,643) | (32,153) |
| Unearned premiums | 35,542 | 52,829 |
| Current income taxes | (5,496) | (28,854) |
| Deferred income taxes | (33,799) | 30,488 |
| Deferred income | (2,478) | 2,107 |
| Accrued agents' profit sharing | (50,636) | 9,992 |
| Other assets, liabilities and accrued expenses | (25,776) | (63,599) |
| Net realized investment gains | (28,945) | (7,665) |
| Other - net | 58,645 | 4,508 |
| Cash provided by operating activities | \$ 91,700 | \$ 220,498 |

Supplemental information:

Purchase transaction:

| | | |
|---------------------------------------|------------|---|
| Fair value of noncash assets acquired | \$ 114,171 | - |
| Fair value of liabilities assumed | 63,670 | - |

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

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The Commerce Group, Inc. and Subsidiaries
Notes to Unaudited Consolidated Financial Statements

1. Organization and Interim Financial Statements

Unless otherwise stated, "we," "our," "us" or "CGI" means The Commerce Group, Inc. and its subsidiaries. Our consolidated financial statements include the accounts of The Commerce Group, Inc. and its subsidiaries. The Commerce Group, Inc. is a publicly-traded holding company and is engaged in various property-casualty insurance operations. CGI owns Commerce Holdings, Inc., which wholly owns two insurance subsidiaries: Commerce Insurance Company (Commerce) and Citation Insurance Company (Citation), as well as 95% of ACIC Holding Company, Inc. (AHI). AHI is a joint venture with AAA Southern New England, which owns the remaining 5%. AHI wholly owns two insurance subsidiaries: American Commerce Insurance Company (American Commerce or ACIC) and Commerce West Insurance Company (Commerce West or CWIC). In addition, AHI wholly owns the recently acquired holding company, SWICO Enterprises, Ltd., which owns a fifth insurer, State-Wide Insurance Company (State-Wide).

On April 2, 2007, AHI completed its acquisition of SWICO Enterprises, Ltd. The total cost of the acquisition was \$55,776. The results of operations of SWICO and State-Wide are included in the consolidated financial statements only for periods subsequent to the date of acquisition. For the 2006 year, State-Wide reported approximately \$38,000 in direct written premiums.

During the second quarter of 2007, Commerce Holdings, Inc. transferred its ownership of Commerce West to AHI, resulting in AAA Southern New England acquiring a 5% indirect ownership in CWIC. We recorded a gain of \$1,510 in this transaction.

We have prepared these financial statements in accordance with accounting principles generally accepted in the United States of America (GAAP). In preparing these financial statements in conformity with GAAP, we are required to make estimates and assumptions that affect the reported amounts of assets and liabilities at reporting dates and the reported amounts of revenues and expenses during the reporting periods. Actual results will differ from these estimates and assumptions. We employ significant estimates and assumptions in the determination of unpaid losses and loss adjustment expenses (LAE), the potential impairment of investments for other-than-temporary declines in market value and accrued agents' profit sharing. Our significant accounting policies are presented in the notes to our consolidated financial statements in our annual report on Form 10-K for the year ended December 31, 2006.

Our interim financial statements do not include all of the disclosures required by GAAP for annual financial statements. The year-end condensed balance sheet was derived from audited financial statements, but does not include all disclosures required by GAAP. In our opinion, we have included all adjustments, consisting of normal, recurring adjustments, considered necessary for a fair statement of the results for the interim periods. Operating results for the three and nine month periods ended September 30, 2007 are not necessarily indicative of the results that may be expected for the year ending December 31, 2007. These unaudited consolidated financial statements should be read in conjunction with our consolidated financial statements in our annual report on Form 10-K for the year ended December 31, 2006. Dollar amounts are in thousands, except per share data and as otherwise noted. We have eliminated significant intercompany accounts and transactions in consolidating these financial statements. Also, we have reclassified certain 2006 amounts to conform with 2007 presentations.

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2. Comprehensive Income

Our comprehensive income for the three and nine months ended September 30 follows:

Three Months

Nine Months

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| | 2007 | 2006 | 2007 | 2006 |
|---|-------------------|-------------------|-------------------|-------------------|
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| Net earnings | \$ 55,500 | \$ 56,535 | \$171,350 | \$182,109 |
| Other comprehensive income (loss), net of taxes: | | | | |
| Unrealized holding gains (losses) arising during the period ^(a) | (18,007) | 46,867 | (47,823) | 20,909 |
| Reclassification adjustment for investment (gains) losses included in net earnings ^(b) | (3,633) | 1,523 | (23,092) | 4,750 |
| Other comprehensive income (loss), net of taxes | (21,640) | 48,390 | (70,915) | 25,659 |
| Comprehensive income | <u>\$ 33,860</u> | <u>\$104,925</u> | <u>\$100,435</u> | <u>\$207,768</u> |

(a) Unrealized holding gains (losses) are net of income tax expense (benefits) of \$(9,696) and \$25,236 for the three months ended September 30, 2007 and 2006, respectively, and \$(25,751) and \$11,259 for the nine months ended September 30, 2007 and 2006, respectively.

(b) Reclassification adjustments are net of income tax expense (benefit) of \$(1,956) and \$820 for the three months ended September 30, 2007 and 2006, respectively, and \$(12,434) and \$2,540 for the nine months ended September 30, 2007 and 2006, respectively.

3. Net Earnings Per Common Share (EPS)

Basic EPS is based on the weighted average number of common shares outstanding. Diluted EPS is based on the weighted average number of common shares outstanding adjusted by the number of additional common shares that would have been outstanding had potentially dilutive common shares been issued and reduced by the number of common shares we could have purchased from the proceeds of the potentially dilutive shares. Our potentially dilutive instruments include stock options and nonvested restricted stock units. We had 5,079,278 and 4,963,434 stock options outstanding at September 30, 2007 and 2006, respectively. Our outstanding stock options at September 30, 2007 and 2006 included 103,928 and 16,084 of stock options, respectively, that were granted to our directors and officers under our Incentive Compensation Plan; the remainder of the total outstanding stock options consisted of American Commerce agents' options. Additionally, at September 30, 2007, there were 613,369 officer nonvested restricted stock units outstanding. Basic and diluted EPS for the three and nine months ended September 30 follow:

| | Three Months | | Nine Months | |
|--|-------------------|-------------------|-------------------|-------------------|
| | 2007 | 2006 | 2007 | 2006 |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| Net earnings for basic and diluted EPS | \$55,500 | \$56,535 | \$171,350 | \$182,109 |

Common share information:

| | | | | |
|--|-----------------------------|-----------------------------|-----------------------------|-----------------------------|
| Average shares outstanding for basic EPS | 62,108,082 | 67,754,791 | 64,489,422 | 67,675,649 |
| Dilutive effect of equity awards | 722,580 | 427,919 | 770,606 | 360,604 |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| Average shares outstanding for diluted EPS | 62,830,662 | 68,182,710 | 65,260,028 | 68,036,253 |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| Basic EPS | \$ 0.89 | \$ 0.83 | \$ 2.66 | \$ 2.69 |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| Diluted EPS | \$ 0.88 | \$ 0.83 | \$ 2.63 | \$ 2.68 |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |

The diluted EPS calculation excludes stock options and nonvested restricted stock units that are anti-dilutive using the treasury stock method. For the three and nine months ended September 30, 2007, there were 1,800,000 and 1,800,000 anti-dilutive options, while for the same periods in 2006, there were 1,250,000 and 2,200,000 anti-dilutive options, respectively. In addition, there were 119,510 officer nonvested restricted stock units excluded for the three months ended September 30, 2007, as they were anti-dilutive. None were anti-dilutive for the nine month period.

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4. Investments

Closed-end Preferred Stock Mutual Funds

Our closed-end preferred stock mutual fund holdings at December 31, 2006 and September 30, 2007 accounted for under the equity method follow:

| | Fund Shares Held | Percentage of Ownership | Carrying Value, at Equity | Cost | Quoted Market Value |
|--------------------|-----------------------------|-------------------------------|---------------------------------|-----------------------------|-----------------------------|
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| December 31, 2006 | | | | | |
| PDT ⁽¹⁾ | 6,803,200 | 45.2% | \$ 88,986 | \$ 74,588 | \$ 78,033 |
| PGD ⁽¹⁾ | 2,118,000 | 25.4% | 31,219 | 26,556 | 27,830 |
| PPF ⁽¹⁾ | 1,499,900 | 20.7% | 21,449 | 19,846 | 19,754 |
| | | | <u> </u> | <u> </u> | <u> </u> |
| | | | \$141,654 | \$120,990 | \$125,617 |
| | | | <u> </u> | <u> </u> | <u> </u> |
| September 30, 2007 | | | | | |
| PDT ⁽¹⁾ | 13,162,574 | 29.8% | \$165,190 | \$147,473 | \$139,392 |
| | | | <u> </u> | <u> </u> | <u> </u> |

(1) John Hancock Patriot Premium Dividend Fund II (PDT), John Hancock Patriot Global Dividend Fund

(PGD) and John Hancock Patriot Preferred Dividend Fund (PPF).

During the second quarter of 2007, three preferred stock mutual funds which we owned (PGD, PPF and John Hancock Patriot Premium Dividend Fund I-PDF) were merged into a fourth fund, which we also owned, PDT. Two of the three merging funds (PGD and PPF) were accounted for under the equity method of accounting. The third fund, PDF, was accounted for under the rules for available for sale portfolios, as our percentage of ownership was below 20%. In the merger, common shareholders of the merging funds received newly-issued shares of PDT. The aggregate net asset value of the new common shares equaled the aggregate net asset value of the common shares held immediately prior to the merger. Upon exchange of shares of PDF, we recognized a gain of \$3.4 million.

A fifth John Hancock fund, John Hancock Patriot Select Dividend Trust (DIV), which we own and account for under the cost method, was merged into PDT effective October 10, 2007. As a result of the DIV merger, we obtained an additional 371,272 shares of PDT and recorded a gain of \$633 during the fourth quarter.

Realized Investment Gains and Losses

Net realized investment gains (losses) for the three and nine months ended September 30 follow:

| | Three Months | | Nine Months | |
|--|--------------|-----------|-------------|-----------|
| | 2007 | 2006 | 2007 | 2006 |
| Transaction net gains (losses): | | | | |
| Fixed maturity securities | \$ 1,756 | \$(2,433) | \$18,411 | \$(1,317) |
| Equity securities | (1,470) | (410) | 15,028 | (1,071) |
| Venture capital funds | (890) | 4,812 | 1,333 | 6,243 |
| Other investments | 1,094 | - | 1,090 | 16 |
| Total transaction net gains | 490 | 1,969 | 35,862 | 3,871 |
| Other-than-temporary impairment losses: | | | | |
| Fixed maturity securities | (1,795) | - | (3,810) | (1,103) |
| Equity securities | (1,304) | (1,839) | (3,255) | (1,839) |
| Total other-than-temporary impairment losses | (3,099) | (1,839) | (7,065) | (2,942) |
| Equity in earnings (losses) of closed-end preferred stock mutual funds | (557) | 7,700 | (2,947) | 6,736 |
| Other: | | | | |
| Sale of agency assets | - | - | 1,585 | - |
| Sale of minority interest in CWIC | - | - | 1,510 | - |
| Net realized investment gains (losses) | \$(3,166) | \$7,830 | \$28,945 | \$ 7,665 |

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Unrealized Investment Gains and Losses

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The change in net unrealized gain (loss) on our fixed maturity and equity securities, excluding the impact of minority interest, from December 31, 2006 to September 30, 2007 follows:

| | September 30, 2007 | December 31, 2006 | Change |
|----------------------------|-----------------------|----------------------|-------------|
| Fixed maturity securities | \$(17,115) | \$32,026 | \$ (49,141) |
| Equity securities | (39,643) | 20,832 | (60,475) |
| Net unrealized gain (loss) | \$(56,758) | \$52,858 | \$(109,616) |

Gross unrealized losses on our fixed maturity and equity securities at September 30, 2007 by duration of unrealized loss follow:

| | Total | 0-6 Months | 7-12 Months | 13-24 Months | Over 24 Months |
|---|-------------|---------------|----------------|-----------------|-------------------|
| Total fixed maturity and equity securities: | | | | | |
| Number of positions with unrealized losses | 402 | 268 | 74 | 10 | 50 |
| Total fair market value | \$1,449,878 | \$ 962,183 | \$304,453 | \$40,207 | \$143,035 |
| Total amortized cost | 1,525,902 | 1,017,193 | 322,330 | 41,628 | 144,751 |
| Unrealized loss | \$ (76,024) | \$ (55,010) | \$ (17,877) | \$ (1,421) | \$ (1,716) |
| Unrealized loss percentage to fair market value | 5.2% | 5.7% | 5.9% | 3.5% | 1.2% |
| Fixed maturity securities: | | | | | |
| Number of positions with unrealized losses | 320 | 202 | 58 | 10 | 50 |
| Total fair market value | \$1,021,620 | \$ 595,624 | \$242,754 | \$40,207 | \$143,035 |
| Total amortized cost | 1,054,662 | 613,506 | 254,777 | 41,628 | 144,751 |
| Unrealized loss | \$ (33,042) | \$ (17,882) | \$ (12,023) | \$ (1,421) | \$ (1,716) |
| Unrealized loss percentage to fair market value | 3.2% | 3.0% | 5.0% | 3.5% | 1.2% |

Equity securities⁽¹⁾:

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| | | | | | |
|---|-------------|-------------|------------|---|---|
| Number of positions with unrealized losses | 82 | 66 | 16 | - | - |
| Total fair market value | \$ 428,258 | \$ 366,559 | \$ 61,699 | - | - |
| Total cost | 471,240 | 403,687 | 67,553 | - | - |
| Unrealized loss | \$ (42,982) | \$ (37,128) | \$ (5,854) | - | - |
| Unrealized loss percentage to fair market value | 10.0% | 10.1% | 9.5% | - | - |

(1) Equity securities include common and preferred stocks.

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Gross unrealized losses on our fixed maturity and equity securities at December 31, 2006 by duration of unrealized loss follow:

| | Total | 0-6 Months | 7-12 Months | 13-24 Months | Over 24 Months |
|---|------------|------------|-------------|--------------|----------------|
| Total fixed maturity and equity securities: | | | | | |
| Number of positions with unrealized losses | 227 | 111 | 20 | 72 | 24 |
| Total fair market value | \$982,017 | \$579,355 | \$96,000 | \$246,591 | \$60,071 |
| Total amortized cost | 991,994 | 583,364 | 97,156 | 250,050 | 61,424 |
| Unrealized loss | \$ (9,977) | \$ (4,009) | \$ (1,156) | \$ (3,459) | \$ (1,353) |
| Unrealized loss percentage to fair market value | 1.0% | 0.7% | 1.2% | 1.4% | 2.3% |
| Fixed maturity securities: | | | | | |
| Number of positions with unrealized losses | 192 | 83 | 17 | 68 | 24 |
| Total fair market value | \$816,677 | \$436,239 | \$90,393 | \$229,974 | \$60,071 |
| Total amortized cost | 825,377 | 439,040 | 91,511 | 233,402 | 61,424 |
| Unrealized loss | \$ (8,700) | \$ (2,801) | \$ (1,118) | \$ (3,428) | \$ (1,353) |
| Unrealized loss percentage to fair market value | 1.1% | 0.6% | 1.2% | 1.5% | 2.3% |

| | | | | | |
|---|------------|------------|----------|-----------|---|
| Equity securities ⁽¹⁾ : | | | | | |
| Number of positions with unrealized losses | 35 | 28 | 3 | 4 | - |
| Total fair market value | \$165,340 | \$143,116 | \$ 5,607 | \$ 16,617 | - |
| Total cost | 166,617 | 144,324 | 5,645 | 16,648 | - |
| Unrealized loss | \$ (1,277) | \$ (1,208) | \$ (38) | \$ (31) | - |
| Unrealized loss percentage to fair market value | 0.8% | 0.8% | 0.7% | 0.2% | - |

(1) Equity securities include common and preferred stocks.

At their respective balance sheet dates, we determined that the impairments of the securities represented in the above gross unrealized loss tables are temporary, based on a review of the credit quality, duration and severity of the unrealized losses for our impaired securities. The portfolio's increase in unrealized losses came in great part from the recent decline in prices in a number of our perpetual preferred stocks and long maturity hybrid bonds. In addition, we saw price declines in some of our longer maturity municipal holdings. Weakness in the housing sector and in many finance companies was a factor in this movement. The increase in unrealized losses, especially in the 0-6 months column on the table, is substantially related to recent unrest in the credit markets that we believe to be temporary. It is important to note that we hold no CBOs, CDOs or SIVs. In addition, our total mortgage-backed securities had a market value of \$522,376. Of these assets, 99% are "AAA" rated and 83% are government guaranteed. We have only a single sub-prime bond, which has a book value of \$1,261. As of September 30, 2007, we have the intent and ability to hold either to full recovery or maturity all of our temporarily impaired securities.

5. Unpaid Losses and LAE

Liabilities for unpaid losses and loss adjustment expenses at September 30, 2007 and December 31, 2006 follow:

| | September 30, 2007 | December 31, 2006 |
|--|-----------------------|----------------------|
| Net voluntary unpaid losses and LAE | \$ 907,159 | \$837,470 |
| Voluntary salvage and subrogation recoverable | (103,255) | (96,954) |
| Assumed unpaid losses and LAE reserves from CAR ^(a) | 119,480 | 130,803 |
| Assumed salvage and subrogation recoverable from CAR | (20,544) | (20,544) |
| Total voluntary and assumed unpaid losses and LAE reserves | 902,840 | 850,775 |
| Adjustment for ceded unpaid losses and LAE reserves | 118,025 | 130,174 |
| Adjustment for ceded salvage and subrogation recoverable | (9,000) | (9,000) |

| | | |
|-----------------------------|-------------|-----------|
| Total unpaid losses and LAE | \$1,011,865 | \$971,949 |
|-----------------------------|-------------|-----------|

(a) Commonwealth Automobile Reinsurers
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The change in reserves for unpaid losses and LAE, net of reinsurance deductions from all reinsurers, including CAR, for the nine months ended September 30 follow:

| | 2007 | 2006 |
|---|-------------|-----------|
| Incurring losses and LAE: | | |
| Provision for insured events of the current year | \$ 934,919 | \$842,258 |
| Decrease in provision for insured events of prior years | (49,739) | (63,346) |
| Total incurred losses and LAE | 885,180 | 778,912 |
| Payments: | | |
| Losses and LAE attributable to insured events of the current year | (520,479) | (458,377) |
| Losses and LAE attributable to insured events of prior years | (356,195) | (326,413) |
| Total payments | (876,674) | (784,790) |
| Change in loss and LAE reserves during the year | 8,506 | (5,878) |
| Loss and loss reserves from acquisition | 43,559 | - |
| Loss and LAE reserves prior to the effect of ceded reinsurance recoverable, beginning of year | 850,775 | 834,699 |
| Loss and LAE reserves prior to the effect of ceded reinsurance recoverable, end of period | 902,840 | 828,821 |
| Ceded reinsurance recoverable | 109,025 | 128,222 |
| Unpaid losses and LAE | \$1,011,865 | \$957,043 |

As a result of changes in estimates of insured events in prior years, the provision for loss and LAE decreased \$49,739 for the nine months ended September 30, 2007. This favorable development, also called redundancy, is due primarily to lower than anticipated losses related to the personal automobile liability line of business. Conditions and trends that have affected development in the past may not necessarily occur in the future. Accordingly, it may not be appropriate to extrapolate future redundancies or deficiencies based upon these developments. The amounts we will ultimately incur from loss and loss adjustment expenses could differ materially in the near term from the amounts recorded.

Approximately \$47,936 in personal automobile liability redundancies developed for the nine months ended September 30, 2007, with approximately 99% of this amount coming from the 2006, 2005 and 2004 accident years. Personal liability redundancies relating to CAR comprised 18% of total personal automobile liability

redundancies. Automobile physical damage had approximately \$623 in net redundancies. Automobile physical damage on voluntary business had \$6,669 in redundancies, partially offset by \$6,046 in deficiencies on automobile physical damage relating to CAR. Commercial automobiles had \$4,559 in redundancies, with approximately 73% of this amount coming from the 2006, 2005 and 2004 accident years. Homeowners had \$4,083 in deficiencies during the current year period, with 96% of this amount coming from the 2006 and 2005 accident years. For the nine months ended September 30, 2007, we experienced various redundancies and deficiencies for the other lines of business and accident years that combined for the remaining \$704 net redundancy.

For the nine months ended September 30, 2006, the provision for loss and LAE decreased \$63,346 as a result of changes in estimates of insured events in prior years. Approximately \$53,844 in personal automobile liability redundancies developed for the nine months ended September 30, 2006, with approximately 97% of this amount coming from the 2005, 2004 and 2003 accident years. Automobile physical damage had approximately \$6,667 in redundancies chiefly related to the 2005 accident year. Redundancies relating to CAR were approximately 15% of the total redundancies relating to prior years. For the nine months ended September 30, 2006, we experienced various redundancies and deficiencies for the other lines of business and accident years that combined for the remaining \$2,835 net redundancy.

6. Bonds Payable

On December 9, 2003, we issued \$300,000 face value of senior unsecured and unsubordinated debt (the Senior Notes) which matures December 9, 2013. The Senior Notes were issued at 99.3% to yield 6.04%, and bear a coupon interest rate of 5.95%, payable semi-annually on June 9 and December 9 beginning in 2004. The fair market value of the Senior Notes at September 30, 2007 was estimated to be \$298,000.

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7. Reinsurance

Ceded reinsurance recoverable amounts, which include amounts ceded to CAR and other unaffiliated reinsurers, are included in unpaid losses and loss adjustment expenses and unearned premiums. At September 30, 2007 and December 31, 2006, \$109,025 and \$121,174 were included in unpaid losses and loss adjustment expense amounts, respectively. At September 30, 2007 and December 31, 2006, \$72,208 and \$73,616 were included in the unearned premium liability amounts, respectively.

Effective July 1, 2007, we renewed our pure catastrophe reinsurance program across five layers as outlined below. The Catastrophe Reinsurance Program provides for reinsurance recovery of a maximum of \$489 million in the event of a \$550 million or greater occurrence, including all states' FAIR Plan losses. The total annual cost of the program is approximately \$28.4 million and includes one reinstatement premium (pro-rated based on loss recoveries) for a maximum additional cost of approximately \$28.4 million. The catastrophe program is based on \$207 million of estimated subject premiums, which will vary based on actual subject premiums. This program covers all FAIR Plan-type participation in excess of reinsurance purchased by any of the Plans, but does not cover comprehensive automobile. Two-year pricing agreements were signed for approximately half of this year's placement. Based on this, the pricing for half of next year's reinsurance program (incepting July 1, 2008) will be the same as this year.

| Layer | Coverage | Percentage of Coverage Purchased for each Layer | Maximum Recovery per Layer |
|-----------------|-------------------------------------|---|----------------------------|
| 1 st | \$25 million excess of \$25 million | 36% | \$ 9,000 |

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| | | | |
|-----------------|---------------------------------------|------|-----------|
| 2 nd | \$50 million excess of \$50 million | 60% | 30,000 |
| 3 rd | \$150 million excess of \$100 million | 100% | 150,000 |
| 4 th | \$200 million excess of \$250 million | 100% | 200,000 |
| 5 th | \$100 million excess of \$450 million | 100% | 100,000 |
| | | | \$489,000 |

The lines of business classified as property and covered under the new Catastrophe Reinsurance Program include fire, allied lines, homeowners, inland marine, special multi-peril and business owner policies. The Catastrophe Reinsurance Program covers losses occurring throughout the United States, excluding Florida, where we currently do not write any business. However, for the fourth and fifth layers coverage will only apply to losses in the states of Massachusetts, New Hampshire, Rhode Island and Connecticut.

We will have no additional reinsurance recoveries for a single event catastrophe in excess of a total loss of \$550 million, including FAIR Plan-type losses. Our average estimated combined total loss for the Commerce, Citation and ACIC insurance subsidiaries, on other than automobile business, was calculated using two prominent catastrophe modeling companies. The average estimated "100 year loss" is \$437 million and the "250 year loss" is \$792 million.

The Catastrophe Reinsurance Program became effective July 1, 2007; however, it will not discharge us from our primary liability to the insured for the full amount of the insured's policies, but it will make the reinsurer liable to us to the extent of the reinsured portion of any loss ultimately suffered. Each reinsurer participating in the reinsurance program will be severally (and not jointly) liable to us for its share of reinsurance coverage. We believe the reinsurers are adequately capitalized and financially able to meet their obligations under the reinsurance agreements with us, though there can be no assurance that they will be able to do so.

8. Commitments and Contingencies

Member companies of CAR have joint and several liabilities for the obligations of CAR, the Massachusetts-mandated personal automobile reinsurance mechanism that enables us and other Servicing Carriers to reinsure in CAR any risk. If one member of CAR fails to pay its assessments, the remaining members of CAR will be required to pay the pro-rata share of the member who fails to pay its obligations. As of September 30, 2007, we were not aware of any CAR member company which has failed to meet its obligations.

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9. Segments

Selected segment information as of and for the three and nine months ended September 30 follows. Earnings are before income taxes and include minority interest. The amounts below are prior to the effects of the interaffiliate pooling agreement.

| | Three Months | | Nine Months | |
|--------|--------------|----------|-------------|----------|
| Assets | Revenue | Earnings | Revenue | Earnings |

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| | | | | | |
|------------------------------------|-------------|-----------|----------|-------------|-----------|
| 2007: | | | | | |
| Property and casualty insurance: | | | | | |
| Massachusetts | \$3,369,496 | \$429,952 | \$74,240 | \$1,321,728 | \$265,006 |
| Other than Massachusetts | 571,098 | 73,593 | 3,823 | 212,244 | 1,758 |
| Real estate and commercial lending | 19,815 | 226 | 226 | 675 | 675 |
| Corporate and other | 19,319 | (52) | (619) | 1,103 | (26,848) |
| Consolidated | \$3,979,728 | \$503,719 | \$77,670 | \$1,535,750 | \$240,591 |
| 2006: | | | | | |
| Property and casualty insurance: | | | | | |
| Massachusetts | \$3,645,180 | \$450,789 | \$84,425 | \$1,276,519 | \$276,401 |
| Other than Massachusetts | 403,758 | 58,667 | 10,476 | 159,498 | 22,559 |
| Real estate and commercial lending | 18,644 | 218 | 218 | 617 | 617 |
| Corporate and other | 22,098 | (197) | (14,765) | (662) | (38,380) |
| Consolidated | \$4,089,680 | \$509,477 | \$80,354 | \$1,435,972 | \$261,197 |

Premium Results

Direct premiums written and earned for the **three** months ended September 30 follow:

| Direct Premiums Written: | 2007 | 2006 | \$ Change | % Change |
|--|-----------|-----------|------------|----------|
| Massachusetts: | | | | |
| Personal automobile | \$317,969 | \$345,246 | \$(27,277) | (7.9)% |
| Commercial automobile | 20,291 | 21,609 | (1,318) | (6.1) |
| Homeowners | 47,621 | 43,066 | 4,555 | 10.6 |
| Other lines | 10,165 | 10,119 | 46 | 0.5 |
| Massachusetts direct premiums written | 396,046 | 420,040 | (23,994) | (5.7) |
| Other than Massachusetts: | | | | |
| Personal automobile | 55,055 | 44,517 | 10,538 | 23.7 |
| Commercial automobile | 2,186 | 2,089 | 97 | 4.6 |
| Homeowners | 12,710 | 12,061 | 649 | 5.4 |
| Other lines | 502 | 449 | 53 | 11.8 |
| Other than Massachusetts direct premiums written | 70,453 | 59,116 | 11,337 | 19.2 |
| Total direct premiums written | \$466,499 | \$479,156 | \$(12,657) | (2.6) |

Direct Earned Premiums:

| | | | | |
|------------------------------|------------------|------------------|-----------------|--------------|
| Massachusetts: | | | | |
| Personal automobile | \$333,747 | \$338,198 | \$ (4,451) | (1.3)% |
| Commercial automobile | 24,084 | 25,192 | (1,108) | (4.4) |
| Homeowners | 38,725 | 35,530 | 3,195 | 9.0 |
| Other lines | 9,633 | 9,582 | 51 | 0.5 |
| | <u>406,189</u> | <u>408,502</u> | <u>(2,313)</u> | <u>(0.6)</u> |
| Other than Massachusetts: | | | | |
| Personal automobile | 54,486 | 42,130 | 12,356 | 29.3 |
| Commercial automobile | 2,231 | 2,266 | (35) | (1.5) |
| Homeowners | 11,425 | 10,561 | 864 | 8.2 |
| Other lines | 440 | 393 | 47 | 12.0 |
| | <u>68,582</u> | <u>55,350</u> | <u>13,232</u> | <u>23.9</u> |
| Total direct earned premiums | <u>\$474,771</u> | <u>\$463,852</u> | <u>\$10,919</u> | <u>2.4</u> |

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Direct premiums written and earned for the **nine** months ended September 30 follow:

| Direct Premiums Written: | 2007 | 2006 | \$ Change | % Change |
|-------------------------------|--------------------|--------------------|-----------------|--------------|
| Massachusetts: | | | | |
| Personal automobile | \$1,025,843 | \$1,060,076 | \$(34,233) | (3.2)% |
| Commercial automobile | 71,961 | 78,349 | (6,388) | (8.2) |
| Homeowners | 121,200 | 108,403 | 12,797 | 11.8 |
| Other lines | 29,273 | 29,179 | 94 | 0.3 |
| | <u>1,248,277</u> | <u>1,276,007</u> | <u>(27,730)</u> | <u>(2.2)</u> |
| Other than Massachusetts: | | | | |
| Personal automobile | 156,148 | 128,454 | 27,694 | 21.6 |
| Commercial automobile | 6,619 | 6,553 | 66 | 1.0 |
| Homeowners | 35,304 | 32,720 | 2,584 | 7.9 |
| Other lines | 1,381 | 1,222 | 159 | 13.0 |
| | <u>199,452</u> | <u>168,949</u> | <u>30,503</u> | <u>18.1</u> |
| Total direct premiums written | <u>\$1,447,729</u> | <u>\$1,444,956</u> | <u>\$ 2,773</u> | <u>0.2</u> |

Direct Earned Premiums:

| | | | | |
|---------------------|-------------|-------------|------------|--------|
| Massachusetts: | | | | |
| Personal automobile | \$1,005,687 | \$1,006,928 | \$ (1,241) | (0.1)% |

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| | | | | |
|---|--------------------|--------------------|-----------------|-------|
| Commercial automobile | 73,246 | 73,729 | (483) | (0.7) |
| Homeowners | 112,530 | 104,301 | 8,229 | 7.9 |
| Other lines | 28,661 | 28,756 | (95) | (0.3) |
| | <u>1,220,124</u> | <u>1,213,714</u> | <u>6,410</u> | |
| Massachusetts direct earned premiums | | | | 0.5 |
| Other than Massachusetts: | | | | |
| Personal automobile | 152,083 | 125,101 | 26,982 | 21.6 |
| Commercial automobile | 6,619 | 7,039 | (420) | (6.0) |
| Homeowners | 33,223 | 30,871 | 2,352 | 7.6 |
| Other lines | 1,279 | 1,135 | 144 | 12.7 |
| | <u>193,204</u> | <u>164,146</u> | <u>29,058</u> | |
| Other than Massachusetts direct earned premiums | | | | 17.7 |
| | <u>\$1,413,328</u> | <u>\$1,377,860</u> | <u>\$35,468</u> | |
| Total direct earned premiums | | | | 2.6 |

10. Recent Accounting Pronouncements

In February 2007, the Financial Accounting Standards Board (FASB) issued Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (SFAS 159). This Statement permits entities to choose to measure many financial instruments and certain other items at fair value. The objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. A business entity shall report unrealized gains and losses on items for which the fair value option has been elected in earnings. SFAS 159 is effective for fiscal years beginning after November 15, 2007. We have yet to determine the impact of SFAS 159 on our results of operations or financial position.

In September 2006, the FASB issued Statement No. 157, *Fair Value Measurements* (SFAS 157). The Statement defines fair value, establishes a framework for measuring fair value in GAAP, and expands disclosures about fair value measurements. SFAS 157 does not require any new fair value measurements but applies under other financial pronouncements that permit or require fair value measurements. SFAS 157 is effective for fiscal years beginning after November 15, 2007 and early application is encouraged. We do not expect the adoption of this Statement to have a material impact on our results of operations or financial position.

11. Income Taxes

The Company adopted the provisions of FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes, an Interpretation of SFAS 109*, on January 1, 2007. This interpretation clarifies the accounting for uncertainties in income taxes recognized in accordance with SFAS 109. As a result, we now apply a more-likely-than-not recognition threshold for all tax uncertainties. There was no cumulative effect of the change in accounting position as of the date of adoption.

The total amount of unrecognized tax benefits as of the date of adoption was \$821. Of this, only \$130 represents positions that, if recognized, would affect the effective tax rate. The total amount of unrecognized tax benefits is not expected to significantly increase or decrease within 12 months.

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We recognize penalties and interest accrued related to unrecognized tax benefits in income tax expense. As of the date of adoption, we had \$34 of accrued interest related to unrecognized tax benefits. There has been no material change in this amount during the nine months ended September 30, 2007.

The Commerce Group, Inc. and its subsidiaries file income tax returns in the U.S. federal jurisdiction and various states. Due to the expiration of applicable statutes of limitations, we are not subject to U.S. federal, state or local income tax examinations in any major taxing jurisdiction for years prior to 2003. There are no examinations currently pending or in process.

12. Equity

Treasury stock purchases for the three and nine months ended September 30 are as follows:

| | 2007 | | 2006 | |
|--------------|-----------|-----------|--------|------|
| | Shares | Cost | Shares | Cost |
| Three months | 3,952,097 | \$122,921 | - | - |
| Nine months | 7,116,176 | \$223,366 | - | - |

13. Subsequent Event

On October 30, 2007, we entered into an Agreement and Plan of Merger (the MAPFRE Merger Agreement) with MAPFRE S.A., a company organized under the laws of Spain (MAPFRE), and Magellan Acquisition Corp., a Massachusetts corporation and an indirect wholly-owned subsidiary of MAPFRE (Subsidiary). The MAPFRE Merger Agreement provides for a merger whereby Subsidiary will be merged with and into the Company, with the Company continuing as the surviving corporation and becoming an indirect wholly-owned subsidiary of MAPFRE. Pursuant to the MAPFRE Merger Agreement, each then issued and outstanding share of our common stock will be cancelled and converted into the right to receive \$36.70 in cash, without interest. In addition, as permitted by the MAPFRE Merger Agreement, the Directors of the Company may declare and pay regular quarterly cash dividends of \$0.30 per share per quarter until the completion of the merger.

Completion of the proposed MAPFRE merger is subject to various customary closing conditions including, but not limited to (1) the requisite approval of the MAPFRE Merger Agreement by the holders of at least two-thirds of our shares, (2) the receipt of all required insurance regulatory approvals and (3) the expiration or termination of applicable waiting periods under the Hart-Scott-Rodino Antitrust Improvements Act of 1976. We currently expect that the MAPFRE merger will be completed in 2008, likely late in the first quarter or early in the second quarter.

The MAPFRE Merger Agreement provides certain termination rights for both us and MAPFRE, and further provides that upon termination of the MAPFRE Merger Agreement under certain circumstances, we will be obligated to pay MAPFRE a termination fee of \$68.0 million.

The foregoing description of the MAPFRE Merger Agreement does not purport to be complete and is qualified in its entirety by reference to the full text of the MAPFRE Merger Agreement, which has been filed with the Securities and Exchange Commission.

The terms of certain of our agreements, including various contracts and employee benefit arrangements, have provisions which could result in changes to the terms or settlement amounts of these agreements upon a

change in control such as would occur upon completion of the proposed MAPFRE merger. The Company is currently evaluating the financial implications of these provisions.

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

Unless otherwise stated, "we," "our," "us" or "the Company" means The Commerce Group, Inc. and its subsidiaries. "Commerce" refers to The Commerce Insurance Company, "Commerce West" refers to Commerce West Insurance Company, "American Commerce" or "ACIC" refers to American Commerce Insurance Company, "Citation" refers to Citation Insurance Company and "State-Wide" refers to State-Wide Insurance Company. In addition, unless otherwise stated, all references to "quarters ended" are for our fiscal quarter beginning July 1 and ending September 30, and dollar amounts are in thousands, except per share data and as otherwise noted.

The purpose of the following discussion and analysis is to provide you with information that will assist you in understanding our financial condition and results of operations as reported in our consolidated financial statements. Therefore, the following should be read in conjunction with our consolidated financial statements in this Form 10-Q and with our Management's Discussion and Analysis of Financial Condition and Results of Operations in our annual report on Form 10-K for the year ended December 31, 2006.

Business Overview

We provide personal and commercial property and casualty insurance primarily in Massachusetts and, to a lesser extent, in other states. Our core product lines are personal automobile, homeowners and commercial automobile. We market our products through our network of independent agents in all states except California and New York, where we use agents and brokers. Our primary business strategy is to focus on the personal automobile insurance market in Massachusetts and to grow and diversify by increasing the proportion of our business written in other states in which we currently have a significant presence, primarily from Commerce West and American Commerce, and by expanding into the New York and New Jersey personal lines markets through State-Wide.

We manage our business in four reportable segments: property and casualty insurance - Massachusetts; property and casualty insurance - other than Massachusetts; real estate and commercial lending; and, corporate and other.

Effective March 2007, A.M. Best reaffirmed our and our insurance subsidiaries' A+ (Superior) rating. This is the second highest financial strength rating given by A.M. Best, a well-known rating agency for the insurance industry.

In August 2007, we extended our contract with the third party service provider, CGI Technologies and Solutions, Inc., through December 31, 2011. CGI Technologies provides Massachusetts policy processing services to us.

In August 2007, we announced that our mortgage subsidiary, Bay Finance Company, would cease writing mortgage loans effective immediately. Bay Finance intends to retain its existing loan portfolio, valued at approximately \$20 million, which will continue to be serviced by Bay Finance.

Our ability to capitalize on our business strengths and implement our strategies is subject to particular risks. For a complete discussion of our risk factors, see Item 1A, Risk Factors, in our annual report on Form 10-K for the year ended December 31, 2006.

Commonwealth Automobile Reinsurers

A significant aspect of our automobile insurance business relates to our interaction with Commonwealth Automobile Reinsurers (CAR). CAR is a reinsurance pooling mechanism mandated in Massachusetts that enables us and the other participating servicing carriers to reinsure any automobile risk that the carriers perceive to be under-priced. Since its inception, CAR has generally generated significant underwriting losses, primarily in the personal automobile pool. All companies writing automobile insurance in Massachusetts share in the underwriting results of CAR business for their respective product line or lines.

Member companies of CAR have joint and several liabilities for the obligations of CAR. If one member of CAR fails to pay its assessments, the remaining members of CAR will be required to pay the pro-rata share of the member who fails to pay its obligations. As of September 30, 2007, we were not aware of any current CAR member company which failed to meet its obligations.

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Massachusetts Personal Automobile Regulatory Reform

On July 16, 2007, the Massachusetts Division of Insurance issued its Opinion, Findings and Decision on the Operation of Competition in Private Passenger Motor Vehicle Insurance in 2008, in which it determined that the Commissioner cannot fix-and-establish rates for 2008. Accordingly, effective April 1, 2008, each insurer will be permitted to file and use its own rates subject to disapproval by the Commissioner. Also on July 16, 2007, the Division issued a decision approving rules which institute an assigned risk plan, the Massachusetts Automobile Insurance Plan (MAIP), to provide private passenger automobile insurance for those individuals unable to obtain insurance voluntarily, in place of CAR. The MAIP will assign these individuals directly to an insurance company. Beginning on April 1, 2008, new and renewal business with ten or more safe driver insurance plan (SDIP) points on their driving record, along with new business previously not insured in Massachusetts for the last twelve months, will be eligible for the MAIP. Based on this criterion, we estimate that approximately 5% of the market will be eligible to be placed in the MAIP during the first year. All business will be eligible for the MAIP beginning on April 1, 2009 however, insurers may not non-renew risks that have had no SDIP points for the most recent three year period (clean-in-three risks), with certain exceptions, until March 31, 2011.

In announcing the Division's decisions on July 16, 2007, the Commissioner stated that the effect of these two decisions will be to introduce "managed competition" to the Massachusetts private passenger automobile insurance market. On October 5, 2007, the Commissioner issued the final regulation governing "managed competition" that provides the framework for the transition from the current market, in which the Commissioner sets rates, to "managed competition" which is effective April 1, 2008. The final regulation provides guidance and sets forth requirements on a number of issues related to "managed competition," including rate filing requirements. The final regulation contains a list of prohibited factors, including a prohibition of the use of credit information in rating or underwriting. In her announcement of the final regulation, the Commissioner stated that she will be reviewing whether credit information should continue to be banned after the one-year transition period ending March 31, 2009. The Commissioner also stated in her announcement that she will be issuing a series of bulletins on various subjects related to the implementation of "managed competition" that are not addressed in the final regulation. The Commissioner has issued a number of bulletins to date providing guidance on various issues including regulatory review standards, discounts, product form, endorsement, and new business application standards and classification plan requirements.

On October 19, 2007, the Automobile Insurers Bureau of Massachusetts filed its Transition Advisory Filing for April 1, 2008, which may be used only by insurance companies that currently write less than 1 percent of the private passenger automobile insurance market in Massachusetts and by insurance companies newly entering the Massachusetts market. On October 24, 2007, CAR filed the Transition Rate Filing for the

residual market. The deadline for insurance companies to submit their Voluntary Market Transition Rate Filings is November 19, 2007.

We are currently preparing our Voluntary Market Transition Rate Filing. At this time, we cannot predict the effect this filing will have on our premiums or market share and, therefore, on our financial condition or results of operations.

Our Revenues and Expenses

Our revenue principally reflects:

- * earned premiums, consisting of:
 - premiums that we receive primarily from sales by our agents of property and casualty insurance policies, primarily personal automobile, homeowners and commercial automobile, which we refer to as direct premiums written, *plus*
 - premiums we receive from insurance policies that we assume, primarily from CAR, which we refer to as assumed premiums, *less*
 - the portion of our premiums that is ceded to CAR and other reinsurers, which we refer to as ceded premiums, *less*
 - the change in the portion of premiums that will not be recognized as income for accounting purposes until a future period, which we refer to as unearned premiums;
- * investment income that we earn on our invested assets;
- * premium finance charges and service fee income that we earn in connection with the billing and deferral of premium payments; and

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- * realized investment gains and losses.

Our expenses principally reflect:

- * direct and assumed incurred losses and loss adjustment expenses (which we sometimes refer to as LAE), including estimates for losses incurred during the period but not yet reported to us and changes in estimates from prior periods related to direct and assumed business, less the portion of those incurred losses and loss adjustment expenses that are ceded to other insurers; and
- * policy acquisition costs, including agent compensation and general and administrative costs, such as salaries and benefits, and advertising that are not deferred for accounting purposes to a future period.

Our Performance Measures

We evaluate our operations by monitoring key measures of growth and profitability. We measure our growth by examining our direct premiums written as well as increases in exposures and policies. We generally measure our operating results in accordance with accounting principles generally accepted in the United States

of America (GAAP) by examining our net earnings, return on equity (ROE), and our loss and LAE, underwriting expense and combined ratios on a consolidated basis. Our key measures include:

* Diluted Earnings per Share

. Diluted earnings per share is net earnings divided by the weighted average number of common shares outstanding adjusted by the number of additional common shares that would have been outstanding had potentially dilutive common shares been issued and reduced by the number of common shares we could have purchased from the proceeds of those potentially dilutive shares.

* Return on Equity

. Return on equity is net earnings divided by stockholders' equity at the beginning of the period.

* Direct Premiums Written.

Direct premiums written is the sum of the total policy premiums, net of cancellations, associated with policies underwritten and issued by our insurance subsidiaries. We use direct premiums written, which includes premiums that we cede to CAR and other reinsurers, as a measure of the underlying growth of our insurance business from period to period.

* Direct Earned Premiums

. Direct earned premiums are the portion of direct premiums written over the preceding twelve-month period equal to the expired portion of policies and recognized as revenue during an accounting period.

* Net Investment Income.

Net investment income represents earnings on our investment portfolio less expenses. We rely on after-tax investment income as a significant source of net earnings.

* Loss and LAE Ratio.

The loss and LAE ratio is the percentage of losses and loss adjustment expenses (including corporate expenses) incurred to earned premiums. We calculate this ratio net of our reinsurance recoveries. We use this ratio as a measure of the overall underwriting profitability of the insurance business we write and to assess the adequacy of our pricing for product lines and states with competitively set premiums.

* Underwriting Expense Ratio.

The underwriting expense ratio is the percentage of underwriting expenses (including corporate expenses) incurred to net premiums written. Underwriting expenses are the aggregate of policy acquisition

costs, including commissions, and the portion of administrative, general and other expenses attributable to underwriting operations. For the purposes of this calculation, underwriting expenses are grossed-up for any change in deferred acquisition costs.

*

Combined Ratio.

The combined ratio is the sum of the loss and LAE ratio and the underwriting expense ratio and measures a company's overall underwriting profit. If the combined ratio is at or above 100%, an insurance company cannot be profitable without investment income, and may not be profitable if investment income is insufficient. We use the combined ratio in evaluating our overall underwriting profitability and for comparing our profitability to that of our competitors. We generally seek to achieve a combined ratio of less than 100%.

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Results of Operations for the Periods Ended September 30, 2007 and 2006

Consolidated Results

Our key operating measures for the three and nine months ended September 30 follow:

| (Dollars in millions, except per share data) | Three Months | | Nine Months | |
|--|--------------|---------|-------------|-----------|
| | 2007 | 2006 | 2007 | 2006 |
| Diluted earnings per share (EPS) | \$0.88 | \$0.83 | \$2.63 | \$2.68 |
| Return on equity, annualized | 15.4% | 16.3% | 15.2% | 18.6% |
| Direct premiums written | \$466.5 | \$479.2 | \$1,447.7 | \$1,445.0 |
| Direct earned premiums | 474.8 | 463.9 | 1,413.3 | 1,377.9 |
| Net investment income | 40.3 | 34.4 | 119.8 | 104.1 |
| Loss and LAE ratio | 61.5% | 59.2% | 64.9% | 59.8% |
| Underwriting expense ratio | 30.4% | 28.4% | 29.1% | 27.5% |
| Combined ratio | 91.9% | 87.6% | 94.0% | 87.3% |

The decrease in the year-to-date **diluted earnings per share** is primarily due to an increased combined ratio, partially offset by increases in net investment income and net realized investment gains and a decline in diluted shares outstanding. Our annualized **return on equity** decreased for the current year-to-date period over the same period in the prior year primarily due to a lower level of net earnings combined with a higher level of equity. For the first nine months of 2007, net realized investment gains totaled \$28,945, while for the same period in 2006, \$7,665 of gains were realized. Included in the reported diluted EPS are realized investment gains of \$0.29 and \$0.07 for the nine months ended September 30, 2007 and 2006, respectively. Diluted EPS also benefited in 2007 from an increase in net investment income of \$15,697, or 15.1%, for the first nine months of 2007 over the comparable 2006 period.

The increase in our **loss and LAE ratio** for the nine month period is primarily due to:

- * Decreased earned premium per earned exposure for private passenger automobiles. The decrease was 4.0% in Massachusetts, due to state-mandated rate decreases, and 3.6% outside of Massachusetts, as a result of increased competition.
- * Additional reserves of \$10,300 were provided at State-Wide during the second quarter. We acquired State-Wide on April 2, 2007 and our review of their loss reserve position indicated that additional reserves were necessary, primarily in personal injury protection claims.
- * Slightly increased automobile bodily injury claim severity, partially offset by slightly lower claims frequency.

The increase in our loss and LAE ratio for the three months ended September 30, 2007 from the same period a year earlier resulted primarily from the decline in earned premium per earned exposure for private passenger automobiles. For the quarter, the decrease was 4.3% in Massachusetts and 2.3% outside of Massachusetts.

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The change in reserves for unpaid losses and LAE, net of reinsurance deductions from all reinsurers, including CAR, for the nine months ended September 30 follow:

| | 2007 | 2006 |
|---|--------------------|-------------------|
| | <u> </u> | <u> </u> |
| Incurring losses and LAE: | | |
| Provision for insured events of the current year | \$ 934,919 | \$842,258 |
| Decrease in provision for insured events of prior years | (49,739) | (63,346) |
| | <u> </u> | <u> </u> |
| Total incurred losses and LAE | 885,180 | 778,912 |
| | <u> </u> | <u> </u> |
| Payments: | | |
| Losses and LAE attributable to insured events of the current year | (520,479) | (458,377) |
| Losses and LAE attributable to insured events of prior years | (356,195) | (326,413) |
| | <u> </u> | <u> </u> |
| Total payments | (876,674) | (784,790) |
| | <u> </u> | <u> </u> |
| Change in loss and LAE reserves during the year | 8,506 | (5,878) |
| Loss and LAE reserves from acquisition | 43,559 | - |
| Loss and LAE reserves prior to the effect of ceded reinsurance recoverable, beginning of year | 850,775 | 834,699 |
| | <u> </u> | <u> </u> |
| Loss and LAE reserves prior to the effect of ceded reinsurance recoverable, end of period | 902,840 | 828,821 |
| Ceded reinsurance recoverable | 109,025 | 128,222 |
| | <u> </u> | <u> </u> |
| Loss and LAE reserves | <u>\$1,011,865</u> | <u>\$957,043</u> |

As a result of changes in estimates of insured events in prior years, the provision for loss and LAE decreased \$49,739 for the nine months ended September 30, 2007. This favorable development, also called redundancy, is due primarily to lower than anticipated losses related to the personal automobile liability line of business. Conditions and trends that have affected development in the past may not necessarily occur in the future. Accordingly, it may not be appropriate to extrapolate future redundancies or deficiencies based upon these developments. The amounts we will ultimately incur from loss and loss adjustment expenses could differ materially in the near term from the amounts recorded.

Approximately \$47,936 in personal automobile liability redundancies developed for the nine months ended September 30, 2007, with approximately 99% of this amount coming from the 2006, 2005 and 2004 accident years. Personal automobile liability redundancies relating to CAR comprised 18% of total personal automobile liability redundancies. Automobile physical damage had approximately \$623 in net redundancies. Automobile physical damage on voluntary business had \$6,669 in redundancies, partially offset by \$6,046 in deficiencies on automobile physical damage relating to CAR. Commercial automobiles had \$4,559 in redundancies, with approximately 73% of this amount coming from the 2006, 2005 and 2004 accident years. Homeowners had \$4,083 in deficiencies during the current year period, with 96% of this amount coming from the 2006 and 2005 accident years. For the nine months ended September 30, 2007, we experienced various redundancies and deficiencies for the other lines of business and accident years that combined for the remaining \$704 net redundancy.

For the nine months ended September 30, 2006, the provision for loss and LAE decreased \$63,346 as a result of changes in estimates of insured events in prior years. Approximately \$53,844 in personal automobile liability redundancies developed for the nine months ended September 30, 2006, with approximately 97% of this amount coming from the 2005, 2004 and 2003 accident years. Automobile physical damage had approximately \$6,667 in redundancies chiefly related to the 2005 accident year. Redundancies relating to CAR were approximately 15% of the total redundancies relating to prior years. For the nine months ended September 30, 2006, we experienced various redundancies and deficiencies for the other lines of business and accident years that combined for the remaining \$2,835 net redundancy.

The primary reason for the increase in our **underwriting expense ratio** was a reduction in ceded reinsurance commissions, which serve to reduce underwriting expenses. This reduction resulted from the termination of our other-than-automobile quota share agreement effective June 30, 2006. Also contributing to the increase was higher agent commissions as a percentage of written premium due to the April 1, 2007 Massachusetts state mandated rate decrease. These were partially offset by an overall decline in agents' profit sharing expense, due to the increase in the loss ratio in the current year. The increase in the third quarter 2007 underwriting expense ratio as compared to the previous year's third quarter was principally due to the impact in the third quarter of 2006 of a substantial increase in net written premium, with the 2006 underwriting ratio being driven lower, as a result of the termination of our other-than-automobile quota share agreement. The effect of this event impacted the nine month ratio to a much lesser extent.

Also impacting both the underwriting expense and loss ratios, especially in the third quarter, were lower expenses related to ACIC agent stock options, primarily as a result of the decrease in our stock price at September 30, 2007. Expense (income)

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related to this item totaled \$377 and \$4,991 for the nine months and \$(9,244) and \$2,079 for the three months ended September 30, 2007 and 2006, respectively. We expect our stock price will be significantly higher at December 31, 2007 than it was at September 30, 2007 due to our pending merger agreement with MAPFRE SA. We expect that a higher stock price will result in a much higher ACIC agents' option expense in the fourth quarter than in the third quarter. Using the per share price in the MAPFRE Merger Agreement of \$36.70 as our year end stock price, we estimate our fourth quarter ACIC agent option expense to be approximately \$11,300.

This expense of \$11,300 contrasts with the \$9,244 of income in the third quarter for ACIC agent options.

Segment Results

We evaluate our performance and allocate resources based primarily on our property and casualty insurance segments, which represent nearly all of our total revenues. Detailed segment information for the three and nine months ended September 30, 2007 and 2006 can be seen in Note 9 of Notes to Unaudited Consolidated Financial Statements.

Massachusetts Segment

Revenues for the nine months ended September 30, 2007 increased from the same period a year ago. The nine month increase in revenues of \$45,209 resulted primarily from increases in earned premiums, investment income and realized investment gains. See Massachusetts segment premium results and net investment income sections below for further discussion.

Earnings for the nine months ended September 30, 2007 declined over the same period a year ago. This decrease was primarily the result of higher loss experience, partially offset by higher revenues as discussed above. The loss and LAE ratio for Massachusetts business increased to 56.9% for 2007 from 53.6% a year earlier, primarily due to decreased earned premium per earned exposure for private passenger automobiles and, to a lesser extent, a slight increase in private passenger automobile bodily injury claim severity, partially offset by a slight decline in frequency.

Other than Massachusetts Segment

Revenues for the nine months ended September 30, 2007 increased from the same period a year ago. This increase resulted from increases in all revenue areas with the largest single contributor being increased earned premium primarily from the acquisition of State-Wide, which added a combined \$18,239 in earned premiums during the second and third quarters.

Earnings for the nine months ended September 30, 2007 decreased over the same period a year ago. This decrease was due to higher policy acquisition costs and loss experience, partially offset by higher revenues as discussed above. The combined ratio for other-than-Massachusetts business increased to 111.7% for 2007 from 91.6% a year earlier. An increased loss ratio resulted from decreased earned premiums per earned exposure for private passenger automobiles, additional reserves of \$10,300 at State-Wide and higher current accident year results, primarily in homeowners business.

Premium Results

Direct premiums written and earned for the three and nine months ended September 30, 2007 and 2006 can be seen in Note 9 of Notes to the Unaudited Consolidated Financial Statements.

Massachusetts Segment

For the first nine months of 2007, direct premiums written decreased \$27,730, or 2.2%, over the comparable period of 2006, while direct premiums earned increased \$6,410, or 0.5%, over the same period. The decrease in direct premiums written resulted primarily from a decrease in premiums written for personal automobile during the third quarter. This primarily resulted from the state-mandated decrease in personal automobile premium rates effective April 1, 2007. Written premiums are reported on the first day the policy is effective (thus reflecting the state mandated rate decrease) while earned premiums are reported ratably over the coverage period (thus, for the second and third quarters of 2007, earned premium includes a higher proportion

of premiums written prior to the state mandated rate decrease than those written subsequently). For the fourth quarter of 2007 and into 2008, an increasingly greater portion of the post-rate decrease premiums will be earned and we anticipate a decline in earned premiums given the same level of exposures. In addition, the number of exposures increased between 2007 and 2006.

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The decrease of \$34,233 in year-to-date direct premiums written for personal automobiles resulted from a decrease of 4.8% in the average written premium per exposure, partially offset by a 1.9% increase in written exposures. The 2007 Commissioner-approved rate decrease of 11.7% in the state mandated average personal automobile rate took effect April 1, 2007. This is reflected in the 8.9% decline in average written premium per exposure during the current year's third quarter. We expect this to result in a 6.4% decline in direct premiums written per written exposure for us by the end of 2007.

Although mandated average personal automobile premium rates decreased 11.7%, our average written premium per exposure is expected to decrease only 6.4% for the year ended December 31, 2007. We believe that the smaller decrease as compared to the Commissioner's state mandated average rate resulted primarily from:

- * the fact that our mix of personal automobile coverage differs from that of the industry;
- * changes to our distribution of risks by class, territory and coverage, including changes resulting from the purchase of new, more expensive automobiles, which were not factored into the Commissioner's rate decrease; and
- * the fact that the Commissioner's mandated rate decline is effective for only three quarters of 2007.

Direct premiums written for homeowners increased for the first nine months of 2007 over the same period a year earlier by \$12,797, or 11.8%. This increase is due to a 7.7% increase in average premium per policy combined with a 3.7% increase in the number of written policies.

Commercial automobile direct written premiums declined \$6,388, or 8.2%, during the nine months of 2007 as compared to the same period in the prior year. This resulted primarily from an 7.7% decline in average premium per policy as the number of policies remained relatively constant. This decrease mainly occurred in the second quarter as average premium per policy declined 14.9%. The decrease occurred as a result of a softening of the market for larger commercial accounts, some of which we lost and were replaced by smaller accounts. The decline in average premium per policy during the third quarter was 4.8%.

Other than Massachusetts Segment

For the nine months of 2007, direct premiums written increased \$30,503, or 18.1% over the comparable period of 2006, while direct earned premiums increased \$29,058, or 17.7%. The increase in direct premiums written resulted primarily from increases in premiums written for personal automobile and homeowners policies. The increase in personal automobile written premiums was \$27,694, or 21.6%. The largest single contributor of increased direct written premium and direct earned premium was \$17,335 of written premium and \$18,239 of earned premium from State-Wide, which was acquired April 2, 2007. At American Commerce, total direct written premiums increased \$7,783, or 6.5%, with \$5,765 of the increase from automobile policies. The increase in automobile direct written premiums resulted from an 11% increase in policies in force, partially offset by a decrease in average premium per policy. ACIC direct written premium increases for all lines resulted principally from increases in Oklahoma (16.5% increase over the prior year), Oregon (16.1%), Rhode Island (8.8%) and Washington (8.5%). Commerce West increased direct written premium by \$4,659, or 11.0%, due primarily to a 16.3% increase in policies in force, partially offset by a decline in average premium

per policy.

Net Investment Income

Key measures of net investment income for the quarter ended September 30 follow:

| | <u>2007</u> | <u>2006</u> | <u>Change</u> |
|--|-------------|-------------|---------------|
| Average month-end investments (at cost) | \$2,933,834 | \$2,865,215 | \$68,619 |
| Net investment income, before federal tax | 40,310 | 34,417 | 5,893 |
| Net investment income, after federal tax | 31,139 | 26,017 | 5,122 |
| Net investment income as an annualized percentage of average net investments (at cost), before federal tax | 5.5% | 4.8% | 0.7% |
| Net investment income as an annualized percentage of average net investments (at cost), after federal tax | 4.2% | 3.6% | 0.6% |

Key measures of net investment income for the nine months ended September 30 follow:

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| | <u>2007</u> | <u>2006</u> | <u>Change</u> |
|--|-------------|-------------|---------------|
| Average month-end investments (at cost) | \$3,037,237 | \$2,834,257 | \$202,980 |
| Net investment income, before federal tax | 119,762 | 104,065 | 15,697 |
| Net investment income, after federal tax | 91,117 | 78,972 | 12,145 |
| Net investment income as an annualized percentage of average net investments (at cost), before federal tax | 5.3% | 4.9% | 0.4% |
| Net investment income as an annualized percentage of average net investments (at cost), after federal tax | 4.0% | 3.7% | 0.3% |

The increase in our net investment income was due primarily to higher investment yields from our increased allocations to preferred stocks and municipal housing bonds, as yields were rising in those sectors. While our overall credit quality was not significantly impacted, the yields of our allocation to these sectors led to an overall increase in our portfolio yield. In addition, the lengthening of the duration of our fixed maturity portfolio during the last year added to our investment yield. The duration at September 30, 2007 and 2006 was 5.8 years and 4.9 years, respectively.

Realized Investment Gains and Losses

Net realized investment gains (losses) for the three and nine months ended September 30 follow:

| | <u>Three Months</u> | | <u>Nine Months</u> | |
|---------------------------------|---------------------|-------------|--------------------|-------------|
| | <u>2007</u> | <u>2006</u> | <u>2007</u> | <u>2006</u> |
| Transaction net gains (losses): | | | | |
| Fixed maturity securities | \$ 1,756 | \$(2,433) | \$18,411 | \$(1,317) |
| Equity securities | (1,470) | (410) | 15,028 | (1,071) |

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| | | | | |
|--|-------------------|-------------------|-------------------|-------------------|
| Venture capital funds | (890) | 4,812 | 1,333 | 6,243 |
| Other investments | 1,094 | - | 1,090 | 16 |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| Total transaction net gains | 490 | 1,969 | 35,862 | 3,871 |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| Other-than-temporary impairment losses: | | | | |
| Fixed maturity securities | (1,795) | - | (3,810) | (1,103) |
| Equity securities | (1,304) | (1,839) | (3,255) | (1,839) |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| Total other-than-temporary impairment losses | (3,099) | (1,839) | (7,065) | (2,942) |
| Equity in earnings (losses) of closed-end preferred stock mutual funds | (557) | 7,700 | (2,947) | 6,736 |
| Other: | | | | |
| Sale of agency assets | - | - | 1,585 | - |
| Sale of minority interest in CWIC | - | - | 1,510 | - |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| Net realized investment gains (losses) | <u>\$ (3,166)</u> | <u>\$ 7,830</u> | <u>\$ 28,945</u> | <u>\$ 7,665</u> |

The large increase in realized capital gains for the nine month period were realized mainly in the first quarter and were principally due to the sale of securities with significant price appreciation in a number of our transportation asset backed bonds and some of our long duration municipal bond holdings as well as large relative gains in several of our common stock holdings. We continue to monitor our invested assets with regard to after tax book income and maintain the ability to realize gains or losses should our investment outlook change.

We have no exposure to collateralized debt obligations, collateralized bond obligations or collateralized loan obligations and we have not invested in credit derivatives.

Financial Condition

Our stockholders' equity per share decreased 1.1% from \$22.53 per share at December 31, 2006 to \$22.28 per share at September 30, 2007, after dividends paid of \$0.90 per share. During the first nine months of 2007, we repurchased 7.1 million shares of our common stock at a cost of \$223,366. The dividend payments, stock repurchases and \$70,915 of unrealized losses on investment securities, partially offset by net income, resulted in a decline in total equity to \$1.34 billion at September 30, 2007 from \$1.50 billion at December 31, 2006. Since December 31, 2006, the ratio of our total liabilities to stockholders' equity increased from 173% to 196% at September 30, 2007, primarily due to the combination of the decrease in equity plus increases in unearned premiums and loss and LAE reserves due primarily to the acquisition of State-Wide, partially offset by lower accrued agents' profit sharing.

Liabilities for unpaid losses and loss adjustment expenses at September 30, 2007 and December 31, 2006 follow:

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| | September 30, 2007 | December 31, 2006 |
|-------------------------------------|-----------------------|----------------------|
| | <u> </u> | <u> </u> |
| Net voluntary unpaid losses and LAE | \$ 907,159 | \$837,470 |

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| | | |
|--|-------------|-----------|
| Voluntary salvage and subrogation recoverable | (103,255) | (96,954) |
| Assumed unpaid losses and LAE reserves from CAR | 119,480 | 130,803 |
| Assumed salvage and subrogation recoverable from CAR | (20,544) | (20,544) |
| | <hr/> | <hr/> |
| Total voluntary and assumed unpaid losses and LAE reserves | 902,840 | 850,775 |
| Adjustment for ceded unpaid losses and LAE reserves | 118,025 | 130,174 |
| Adjustment for ceded salvage and subrogation recoverable | (9,000) | (9,000) |
| | <hr/> | <hr/> |
| Total unpaid losses and LAE | \$1,011,865 | \$971,949 |
| | <hr/> | <hr/> |

Industry and regulatory guidelines suggest that the ratio of a property and casualty insurer's annual net premiums written to statutory policyholders' surplus should not exceed 3.00 to 1.00. Our twelve-month rolling net premiums written to statutory surplus ratio was 1.13 to 1.00 for the period ended September 30, 2007 and 1.16 to 1.00 for the period ended September 30, 2006.

Liquidity and Capital Resources

Liquidity management allows us to meet our cash needs at a reasonable cost under various operating environments. Liquidity is actively managed and reviewed in order to maintain stable, cost-effective funding to meet our operating needs. Liquidity comes from a variety of sources such as cash flow from operating activities and borrowing capacity. Management believes its current liquidity exceeds its operational requirements as of September 30, 2007.

The primary sources of our liquidity are funds generated from insurance premiums, net investment income, premium finance and service fees and the maturing and sale of investments. The primary uses of our liquidity are payment of policy claims, commissions and agents' profit sharing, operating costs, interest on our senior notes, purchases of investment securities and treasury stock and payment of dividends to our stockholders.

We have additional liquidity capacity through our Federal Home Loan Bank (FHLB) membership and our investment portfolio. Commerce, as a member of FHLB of Boston, is able to borrow from the FHLB on a fully secured basis. Our borrowing capacity is based primarily upon the composition and market value of Commerce's investment portfolio. At September 30, 2007, we estimate Commerce's borrowing capacity at approximately \$360,000. Since becoming a member in 2005, Commerce has not borrowed from FHLB of Boston.

During the third quarter of 2007, we paid \$122,921 for the repurchase of Treasury stock. This amount was funded through cash, short-term investments and cash flow from our investment portfolio and normal operating activities. This activity contributed to the decrease in the investment portfolio during the current quarter.

Investment Strategy and Interest Rate Risk

The primary focus of our investment objectives continues to be maximizing after-tax investment income through investing primarily in high-quality diversified fixed income investments structured to maximize after-tax investment income while minimizing risk. We generally invest in securities with maturities intended to provide adequate funds to pay claims and meet other operating needs without the forced sale of investments. When the appropriate opportunity arises, we may sell investment securities to increase after-tax total return. We held no derivatives, emerging market securities or hedge funds at September 30, 2007 and December 31, 2006.

Interest Rate Sensitivity

Our investments include positions in fixed maturity, equity, short-term and cash equivalents markets. Therefore, we are exposed to the impacts of interest rate changes in the market value of investments. We estimated our exposure to interest rate changes and equity price risk at September 30, 2007 using sensitivity analysis. The interest rate impact is the effect of a hypothetical interest rate change of plus-or-minus 100 and 200 basis points on the market value of fixed maturities and preferred stocks.

Changes in interest rates would result in unrealized gains or losses in the market value of the fixed maturity and preferred stock portfolio. The following table summarizes our interest rate risk, based on the results of the sensitivity analysis at September 30, 2007.

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| Hypothetical Change in Interest Rates | Estimated Market Value of Fixed Income and Preferred Stock Investments | Estimated Increase (Decrease) in Market Value | Hypothetical Percentage Increase (Decrease) in Stockholders' Equity ⁽¹⁾ |
|---------------------------------------|--|---|--|
| 200 basis point increase | \$2,109,111 | \$(341,516) | (16.6)% |
| 100 basis point increase | 2,274,405 | (176,222) | (8.5) |
| No change | 2,450,627 | - | - |
| 100 basis point decrease | 2,567,055 | 116,428 | 5.6 |
| 200 basis point decrease | 2,692,048 | 241,421 | 11.7 |

(1) Net of income taxes at an assumed rate of 35%.

The duration of a security is the time-weighted present value of the security's expected cash flows and is used to measure a security's price sensitivity to changes in interest rates. The duration reflects industry prepayment assumptions. The analytic systems we used to calculate the above utilize optional call dates, sinking fund requirements and assume a non-static prepayment pattern in deriving market value estimates and duration averages. As of September 30, 2007, December 31, 2006 and September 30, 2006, our weighted average duration was 5.8 years, 5.4 years and 4.9 years, respectively. Our fixed income portfolio's weighted average duration includes all fixed maturities and preferred stocks. Our percentage of adjustable rate investments amounted to 19.6% of total fixed maturity investments at September 30, 2007 as compared to 22.1% a year earlier.

Equity Price Risk

We estimated that our exposure to equity price risk at September 30, 2007 has not changed materially from that at December 31, 2006.

Forward-Looking Statements

This quarterly report may contain statements that are not historical fact and constitute "forward-looking statements" within the meaning of Section 27A of the Securities Act and Section 21E of the Securities Exchange Act. Statements about our expectations, beliefs, plans, objectives, assumptions or future events or performance are not historical facts and may be forward-looking. Forward-looking statements also include any

statement concerning the proposed MAPFRE merger including the expected timetable for completing the MAPFRE merger and the payment of dividends by us between now and the completion of the MAPFRE merger. These statements are often, but not always, made through the use of words or phrases such as "anticipates," "estimates," "plans," "projects," "continuing," "ongoing," "expects," "may," "will," "could," "likely," "should," "management believes," "we believe," "we intend," and similar words or phrases. These statements may address, among other things, our strategy for growth, business development, regulatory approvals, market position, expenditures, financial results and reserves. Accordingly, these statements involve estimates, assumptions and uncertainties that could cause actual results to differ materially from those expressed in them. All forward-looking statements are qualified in their entirety by reference to the factors discussed throughout this quarterly report and in our recently filed annual report on Form 10-K and in other documents filed with the SEC. A number of important factors could cause actual results to differ materially from those contained in any forward-looking statement. Such factors include, but are not limited to, the ability of the Company to obtain shareholder approval of the MAPFRE merger and the possibility that the proposed MAPFRE merger will not close or that the closing will be delayed, and those factors that are more particularly described under the heading "Item 1A. Risk Factors" of this Form 10-Q. Among the key factors that could cause actual results to differ materially from forward-looking statements are:

- * the possibility of severe weather, terrorism and other adverse catastrophic experiences;
- * adverse trends in claim severity or frequency and uncertainties in estimating property and casualty losses;
- * adverse state and federal regulations and legislation;
- * adverse judicial decisions;
- * adverse changes to the laws, regulations and rules governing the residual market system in Massachusetts;
- * premium rate making decisions for private passenger automobile policies in Massachusetts;
- * the implementation of managed competition and an Assigned Risk Plan in Massachusetts;
- * heightened competition, especially in Massachusetts if large national competitors enter the state in response to the proposed managed competition regulations;

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- * potential rate filings;
- * our concentration of business within Massachusetts and within the personal automobile line of business;
- * market disruption in Massachusetts, if competitors exit the market or become insolvent;
- * fluctuations in interest rates and the performance of the financial markets in relation to the composition of our investment portfolio;
- * the cost and availability of reinsurance;
- * our ability to collect on reinsurance and the solvency of our reinsurers;
- * the effectiveness of our reinsurance strategies;

- * telecommunication and information system problems, including failures to implement information technology projects timely and within budget;
- * our ability to maintain favorable ratings from rating agencies, including A.M. Best, Fitch, Moody's and S&P;
- * our ability to attract and retain independent agents;
- * our ability to retain our affinity relationships with AAA clubs;
- * our dependence on a key third party service vendor for our automobile business in Massachusetts;
- * our dependence on our executive officers; and
- * the economic, market or regulatory conditions and risks associated with entry into new markets and diversification.

You should not place undue reliance on any forward-looking statement. The risk factors referred to above, as well as those set forth in Part I, Item 1A of our annual report on Form 10-K for the year ended December 31, 2006, as well as those elsewhere in this quarterly report, could cause actual results or outcomes to differ materially from those expressed in any forward-looking statement made by us or on our behalf. Further, any forward-looking statement speaks only as of the date on which it is made, and we undertake no obligation to update any forward-looking statement to reflect events or circumstances after the date on which the statement is made or to reflect the occurrence of unanticipated events. New factors emerge from time to time, and it is not possible for us to predict which factors will arise. In addition, we cannot assess the impact of each factor on our business or the extent to which any factor, or combination of factors, may cause actual results to differ materially from those contained in any forward-looking statements.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Refer to "Investment Strategy and Interest Rate Risk" in Item 2, Management's Discussion and Analysis of Financial Condition and Results of Operations, for the interim period information required by this item. Such disclosure is incorporated by reference into this Item 3.

Item 4. Controls and Procedures

Evaluation of disclosure controls and procedures

Under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, we evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) and 15d-15(e) under the Exchange Act) as of the end of the period covered by this report. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective to ensure that information required to be disclosed in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the Securities and Exchange Commission's rules and forms.

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Changes in internal control

There has been no change in our internal control over financial reporting that has occurred during our last fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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Part II - Other Information

Item 1. Legal Proceedings

As is common with property and casualty insurance companies, we are a defendant in various legal actions arising from the normal course of our business, including claims based on the Massachusetts Unfair Claims Settlement Practices Act, or Chapter 176D and the Massachusetts Consumer Protection Act, or Chapter 93A. Similar provisions exist in other states where we do business. These proceedings are considered ordinary to operations or without foundation in fact. We believe that these actions will not have a material adverse effect on our consolidated financial position.

In our annual report on Form 10-K for the year ended December 31, 2006, we discussed two individual legal matters outstanding, AAA Arizona and Commerce Bancorp, Inc. et al. An update on each matter is presented below. For a full discussion of these matters, refer to Item 3 of the Form 10-K. A new legal matter, California State Automobile Association Inter-Insurance Bureau v. The Commerce Insurance Group et al., was initiated on April 25, 2007 and disclosed in our quarterly report on Form 10-Q for the quarter ended June 30, 2007. An update on this matter is presented below.

AAA Arizona

On September 10, 2007, the Court issued a Memorandum of Decision and Order (the Order) on the parties' summary judgment motions. The Order is under seal, which prevents public disclosure of its contents. Publicly available information, however, reveals that the Court denied American Commerce's motion for summary judgment, and granted AAA Arizona's Motion for Partial Summary Judgment. The Court also granted third-party defendants D. James McDowell and Joanne Tenney McDowell's motion for summary judgment. By granting AAA Arizona's motion, the Court held that AAA Arizona is entitled to approximately \$1,700 in profit sharing that it claimed was earned in 2004, and further that American Commerce must pay commissions to AAA Arizona, in an amount to be determined at trial, for renewal policies previously written through AAA Arizona. The Order also results in the dismissal of American Commerce's counterclaims against AAA Arizona, and its third-party claims against D. James and Joanne Tenney McDowell. We intend to appeal the Court's Order.

The Court's Order does not resolve all of AAA Arizona's claims against American Commerce, the resolution of which will require a trial. No trial date has been set. We intend to defend vigorously against AAA Arizona's claims.

Commerce Bancorp, Inc., et al.

On February 2, 2007, the Court denied Commerce Bancorp, Inc.'s motion to dismiss the complaint for lack of personal jurisdiction. Commerce Bancorp, Inc. thereafter answered the complaint on February 26, 2007, and in its answer asserted counterclaims against Commerce, CGI, Commerce Holdings, Inc., ACIC and Commerce West alleging trademark infringement outside of Massachusetts. Specifically, the counterclaims consist of three counts: Count I alleges federal service mark infringement; Count II alleges a violation of [SECTION] 43(a) of the Lanham Act; and Count III seeks a declaratory judgment under 28 U.S.C. [SECTION]2201, *et seq.* On March 19, 2007, we moved to dismiss, or in the alternative sever, the counterclaims. On April 2, 2007, the defendants filed a motion for summary judgment, which we opposed on April 16, 2007.

On June 12, 2007, the Court granted our motion to dismiss Commerce Bancorp's counterclaims against Commerce, CGI, Commerce Holdings, Inc., ACIC and Commerce West which alleged trademark infringement outside of Massachusetts. The dismissal was without prejudice to the defendants filing its claim in a separate action. On June 11, 2007, the Court denied the defendants' motion for summary judgment.

On August 7, 2007, the Company entered into a Settlement Agreement and Mutual Release (the Agreement) with the defendants to resolve the lawsuit in Federal Court and the related proceedings in the U.S. Patent and Trademark Office. As part of the Agreement, the defendants agreed not to use, advertise, promote, or display any name or mark containing the name or mark "Commerce" in Massachusetts for insurance-related services. The defendants further agreed that any name or mark used by them in Massachusetts for insurance-related services shall use only the letter designations CBIS or CIS and also include their logo. In addition, the defendants agreed that in the states of Maine, New Hampshire, Vermont, and Rhode Island, the defendants will use the names and marks "CBIS/Commerce" or "CIS/Commerce," and will not use the name or mark "Commerce Insurance" or "Commerce" as a stand alone name or mark. The Agreement also specifies that neither the defendants nor the Company will contest or object to the respective use of the parties' current names and marks as used in the state of Connecticut.

Under the terms of the Agreement, the Company agreed not to do business under the name or mark "The Commerce Insurance Company" in the states of New York, New Jersey, Pennsylvania, Delaware, Maryland, Florida, Washington D.C., Virginia, and Nevada. The Agreement, however, expressly allows The Commerce Insurance Company to be licensed in any of those states as a reinsurer to meet its obligations under intercompany pooling arrangements. In addition, the Agreement

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specifies that the Company shall be permitted to use the names and marks "Commerce West Insurance," "American Commerce Insurance," and formatives of those names and marks, anywhere in the United States, and "Commerce Insurance" and formatives of that name and mark except as stated above.

As part of the settlement, the parties also agreed that upon mutually agreeable terms to be negotiated by the parties, Commerce Banc Insurance Services will include The Commerce Insurance Company among its underwriters in Massachusetts and an appropriate subsidiary of the Company in New Jersey for purposes of underwriting personal lines and small commercial business. The parties further agreed to consider similar arrangements in other states in the future.

In addition, the defendants agreed to include on their website appropriate disclaimer language to reflect the permitted use of the names or marks in the respective states as provided in the Agreement.

CSAA

On April 25, 2007, California State Automobile Inter-Insurance Bureau (CSAA) filed a lawsuit in the Superior Court of California, County of Alameda, against Commerce West, American Commerce, and CGI. In that lawsuit, styled *California State Automobile Association Inter-Insurance Bureau v. The Commerce Insurance Group, Inc. et al.*, CSAA alleged that, through the hiring of several CSAA employees, the defendants misappropriated CSAA's trade secrets or proprietary information, intentionally interfered with a confidentiality agreement between CSAA and one of those employees, engaged in unfair business practices and unfair competition, and has been and will be unjustly enriched. CSAA cited in support of its allegations the Company's hiring of Lawrence R. Pentis, and the Company's subsequent hiring of three other former CSAA employees. Mr. Pentis is a Commerce Group Executive Vice President and the Chief Operating Officer and Executive Vice President of American Commerce and Commerce West.

In the original complaint, CSAA sought injunctive relief, including prohibiting the defendants from using CSAA's trade secret or proprietary information or from soliciting CSAA's employees, and money damages in an unspecified amount. On May 29, 2007, we filed a motion to dismiss five of the six causes of action alleged in the complaint. The Court granted our motion on June 25, 2007, but granted CSAA leave to amend the complaint. On July 25, 2007, CSAA filed a First Amended Complaint in which it repeats its claims alleged in the original complaint, and adds two counts alleging conversion and civil conspiracy. The First Amended Complaint seeks injunctive relief, including prohibiting the defendants from using CSAA's trade secret or proprietary information or from soliciting CSAA's employees, and money damages in an unspecified amount.

On August 27, 2007, we filed a motion to dismiss seven of the eight causes of action alleged in the First Amended Complaint. On October 16, 2007, the Court issued a tentative ruling granting our motion to dismiss but providing CSAA further leave to amend five of the seven counts dismissed by the Court. The Court's tentative ruling is not a final order and the Court held a hearing on our motion on October 18, 2007. The Court has not rendered its final decision on our motion to dismiss.

The Company is unable to predict with certainty the outcome of the CSAA proceeding, however based upon the information available to the Company as of the date of this report, the Company does not believe that potential consequences of CSAA's claims, if proven, would have a material adverse effect on the Company's business, financial condition, liquidity or results of operations.

Item 1A. Risk Factors

There has been no material change regarding risk factors from those set forth in our annual report on Form 10-K for the year ended December 31, 2006. The risk factors as set forth in our annual report on Form 10-K refer to litigation between us and Commerce Bancorp. See Item 1, Legal Proceedings, elsewhere within this Form 10-Q for an update to these proceedings.

An additional risk factor is as follows:

The pending merger with MAPFRE may not occur.

On October 30, 2007, we entered into the MAPFRE Merger Agreement, pursuant to which an indirect wholly-owned subsidiary of MAPFRE will be merged with and into the Company, with the Company continuing as the surviving

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corporation and becoming an indirect wholly-owned subsidiary of MAPFRE. Completion of the proposed MAPFRE merger is subject to various customary closing conditions including, but not limited to, (1) the requisite approval of the MAPFRE Merger Agreement by the holders of at least two-thirds of the shares of our common stock, (2) the receipt of all required insurance regulatory approvals, and (3) the expiration or termination of applicable waiting periods under the Hart-Scott-Rodino Antitrust Improvements Act of 1976. We currently expect that the MAPFRE merger will be completed in 2008, likely late in the first quarter or early in the second quarter. It is possible, however, that factors outside of our control could require the parties to complete the MAPFRE merger at a later time or not to complete it at all.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

(a) None.

(b) None.

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(c) On May 18, 2007, our Board of Directors authorized an increase in the stock buy-back program to allow for the purchase of up to 5,000,000 shares of our common stock from that date.

| Period | Total Number of Shares Purchased | Average Cost 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 |
|----------------------|----------------------------------|------------------------|--|--|
| July 1-31, 2007 | 882,387 | \$32.96 | 882,387 | 3,069,710 |
| August 1-31, 2007 | 2,085,380 | 30.08 | 2,085,380 | 984,330 |
| September 1-30, 2007 | 984,330 | 31.60 | 984,330 | - |
| Total | 3,952,097 | 31.10 | 3,952,097 | |

Item 3. Defaults upon Senior Securities

None.

Item 4. Submission of Matters to a Vote of Security Holders

None.

Item 5. Other Information

None.

Item 6. Exhibits

Exhibits:

31.1 CEO Certification Statements under Section 302 of The Sarbanes-Oxley Act of 2002

31.2 CFO Certification Statements under Section 302 of The Sarbanes-Oxley Act of 2002

32 CEO and CFO Certification Statements under Section 906 of The Sarbanes-Oxley Act of 2002

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Signature

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

THE COMMERCE GROUP, INC.

/s/ Randall V. Becker

Randall V. Becker

Dated: November 8, 2007

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