SELECTIVE INSURANCE GROUP INC
Form 10-K
February 24, 2012

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10-K

(Mark One)

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

For the fiscal year ended December 31, 2011

or

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

For the transition period from __________ to __________

Commission file number 001-33067

SELECTIVE INSURANCE GROUP, INC.

(Exact Name of Registrant as Specified in Its Charter)

New Jersey	22-2168890
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)
40 Wantage Avenue, Branchville, New Jersey	07890
(Address of Principal Executive Offices)	(Zip Code)
Registrant’s telephone number, including area code:	(973) 948-3000

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

Title of each class	Name of each exchange on which registered
Common Stock, par value $2 per share	NASDAQ Global Select Market
7.5% Junior Subordinated Notes due September 27, 2066	New York Stock Exchange

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

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

x Yes ¨ No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.

¨ Yes x No

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

x Yes ¨ No

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

x Yes ¨ No

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

¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting

company” in Rule 12b-2 of the Exchange Act.

Large accelerated filer x	Accelerated filer ¨
Non-accelerated filer ¨ (Do not check if a smaller reporting company)	Smaller reporting company ¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act).

¨ Yes x No

The aggregate market value of the voting company common stock held by non-affiliates of the registrant, based on the closing price on the NASDAQ Global Select Market, was $859,389,812 on June 30, 2011. As of February 15, 2012, the registrant had outstanding 54,741,402 shares of common stock.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant’s definitive Proxy Statement for the 2012 Annual Meeting of Stockholders to be held on April 25, 2012 are incorporated by reference into Part III of this report.

SELECTIVE INSURANCE GROUP, INC.

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PART I

Item 1. Business.

Overview

Selective Insurance Group, Inc. (referred to as the "Parent") is a New Jersey holding company, incorporated in 1977, that offers property and casualty insurance products and services through its insurance subsidiaries (collectively referred to as "we," "us," or "our"). Our main offices are located in Branchville, New Jersey and our Parent's common stock is publicly traded on the NASDAQ Global Select Market under the symbol "SIGI." In 2011, we were ranked as the 50th largest property and casualty group in the United States based on 2010 net premium written ("NPW") in A.M. Best and Company's ("A.M. Best") annual list of "Top 200 U.S. Property/Casualty Writers." We have provided a glossary of terms as Exhibit 99.1 to this Form 10-K, which defines certain industry-specific and other terms that are used in this Form 10-K.

We classify our business into two operating segments:

- Insurance Operations, which sells property and casualty insurance products and services; and
- Investments, which invests the premiums collected by our insurance operations.

Our Insurance Operations offers standard market insurance products and services through seven insurance subsidiaries and, in 2011, we began offering excess and surplus lines ("E&S") insurance products as the result of the following acquisition activity:

- The purchase of the renewal rights to an E&S book of business in August 2011. This renewal book had gross annual premiums of approximately $77 million in 2010.
- The purchase of Montpelier U.S. Insurance Company ("MUSIC") in December 2011. MUSIC had gross annual premiums of approximately $48 million in 2010.
- For each of the acquisitions, all unearned premium reserves remained with the selling entities. Only premium written after the closings is for our account. For the renewal rights book, this was August 1, 2011 and for the MUSIC book this was January 1, 2012.
- During 2011, $24.1 million of E&S lines premium was recorded by us.

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

We derive substantially all of our income in three ways:

- Underwriting income from Insurance Operations. Underwriting income is comprised of revenues, which are the premiums earned on our insurance products and services, less expenses. The gross premiums we bill our insureds are direct premium written ("DPW") plus premiums assumed from other insurers. Gross premiums billed less premium ceded to reinsurers, is NPW. NPW is recognized as revenue ratably over the policy's term as net premiums earned ("NPE"). Expenses related to our Insurance Operations fall into three main categories: (i) losses associated with claims and various loss expenses incurred for adjusting claims (referred to as "loss and loss expenses"); (ii) expenses related to insurance policy issuance, such as agent commissions, premium taxes, reinsurance, and other expenses incurred in issuing and maintaining policies, including employee compensation and benefits (referred to as "underwriting expenses"); and (iii) policyholder dividends.

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

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

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

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

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

Insurance Operations

Overview

We derive all of our Insurance Operations revenue from selling insurance products and services to businesses and individuals for premium. Our sales to businesses, non-profit organizations, and local government entities, which we refer to as Commercial Lines, represent about 82% of our NPW. Our sales to individuals, which we refer to as Personal Lines, represent about 18% of our NPW. The majority of our sales are annual insurance policies. Commercial Lines sales are seasonally heaviest in January and July and lightest during the fourth quarter of the year.

Insurance Operations Products and Services

The types of insurance we sell in our Insurance Operations fall into three broad categories:

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

of time;

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

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

The main Commercial Lines we underwrite and insure primarily through traditional insurance and, to a lesser extent, through alternative risk management products, such as retrospective rating plans, self-insured group retention programs, or individual self-insured accounts, are as follows:

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

[1]Flood insurance premiums and losses are 100% ceded to the federal government's write-your-own ("WYO") Program. Certain other policies contain minimal Flood or Flood related coverages.

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

Type of Policy	Category of Insurance
Homeowners	Property/Casualty
Personal Automobile	Property/Casualty
Flood[1]	Property

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

The main E&S products that we underwrite and insure are as follows:

Type of Policy	Category of Insurance
General Liability (including Excess Liability/Umbrella)	Casualty
Commercial Property	Property

Product Development and Pricing

Our Insurance Operations policies are contracts that specify our coverages – what we will pay to or for an insured upon specified losses. We develop our coverages internally and by adopting and modifying forms and statistical data licensed from third party aggregators, notably Insurance Services Office, Inc. ("ISO"). Determining the price to charge for our coverages is complicated. At the time we underwrite and issue a policy, we do not know what our actual costs

for the policy will be in the future. To calculate and project future costs, we examine and analyze historical statistical data and factor in expected changes in loss trends. In the last five years, we have also developed predictive models for certain of our standard insurance lines. Predictive models analyze historical statistical data regarding our insureds and their loss experience, ranks our policies based on this analysis, and applies this risk data to current and future insureds to predict the likely profitability of an account. A model's predictive capabilities are limited by the amount and quality of the statistical data available. As a regional insurance group, our loss experience is not always statistically large enough to analyze and project future costs. Consequently, we use ISO data to supplement our own.

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Customers and Customer Markets

Commercial Lines customers represent 81% of our total DPW. We categorize this business as follows:

	Percent of Total Commercial Lines	**Average Premium per Policy**	Description
Small Business	21 %	$ 2,314	Standard insurance policies generally under $25,000, with certain restrictions for hazard grade and exposure that can be written through our internet-based One & Done® and Two & Done automated underwriting templates.
Middle Market Business	66 %	$ 8,563	Standard insurance policies that cannot be written through our automated systems and are the focus of our field-based underwriters, known as agency management specialists ("AMSs").
Large Account Business	11 %	$ 138,750	Standard insurance policies that are larger in size or include alternative risk transfer. This business is written by large account specialists. Approximately 24% of these accounts include alternative risk transfer mechanisms.
E&S Business	2 %	$ 2,204	E&S insurance policies that are generally written through contract binding authority through established underwriting guidelines with our wholesale general agency partners.

We do not sub-divide our Personal Lines customers by size or class. No one customer accounts for 10% or more of our premium within our Insurance Operations segment.

Geographic Markets

We principally sell our standard insurance products and services in 22 states in the Eastern and Midwestern regions of the country. In addition, beginning in 2012, we have the ability to write E&S business in all 50 states and the District of Columbia. We believe this geographic diversification lessens our exposure to regulatory, competitive, and catastrophic risk. The principal states where we conduct business and their respective percentage of our total NPW over the last three fiscal years is shown in the following table:

	Year Ended December 31,		
% of NPW	2011	2010	2009
New Jersey	25.3 %	26.2	26.9
Pennsylvania	13.0	13.8	14.0
New York	8.3	9.0	10.1
Maryland	6.4	6.9	7.1
Illinois	5.5	5.5	5.6
Virginia	5.3	5.3	5.4
Indiana	4.9	4.8	4.1
Michigan	3.6	3.0	2.7
Georgia	3.1	3.1	3.5
North Carolina	3.0	3.3	3.5
South Carolina	2.7	2.6	2.6
Ohio	2.7	2.5	2.3
Other states	16.2	14.0	12.2
Total	100.0%	100.0	100.0

Distribution and Marketing

We sell and distribute our Insurance Operations standard products and services through independent retail insurance agents. As of December 31, 2011, we had retail agency agreements with approximately 1,000 independent agencies. As these agencies often have multiple offices, we have approximately 1,800 independent agency offices selling our products and services. We sell and distribute our Insurance Operations E&S products primarily through contract binding authority with approximately 90 wholesale general agencies, who in-turn receive their business through numerous retail agencies. We pay our agencies commissions and other consideration for business placed with us. We seek to compensate our agencies fairly and consistent with market practices. No one agency is responsible for 10% or more of our Insurance Operations premium.

Independent insurance agents and brokers write approximately 80% of commercial property and casualty insurance and approximately a third of the personal lines insurance business in the United States according to a study released in 2011 by the Independent Insurance Agents & Brokers of America. We believe that independent insurance agents will remain a significant force in overall insurance industry premium production because they represent more than one insurance carrier and can provide a wider choice of commercial lines and personal lines insurance products to insureds. Because our agencies generally represent several of our competitors and we face competition within our distribution channel, it is sometimes difficult to develop brand recognition among our customers, who do not always differentiate between insurance carriers and insurance coverages because of their reliance on their independent insurance agent. Our primary marketing strategy with agents is to:

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

- Develop close relationships with each agency and its principals: (i) by soliciting their feedback on products and services; (ii) by advising them concerning company developments; and (iii) through significant interaction with them; and

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

In our most recent survey, which was conducted in 2010, we received an overall satisfaction score of 8.3 out of 10 from our agent survey, which highlighted our agents' satisfaction with our Commercial Lines products, the ease of reporting claims, and the professionalism and effectiveness of our employees.

Field and Technology Strategies Supporting Independent Agent Distribution

We use the service mark "High-tech x High-touch = HT^{2} SM" to describe our Insurance Operations business strategy. "High-tech" refers to our technology that we use to make it easy for our independent insurance agents and customers to do standard business with us. "High-touch" refers to the close relationships that we have with our independent insurance agents and customers due to our field business model that places underwriters, claims representatives, technical staff, and safety management representatives near our agents and customers.

Employees

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

At December 31, 2011, including our E&S business, we had approximately 2,000 employees, 300 of which work in the field.

We support our field model with our corporate headquarters in Branchville, New Jersey, and regional branch offices ("Regions"). As of December 31, 2011, the Regions and their office locations were as follows:

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

Underwriting Process Involving Agents and Field Model

Our underwriting process requires communication and interaction among:

- Our independent agents, who act as front-line underwriters, our AMSs, our field marketing specialists, and our corporate underwriters;
- Our corporate underwriting department, which includes our strategic business units ("SBUs"), organized by product and customer type, and our line-of-business units. These units develop our pricing and underwriting guidelines in conjunction with the Regions;
- Our Regions, which establish: (i) annual premium and pricing goals in consultation with the SBUs; (ii) agency new business targets; and (iii) agency profit improvement plans; and
- Our Actuarial Department, located in our corporate headquarters, which assists in the determination of rate and pricing levels, while also monitoring pricing and profitability.

We also have an underwriting service center ("USC") located in Richmond, Virginia. The USC assists our independent agents by servicing Personal Lines and Commercial Lines Small Business and Middle Market accounts. At the USC, our employees are licensed agents who respond to customer inquiries about insurance coverage, billing transactions, and other matters. For the convenience of using the USC and our handling of certain transactions, our independent agents agree to receive a slightly lower than standard commission for the premium associated with the USC. As of December 31, 2011, our USC was servicing Commercial Lines NPW of $45 million and Personal Lines NPW of $29 million. The $74 million total serviced by the USC represents 5% of our total NPW.

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

Claims Management and Field Claims Model

Effective, fair, and timely claims management is one of the most important services that we provide our customers and agents. It also is one of the critical factors in achieving underwriting profitability. We have structured our claims organization to emphasize: (i) cost-effective delivery of claims services and control of loss and loss expenses; and (ii) maintenance of timely and adequate claims reserves. We believe that we can achieve lower claims expenses through our field model by locating claims representatives in close proximity to our customers and independent agents.

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

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

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

Technology

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

- Our independent agents and customers with access to accurate business information and the ability to process certain transactions from their locations, seamlessly integrating those transactions into our systems;
- Our SIU investigators access to our business intelligence systems to better indentify claims with potential fraudulent activities;
- Our claims recovery and subrogation departments the ability to expand and enhance their models through the use of our business intelligence systems, an effort that is expected to be completed over the coming year; and
- Our underwriters with targeted pricing tools to enhance profitability while growing the business.

In 2011, for the fourth consecutive year, we received the Interface Partner Award from Applied Systems, an automated solutions provider to independent insurance agents, for our commitment to real-time communication with agencies. The award recognized our leadership and innovation, specifically citing our interface advancements in download and real-time rating. In 2011, we also received the Quantum Award from NetVu, for outstanding achievements in agency-company technology, offering superior workflow productivity and profitability for the company's independent agency partners.

We manage our information technology projects through an enterprise project management office ("EPMO"). The EPMO is staffed by certified individuals who apply methodologies to: (i) communicate project management standards; (ii) provide project management training and tools; (iii) review project status and cost; and (iv) provide non-technology project management consulting services to the rest of the organization. The EPMO, which includes senior management representatives from all major business areas, corporate functions and information technology, meets regularly to review all major initiatives and receives reports on the status of other projects. We believe that the EPMO is an important factor in the success of our technology implementation. Our technology operations are located in Branchville, New Jersey and Glastonbury, Connecticut. We also have agreements with two consulting and information technology services companies from India that have a significant presence in the United States to provide supplemental staffing services to our information technology operation. Together, they provide approximately 24% of our total capacity for skilled technology resources. We retain management oversight of all projects and ongoing information technology production operations. We believe we would be able to manage an efficient transition to new vendors without significant impact to our operations if we terminated either vendor.

In 2011, we launched several initiatives to enhance our customers' experience with us. In addition to redesigning our bill to provide clearer communication to our customers, we are currently working on changes to our customer Internet portal, and are conducting customer and brand assessment surveys.

Insurance Operations Competition

Market Competition

The commercial lines property and casualty market is highly competitive and market share is fragmented among many companies. Despite a slight economic improvement and some encouraging signs of price firming, A.M. Best maintains its negative outlook for the commercial lines segment for 2012. We compete with four types of companies, primarily on the basis of price, coverage terms, claims service, safety management services, ease of technology, and financial ratings:

- Regional insurers, such as Cincinnati Financial Corporation, The Hanover Insurance Group, Inc., and Harleysville Group, Inc., which offer commercial lines and personal lines products and services;

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

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

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

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

Some of these competitors are public companies and some are mutual companies. Some, like us, rely solely on independent insurance agents for distribution of their products and services and have competition within their distribution channel. Others either employ their own agents who only represent one insurance carrier or use a combination of independent and captive agents. In 2011, we, along with the Independent Insurance Agents and

Brokers of America and several other insurance companies, have invested in an initiative that will provide independent agents with digital marketing products and services. This initiative seeks to increase the independent agents' share of the personal lines marketplace by improving their online visibility.

Financial Ratings

Because agent and customer concerns about a carrier's ability to pay claims in the future are such an important factor in our competitiveness, our financial ratings are important. Major financial rating agencies evaluate us on our financial strength, operating performance, strategic position, and ability to meet policyholder obligations. We believe that our ability to write insurance business is most significantly influenced by our rating from A.M. Best. We have had our current rating of "A+ (Superior)" for the last 50 years. A.M. Best uses its Financial Strength Rating of "Secure," and a descriptor of "Superior," for its "A+" rating, which it defines as, "assigned to companies that have, in our opinion, a superior ability to meet their ongoing obligations." It is the second highest of 15 ratings. Only approximately 9% of ratings groups carry an "A+" or better rating from A.M. Best.

Our A.M. Best Financial Strength Rating of "A+ (Superior)" with a "negative" outlook was most recently reaffirmed in the second quarter of 2011. A.M. Best cited our strong capitalization, solid level of operating profitability and established presence within our targeted regional markets in establishing their rating. The negative outlook reflects the ongoing challenges to improve underwriting performance given the competitive nature of the marketplace coupled with elevated catastrophe losses through April 2011. Following the acquisition of MUSIC, the newly-acquired company was included in our Insurance Subsidiaries intercompany pooling agreement. As a result, on January 12, 2012, A.M. Best upgraded the Financial Strength Rating of MUSIC to "A+ (Superior)" from "A- (Excellent)" with a negative outlook to reflect their revised pooled rating. A downgrade from A.M. Best to a rating below "A-" could affect our ability to write new business with customers and/or agents, some of whom are required (under various third party agreements) to obtain insurance with a carrier that maintains a minimum A.M. Best rating; usually an "A-."

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

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

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

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

Reinsurance

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

Reinsurance Pooling Agreement

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

- Pool or share proportionately the underwriting profit and loss results of property and casualty insurance underwriting operations through reinsurance;
- Prevent any of our Insurance Subsidiaries from suffering undue loss;
- Reduce administration expenses; and
- Permit all of the Insurance Subsidiaries to obtain a uniform rating from A.M. Best.

Under the Pooling Agreement, as of December 31, 2011, the following Insurance Subsidiaries mutually reinsure all insurance risks written by them pursuant to the respective percentage set forth opposite each Insurance Subsidiary's name on the table below:

Insurance Subsidiary	Respective Percentage	
Selective Insurance Company of America (SICA)	49.5	%
Selective Way Insurance Company (SWIC)	21.0	%
Selective Insurance Company of South Carolina (SICSC)	9.0	%
Selective Insurance Company of the Southeast (SICSE)	7.0	%
Selective Insurance Company of New York (SICNY)	7.0	%
Selective Auto Insurance Company of New Jersey (SAICNJ)	6.0	%
Selective Insurance Company of New England (SICNE)	0.5	%

On January 1, 2012, the Pooling Agreement was revised as follows to include our recent E&S acquisition:

Insurance Subsidiary	Respective Percentage	
Selective Insurance Company of America	44.5	%
Selective Way Insurance Company	21.0	%
Selective Insurance Company of South Carolina	9.0	%
Selective Insurance Company of the Southeast	7.0	%
Selective Insurance Company of New York	7.0	%
Selective Auto Insurance Company of New Jersey	6.0	%
Montpelier U.S. Insurance Company (MUSIC)	5.0	%
Selective Insurance Company of New England	0.5	%

Reinsurance Treaties and Arrangements

By entering reinsurance treaties and arrangements, we are able to increase underwriting capacity and accept larger risks and a larger number of risks without directly increasing capital or surplus. All of our reinsurance treaties are for traditional reinsurance; we do not purchase finite reinsurance. Under our reinsurance treaties, the reinsurer generally assumes a portion of the losses we cede to them in exchange for a portion of the premium. Amounts not reinsured are known as retention. Reinsurance does not legally discharge us from liability under the terms and limits of our policies, but it does make our reinsurer liable to us for the amount of liability we cede to them. Accordingly, we have counterparty credit risk to our reinsurers. We attempt to mitigate this credit risk by: (i) pursuing relationships with reinsurers rated "A-" or higher; and (ii) obtaining collateral to secure reinsurance obligations. Some of our reinsurance contracts include provisions that permit us to terminate or commute the reinsurance treaty if the reinsurer's financial condition or rating deteriorates. We continuously monitor the financial condition of our reinsurers. We also continuously review the quality of reinsurance recoverables and reserves for uncollectible reinsurance.

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

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

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

- Protection provided under the Terrorism Risk Insurance Act of 2002 as modified and extended through December 31, 2014 by the Terrorism Risk Insurance Program Reauthorization Act of 2007 (collectively referred to as “TRIA”). Under TRIA, terrorism coverage is mandatory for all primary workers compensation policies. Insureds with non-workers compensation commercial policies, however, have the option to accept or decline our terrorism coverage or negotiate with us for other terms. Under TRIA, each participating insurer is responsible for paying a deductible of specified losses based on a percentage of the prior year’s applicable commercial lines direct premiums earned before federal assistance is available. In 2012, the deductible is approximately $182 million. For losses above the deductible, the federal government will pay 85% and the insurer retains 15%. Although TRIA’s provisions will mitigate our loss exposure to a large-scale terrorist attack, our deductible is substantial.

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

PROPERTY REINSURANCE ON INSURANCE PRODUCTS

Treaty Name	Reinsurance Coverage	Terrorism Coverage
Property Excess of Loss (covers standard lines)	$28 million above $2 million retention in two layers. Losses other than TRIA certified losses are subject to the following reinstatements and annual aggregate limits: · $8 million in excess of $2 million layer provides unlimited reinstatements; and · $20 million in excess of $10 million layer provides three reinstatements, $80 million in aggregate limits.	All nuclear, biological, chemical, and radioactive (“NBCR”) losses are excluded regardless of whether or not they are certified under TRIA. For non-NBCR losses, the treaty distinguishes between acts certified under TRIA and those that are not. The treaty provides annual aggregate limits for TRIA certified (other than NBCR) acts of $24 million for the first layer and $40 million for the second layer. Non-certified terrorism losses (other than NBCR) are subject to the normal limits under the treaty.
Property Catastrophe Excess of Loss (covers both standard and E&S lines)	$435 million above $40 million retention in three layers: · 95% of losses in excess of $40 million up to $100 million; · 90% of losses in excess of $100 million up to $225 million; and · 90% of losses in excess of $225 million up to $475 million.	All nuclear, biological, and chemical (“NBC”) losses are excluded regardless of whether or not they are certified under TRIA. TRIA losses related to foreign acts of terrorism are excluded from the treaty. Domestic terrorism is included regardless of whether it is certified under TRIA or not. Please see Item 1A. “Risk Factors.” of this Form 10-K for further discussion regarding changes in TRIA.

	The treaty provides one reinstatement per layer, $789 million annual aggregate limit, net of the Insurance Subsidiaries' co-participation.	
Flood	100% reinsurance by the federal government's WYO Program.	None

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

CASUALTY REINSURANCE ON INSURANCE PRODUCTS

Treaty Name	Reinsurance Coverage	Terrorism Coverage
Casualty Excess of Loss (covers standard lines)	There are six layers covering 100% of $88 million in excess of $2 million. Losses other than terrorism losses are subject to the following reinstatements and annual aggregate limits: · $3 million in excess of $2 million layer provides 23 reinstatements, $72 million net annual aggregate limit; · $7 million in excess of $5 million layer provides three reinstatements, $28 million annual aggregate limit; · $9 million in excess of $12 million layer provides two reinstatements, $27 million annual aggregate limit; · $9 million in excess of $21 million layer provides one reinstatement, $18 million annual aggregate limit; · $20 million in excess of $30 million layer provides one reinstatement, $40 million annual aggregate limit; and · $40 million in excess of $50 million layer provides with one reinstatement, $80 million in net annual aggregate limit.	All NBCR losses are excluded. All other losses stemming from the acts of terrorism are subject to the following reinstatements and annual aggregate limits: · $3 million in excess of $2 million layer provides four reinstatements for terrorism losses, $15 million net annual aggregate limit; · $7 million in excess of $5 million layer provides two reinstatements for terrorism losses, $21 million annual aggregate limit; · $9 million in excess of $12 million layer provides two reinstatements for terrorism losses, $27 million annual aggregate limit; · $9 million in excess of $21 million layer provides one reinstatement for terrorism losses, $18 million annual aggregate limit;

		· $20 million in excess of $30 million layer provides one reinstatement for terrorism losses, $40 million annual aggregate limit; and
		· $40 million in excess of $50 million layer provides one reinstatement for terrorism losses, $80 million in net annual aggregate limit.
Montpelier Re Quota Share and Loss Development Cover (covers E&S lines)	As part of the acquisition of MUSIC we entered into several reinsurance agreements that together provide protection for losses on policies written prior to the acquisition and any development on reserves established by MUSIC as of the date of acquisition. The reinsurance recoverables under these treaties are 100% collateralized.	Provides full terrorism coverage including NBCR.

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

Claims Reserves

Net Loss and Loss Expense Reserves

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

- Information regarding each claim for losses, including potential extra-contractual liabilities, or amounts paid in excess of the policy limits, which may not be covered by our contracts with reinsurers;
- Our loss history and the industry's loss history;
- Legislative enactments, judicial decisions and legal developments regarding damages;
- Changes in political attitudes; and
- Trends in general economic conditions, including inflation.

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

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

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

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

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

- Section IV shows the re-estimated gross liability and re-estimated reinsurance recoverables through December 31, 2011.

- Section V shows the cumulative net (deficiency)/redundancy representing the aggregate change in the liability from the original balance sheet dates and the re-estimated liability through December 31, 2011.

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

($ in millions)	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
I. Gross reserves for unpaid losses and loss expenses at December 31	$1,298.3	1,403.4	1,587.8	1,835.2	2,084.0	2,288.8	2,542.5	2,641.0	2,745.8	2,830.1	3,144
Reinsurance recoverables on unpaid losses and loss expenses at December 31	$(166.5)	(160.4)	(184.6)	(218.8)	(218.2)	(199.7)	(227.8)	(224.2)	(271.6)	(313.7)	(549.5
Net reserves for unpaid losses and loss expenses at December 31	$1,131.8	1,243.1	1,403.2	1,616.4	1,865.8	2,089.0	2,314.7	2,416.8	2,474.2	2,516.3	2,595
II. Net reserves estimate as of:											
One year later	$1,151.7	1,258.1	1,408.1	1,621.5	1,858.5	2,070.2	2,295.4	2,387.4	2,430.6	2,477.6	
Two years later	1,175.8	1,276.3	1,452.3	1,637.3	1,845.1	2,024.0	2,237.8	2,324.6	2,368.1		
Three years later	1,210.7	1,344.6	1,491.1	1,643.7	1,825.2	1,982.4	2,169.7	2,286.0			
Four years later	1,290.2	1,371.5	1,522.9	1,649.8	1,808.9	1,931.1	2,155.8				
Five years later	1,306.8	1,413.8	1,529.2	1,653.6	1,780.7	1,916.0					
Six years later	1,349.6	1,420.8	1,538.4	1,639.5	1,777.3						
Seven years later	1,357.6	1,428.7	1,535.6	1,638.7							
Eight years later	1,363.4	1,430.0	1,539.1								
Nine years later	1,362.7	1,435.7									
Ten years later	1,367.5										

Cumulative net redundancy (deficiency)	$(235.7)	(192.7)	(135.9)	(22.3)	88.5	173.1	158.9	130.8	106.1	38.7
III. Cumulative amount of net reserves paid through:										
One year later	$377.1	384.0	414.5	422.4	468.6	469.4	579.4	584.5	561.3	569.9
Two years later	627.3	653.3	691.4	729.5	775.0	841.3	945.5	966.8	936.7	
Three years later	807.2	836.3	903.7	942.4	1,026.9	1,080.0	1,201.6	1,238.3		
Four years later	926.9	966.2	1,033.5	1,101.0	1,174.2	1,235.2	1,388.7			
Five years later	1,003.3	1,044.6	1,128.4	1,189.2	1,267.1	1,347.0				
Six years later	1,053.8	1,110.0	1,184.5	1,245.4	1,341.8					
Seven years later	1,100.3	1,151.8	1,225.3	1,294.2						
Eight years later	1,133.9	1,183.0	1,262.5							
Nine years later	1,157.4	1,213.4								
Ten years later	1,182.7									
IV. Re-estimated gross liability	$1,674.8	1,716.8	1,840.5	1,947.7	2,100.7	2,196.0	2,433.0	2,573.1	2,668.8	2,801.4
Re-estimated reinsurance recoverables	$(307.3)	(281.0)	(301.4)	(309.0)	(323.4)	(280.0)	(277.2)	(287.1)	(300.7)	(323.8)
Re-estimated net liability	$1,367.3	1,435.7	1,539.1	1,638.7	1,777.3	1,916.0	2,155.8	2,286.0	2,368.1	2,477.6
V. **Cumulative gross redundancy (deficiency)**	$(376.5)	(313.4)	(252.7)	(112.5)	(16.7)	92.8	109.5	67.9	77.0	28.7
Cumulative net redundancy (deficiency)	$(235.7)	(192.7)	(135.9)	(22.3)	88.5	173.1	158.9	130.8	106.1	38.7

Note: Some amounts may not foot due to rounding.

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We experienced favorable prior year loss and loss expense reserve development in 2011, 2010, and 2009:

- The primary drivers of 2011's favorable development of $38.7 million were the following:
  - Our commercial automobile line experienced favorable development of approximately $13 million driven by accident years 2007 through 2009. This represents a continued trend driven by lower frequencies in these years.
  - Our general liability line had favorable development of approximately $12 million. This is driven by favorable development on the premises and operations coverages for accident years 2009 and prior. The favorable premises development was largely offset by adverse development for the products coverage in 2010 and prior.
  - Our business owners' policy line had favorable development of approximately $11 million. This is driven by favorable development on the liability coverage for accident years 2008 through 2010. While the profitability of the property portion of this line continues to perform adversely, the liability coverage has experienced continued favorable reported loss emergence in recent years.
  - Our workers compensation line experienced unfavorable loss development of approximately $7 million. This was driven by increases in the 2010 accident year partially offset by various earlier accident years. This increase represents a continued trend related to increased severities in recent years.
  - Our remaining lines of business collectively experienced approximately $10 million of favorable development largely driven by favorable prior year catastrophe development.
- The primary drivers of 2010's favorable development of $43.6 million were the following:
  - Our commercial automobile line experienced favorable development of approximately $28 million driven by accident years 2004 through 2009, representing a consistent trend in recent years, as reported loss activity continues to emerge lower than expected.
  - Our general liability line had favorable development of approximately $26 million. This was driven by favorable development on the premises and operations coverages for accident years 2006 and prior. Favorable premises development for 2007 through 2009 was essentially offset by increases for the products coverage.
  - Our workers compensation line experienced unfavorable loss development of approximately $22 million. This was driven by increases in the 2008 and 2009 accident years, which experienced increases in average severity.

- Our remaining lines of business collectively experienced approximately $11 million of favorable development. While there were some offsetting impacts among these lines, homeowners contributed $6 million of favorable development towards the total. This was due to lower than expected liability losses in accident years 2008 and 2009.

- The primary drivers of 2009's favorable development of $29.4 million were the following:

  - Our workers compensation line experienced favorable development of approximately $11 million. Accident years 2005 to 2007 had favorable development of approximately $36 million from the impact of a series of underwriting improvement strategies in that period, partially offset by approximately $22 million of adverse development due to higher than expected severity in accident year 2008.

  - Our commercial automobile line experienced favorable development of approximately $10 million from lower than anticipated severity emergence primarily in accident year 2007.

  - Our general liability line had favorable development of approximately $8 million. We had favorable loss emergence in accident years 2004 through 2007 in our premises coverage business that was partially offset by adverse development in our products/completed operations business.

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The significant cumulative loss and loss expense reserve net deficiencies seen between 2001 and 2003 reflect the property and casualty insurance industry's soft market pricing during those years. As a whole, the industry underestimated reserves and loss trends and created intense pricing competition.

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

($ in thousands)	2011	2010
Statutory losses and loss expense reserves	$2,591,570	2,513,065
Provision for uncollectible reinsurance	3,900	3,400
Other	(36)	(146)
GAAP losses and loss expense reserves – net	2,595,434	2,516,319
Reinsurance recoverables on unpaid losses and loss expenses	549,490	313,739
GAAP losses and loss expense reserves – gross	$3,144,924	2,830,058

Environmental Reserves

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

"Asbestos claims" are claims for bodily injury alleged to have occurred from exposure to asbestos-containing products. In the past, we were the insurer of various distributors of asbestos-containing products, such as electrical and plumbing materials, and, in some cases, the manufacturers of these products. Over the last 20 years, a large number of asbestos claims have been made against the insurance industry. While most of our claims are the result of incidental exposure, we insure a former manufacturer of asbestos related products, which comprises more than half of our outstanding claims. These claims are associated with two policies, each written with a $1.0 million policy aggregate limit.   At December 31, 2011, asbestos claims constituted 17% of our $38.4 million net environmental reserves compared to 21% of our $39.4 million net environmental reserves at December 31, 2010.

"Non-asbestos claims" are claims alleging bodily injury or property damage from pollution or other environmental contaminants other than asbestos. These claims primarily include landfills and leaking underground storage tanks. Landfill claims continue to account for a significant portion of our environmental claim unit's litigation costs. In past years, we experienced adverse development in our homeowners line of business due to unfavorable trends in claims for groundwater contamination from leaking underground heating oil storage tanks in New Jersey. Over the past couple of years, claims related to leaking underground heating oil storage tanks has stabilized. In addition, in 2007 we

instituted a fuel oil system exclusion on our New Jersey homeowners policies that limits our exposure to leaking underground storage tanks for certain customers. At that time, existing insureds were offered a one-time opportunity to buy back oil tank liability coverage. The exclusion applies to all new homeowners policies in New Jersey. These customers are eligible for the buy-back option only if the tank meets specific eligibility criteria.

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

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Estimating IBNR reserves for environmental claims is difficult because, in addition to other factors, there are significant uncertainties associated with estimating critical assumptions, such as average clean-up costs, third-party costs, potentially responsible party shares, allocation of damages, litigation and coverage costs, and potential state and federal legislative changes. Normal historically based actuarial approaches are difficult to apply to environmental claims because past loss history is not indicative of future potential environmental losses. In addition, while models can be applied, such models can produce significantly different results with small changes in assumptions. As a result, we do not calculate a specific environmental loss range. Historically, our environmental claims have been significantly less volatile and uncertain than other competitors in the commercial lines industry. In part, this is due to the fact that we are the primary insurance carrier on the majority of our environmental exposures, thus providing more certainty in our reserve position compared to others in the insurance marketplace.

Measure of Insurance Operations Profitability

We manage and evaluate the performance and profitability of our Insurance Operations in accordance with SAP, which differs from GAAP. We base our incentive compensation to our employees and our independent agents on the SAP results of our Insurance Operations. In addition, our rating agencies use SAP information to evaluate our performance, including against our industry peers.

We measure our statutory underwriting performance by four different ratios:

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

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

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

- <u>With regard to income</u>:

  - Underwriting expenses are deferred and amortized to expense over the life of an insurance policy under GAAP; whereas they are recognized when incurred under SAP.

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

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

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· <u>With regard to equity under GAAP and statutory surplus under SAP</u>:

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

o Regarding unrealized gains and losses on fixed maturity securities:

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

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

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

o Regarding recognition of the liability for our defined benefit plan:

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

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

Our Insurance Operations statutory results for the last three completed fiscal years are shown on the following table:

	Year Ended December 31,		
($ in thousands)	2011	2010	2009
Insurance Operations Results			
NPW	$1,485,349	1,388,556	1,422,655

NPE	$1,439,313	1,414,612	1,431,047
Losses and loss expenses incurred	1,074,446	980,534	972,040
Net underwriting expenses incurred	470,892	445,172	459,758
Policyholders' dividends	5,284	3,878	3,640
Underwriting loss	$(111,309)	(14,972)	(4,391)
Ratios:			
Loss and loss expense ratio	74.6 %	69.3	67.9
Underwriting expense ratio	31.7	32.0	32.3
Policyholders' dividends ratio	0.4	0.3	0.3
Combined ratio	106.7 %	101.6	100.5
GAAP combined ratio	107.4 %	101.6	99.8

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A comparison of certain statutory ratios for our Insurance Operations and our industry are shown in the following table:

	Simple Average of All Periods Presented	2011	2010	2009	2008	2007
Insurance Operations Ratios:[1]						
Loss and loss expense	68.9	74.6	69.3	67.9	67.2	65.4
Underwriting expense	31.9	31.7	32.0	32.3	31.7	31.6
Policyholders' dividends	0.4	0.4	0.3	0.3	0.3	0.5
Statutory combined ratio	101.1	106.7	101.6	100.5	99.2	97.5
Growth in NPW	(0.6)	7.0	(2.4)	(4.7)	(4.5)	1.4
Industry Ratios:[1, 2]						
Loss and loss expense	72.4	79.1	72.0	70.8	73.1	66.9
Underwriting expense	27.8	27.8	28.3	28.1	27.5	27.1
Policyholders' dividends	0.6	0.6	0.7	0.6	0.6	0.7
Statutory combined ratio	100.8	107.5	101.0	99.5	101.2	94.8
Growth in NPW	(0.4)	3.5	0.9	(3.6)	(1.9)	(1.0)
Favorable (Unfavorable) to Industry:						
Statutory combined ratio	(0.3)	0.8	(0.6)	(1.0)	2.0	(2.7)
Growth in NPW	(0.2)	3.5	(3.3)	(1.1)	(2.6)	2.4

[1] The ratios and percentages are based on SAP prescribed or permitted by state insurance departments in the states in which the Insurance Subsidiaries are domiciled.
[2] Source: A.M. Best. The industry ratios for 2011 have been estimated by A.M. Best.

Insurance Regulation

Primary Oversight from the States in Which We Operate

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

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

IRIS, RBC, and the Model Audit Rule

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

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

- Risk-Based Capital. Risk-based capital is measured by the four major areas of risk to which property and casualty insurers are exposed: (i) asset risk; (ii) credit risk; (iii) underwriting risk; and (iv) off-balance sheet risk. Insurers with total adjusted capital that is two times or less than their calculated "Authorized Control Level," are subject to different levels of regulatory intervention and action. Based upon the unaudited 2011 statutory financial statements, the total adjusted capital for each of our Insurance Subsidiaries substantially exceeded two times their Authorized Control Level.

- Annual Financial Reporting Regulation (referred to as the “Model Audit Rule”). Effective January 1, 2010, the regulators of our Insurance Subsidiaries adopted the Model Audit Rule, modeled closely on the Sarbanes-Oxley Act of 2002, concerning: (i) auditor independence; (ii) corporate governance; and (iii) internal control over financial reporting. As permitted under the regulation, the Audit Committee of the Board of Directors (the “Board”) of the Parent also serves as the audit committee of each of our Insurance Subsidiaries.

Federal Regulation

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

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

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

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

Investments

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

Our Investments segment invests the premiums collected by the Insurance Operations to satisfy our equity and debt obligations and generate investment income. At December 31, 2011, our investment portfolio consisted of the following:

Category of Investment ($ in millions)	Carrying Value	% of Investment Portfolio
Fixed maturities	$ 3,609.7	88
Equities	157.4	4
Short-term investments	217.0	5
Other investments, including alternatives	128.3	3
Total	$ 4,112.4	100

Our investment philosophy includes setting certain return and risk objectives for the fixed maturity and equity portfolios. The primary fixed maturity portfolio return objective is to maximize after-tax investment yield and income while balancing risk. A secondary objective is to meet or exceed a weighted-average benchmark of public fixed income indices. Within the equity portfolio, the high dividend yield strategy, which was implemented in 2011, is designed to generate consistent dividend income while maintaining a minimal tracking error to the S&P 500 Index. Additional equity strategies are focused on meeting or exceeding strategy specific benchmarks of public equity indices. The risk objectives for our portfolios are focused on: (i) asset diversification; (ii) investment quality; (iii) liquidity, particularly to coincide with cash obligations of the Insurance Operations; (iv) consideration of taxes; and (v) preservation of capital. Our overall philosophy is to invest with a long-term horizon along with a “buy-and-hold” principle; however, yield and income generation remain the key drivers to our investment strategy.

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

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Executive Officers of the Registrant

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

Name, Age, Title	Occupation and Background
Gregory E. Murphy, 56 Chairman, President, and Chief Executive Officer	· Present position since May 2000 · President, Chief Executive Officer, and Director, Selective, 1999 – 2000 · President, Chief Operating Officer, and Director, Selective, 1997 – 1999 · Other senior executive, management, and operational positions, Selective, since 1980 · Certified Public Accountant (New Jersey) (Inactive) · Trustee, Newton Medical Center Foundation, since 1999 · Director, Property Casualty Insurers Association of America, since 2008 · Director, Insurance Information Institute, since 2000 · Trustee, the American Institute for CPCU (AICPCU) and the Insurance Institute of America (IIA), since June 2001 · Graduate of Boston College (B.S. Accounting) · Harvard University (Advanced Management Program) · M.I.T. Sloan School of Management
Dale A. Thatcher, 50 Executive Vice President and Chief Financial Officer	· Present position since April 2010 · Executive Vice President, Chief Financial Officer and Treasurer, 2003 – 2010 · Senior Vice President, Chief Financial Officer and Treasurer, Selective, 2000 – 2003 · Certified Public Accountant (Ohio) (Inactive) · Chartered Property and Casualty Underwriter (CPCU) · Chartered Life Underwriter (CLU) · Member, American Institute of Certified Public Accountants

- Member, Ohio Society of Certified Public Accountants
- Member, Financial Executives Institute
- Member, Insurance Accounting and Systems Association
- University of Cincinnati (B.B.A. Accounting; M.B.A. Finance)
- Harvard University (Advanced Management Program)

Ronald J. Zaleski Sr., 57

Executive Vice President and Chief Actuary

- Present position since February 2003
- Senior Vice President and Chief Actuary, Selective, 2000 – 2003
- Vice President and Chief Actuary, Selective, 1999 – 2000
- Fellow of Casualty Actuarial Society
- Member, American Academy of Actuaries
- Loyola College (B.A. Mathematics)

Name, Age, Title	Occupation and Background
Michael H. Lanza, 50 Executive Vice President, General Counsel, and Chief Compliance Officer	· Present position since October 2007 · Senior Vice President and General Counsel, Selective, 2004 – 2007 · Member, Society of Corporate Secretaries and Corporate Governance Professionals · Member, National Investor Relations Institute · University of Connecticut (B.A.) · University of Connecticut School of Law (J.D.)
John J. Marchioni, 42 Executive Vice President, Insurance Operations	· Present position since February 2010 · Executive Vice President, Chief Underwriting and Field Operations Officer, 2008 – February 2010 · Executive Vice President, Chief Field Operations Officer, Selective 2007 – 2008 · Senior Vice President, Director of Personal Lines, Selective 2005 – 2007 · Various insurance operation and government affairs positions, Selective, 1998 – 2005 · Director, Consumer Agent Portal, LLC, since September 2011 · Chartered Property Casualty Underwriter (CPCU) · Princeton University (B.A. History) · Harvard University (Advanced Management Program)
Ronald E. St. Clair, 47 Executive Vice President and Chief Information Officer	· Present position since April 2011 · IT Executive, Enterprise Resource Organization, Progressive Casualty Insurance, 2008 – March 2011 · IT Executive, Progressive Commercial Auto, Progressive Casualty Insurance, 2006 – 2008 · Harding University (B.S. Computer Science) · Case Western Reserve University (M.B.A.)

Kimberly Burnett, 54 Executive Vice President and Chief Human Resources Officer	· Present position since February 2012 · Vice President, Human Resources Operations, 2006 – 2012 · Assistant Vice President, Leadership and Professional Development, 2003 – 2006 · Assistant Vice President, Employee Relations, 1998 – 2003 · Senior Professional in Human Resources (SPHR) · Member, Society for Human Resource Management · The Ohio State University (B.A.) · Fairleigh Dickinson University, Human Resources Professional Development Certificate

Information about our Board is in our definitive Proxy Statement for the 2012 Annual Meeting of Stockholders to be held on April 25, 2012 in "Information About Proposal 1, Election of Directors," and is also incorporated by reference into Part III of this Form 10-K.

Reports to Security Holders

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

Item 1A. Risk Factors

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

Risks Related to Insurance Operations

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

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

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

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

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

We are required to maintain loss reserves for our estimated liability for losses and loss expenses associated with reported and unreported insurance claims. Our estimates of reserve amounts are based on facts and circumstances that we know, including our expectations of the ultimate settlement and claim administration expenses, predictions of future events, trends in claims severity and frequency, and other subjective factors relating to our insurance policies in force. There is no method for precisely estimating the ultimate liability for settlement of claims. From time-to-time, we adjust reserves and increase them if they are inadequate or reduce them if they are redundant. We cannot be certain

that the reserves we establish are adequate or will be adequate in the future. An increase in reserves: (i) reduces net income and stockholders' equity for the period in which the deficiency in reserves is identified; and (ii) could have a material adverse effect on our results of operations, liquidity, financial condition, financial strength, and debt ratings.

We are subject to losses from catastrophic events.

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

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

Catastrophe losses are determined by the severity of the event and the total amount of insured exposures in the area affected by the event. Most of the risks underwritten by our Insurance Operations are concentrated geographically in the Eastern and Midwestern regions of the United States, particularly in New Jersey, which represented approximately 25% of our total NPW during the year ended December 31, 2011. Catastrophes in the Eastern and Midwestern regions of the United States could adversely impact our financial results, as was the case for the past two years.

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

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

TRIA requires private insurers and the United States government to share the risk of loss on future acts of terrorism that are certified by the U.S. Secretary of the Treasury. As a Commercial Lines writer, we are required to participate in TRIA. Under TRIA, terrorism coverage is mandatory for all primary workers compensation policies. Insureds with non-workers compensation commercial policies, however, have the option to accept or decline our terrorism coverage or negotiate with us for other terms. In 2011, approximately 86% of our Commercial Lines non-workers compensation policyholders purchased terrorism coverage.

TRIA rescinded all previously approved coverage exclusions for terrorism. Many of the states in which we write commercial property insurance, however, mandate that we cover fire following an act of terrorism. Under TRIA, each participating insurer is responsible for paying a deductible of specified losses before federal assistance is available. This deductible is based on a percentage of the prior year's applicable commercial lines premiums. In 2012, the deductible is approximately $182 million. For losses above the deductible, the federal government will pay 85%, up to an industry limit of $100 billion, and the insurer retains 15%. Although TRIA's provisions will mitigate our loss exposure to a large-scale terrorist attack, our deductible is substantial and could have a material adverse effect on our results of operations, liquidity, financial condition, financial strength, and debt ratings. TRIA legislation is in effect through December 31, 2014.

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

We transfer a portion of our underwriting risk exposure to reinsurance companies. Through our reinsurance arrangements, a specified portion of our losses and loss adjustment expenses are assumed by the reinsurer in exchange for a specified portion of premiums. The availability, amount, and cost of reinsurance depend on market conditions, which may vary significantly. Our major reinsurance contracts renew annually and may be impacted by the market

conditions at the time of the renewal that are unrelated to our specific book of business or experience. Any decrease in the amount of our reinsurance will increase our risk of loss. Any increase in the cost of reinsurance, absent a decrease in the amount of reinsurance, will reduce our earnings. Accordingly, we may be forced to incur additional expenses for reinsurance or may not be able to obtain sufficient reinsurance on acceptable terms. Either could adversely affect our ability to write future business or result in the assumption of more risk with respect to those policies we issue.

We are exposed to credit risk.

We are exposed to credit risk in several areas of our Insurance Operations business, including from:

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

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

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

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

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

The property and casualty insurance industry is subject to general economic conditions and is cyclical.

The property and casualty insurance industry has experienced significant fluctuations in its historic results due to competition, occurrence or severity of catastrophic events, levels of capacity, general economic conditions, interest rates, and other factors. Demand for insurance is influenced significantly by prevailing general economic conditions. The supply of insurance is related to prevailing prices, the levels of insured losses and the levels of industry surplus which, in turn, may fluctuate in response to changes in rates of return on investments being earned in the insurance industry. As a result, the insurance industry historically has been a cyclical industry characterized by periods of intense price competition due to excessive underwriting capacity as well as periods when shortages of capacity permitted favorable premium levels. Competitors pricing business below technical levels could force us to reduce our profit margin in order to protect our best business.

Pricing and loss trends impact our profitability. For example, assuming retention and all other factors remain constant:

- A pure price decline of approximately 1% increases the statutory combined ratio by approximately one point;

A 3% increase in expected claim costs for the year will cause the loss and loss adjustment expense ratio to increase by approximately two points; and

- A combination of the two could raise the combined ratio approximately three points.

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

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

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

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

General economic conditions in the United States and throughout the world and volatility in financial and insurance markets materially affect our results of operations. Concerns over such issues as the availability and cost of credit, the stability of the United States mortgage market, weak real estate markets, high unemployment, volatile energy and commodity prices, and geopolitical issues, also have led to declines in business and consumer confidence and precipitated an economic slowdown.

Factors such as consumer spending, business investment, government spending, the volatility and strength of the capital markets, and inflation all affect the business and economic environment and, indirectly, the amount and profitability of our business. With continuing high unemployment, lower family income, lower corporate earnings, lower business investment, and lower consumer spending, the demand for insurance products is adversely affected. In addition, we are impacted by the recent decrease in commercial and new home construction and home ownership because 34% of direct premiums written in our Commercial Lines business during 2011 were generated through contractors business. In addition, 38% of direct premiums written in our Commercial Lines business during 2011 was based on payroll/sales of our underlying insureds. The impact of an economic downturn in Commercial Lines will adversely affect our audit and endorsement premium, as it had in 2010 and 2009. Further unfavorable economic developments could adversely affect our earnings if our customers have less need for insurance coverage, cancel existing insurance policies, modify coverage, or choose not to renew with us. Challenging economic conditions also may impair the ability of our customers to pay premiums as they come due. We are unable to predict the likely duration and severity of the current economic conditions in the United States. and other countries, which may have a material adverse effect on our results of operations, liquidity, financial condition, financial strength, and debt ratings.

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

We are rated on our financial strength, primarily our ability to pay claims, by various Nationally Recognized Statistical Rating Organizations ("NRSROs"). The financial strength ratings on our standard market Insurance Subsidiaries, which does not take into consideration our acquisition of MUSIC, are as follows:

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

Following the acquisition of MUSIC, the newly-acquired company was included in our Insurance Subsidiaries' intercompany pooling agreement. As a result, on January 12, 2012, A.M. Best upgraded the financial strength rating of MUSIC to "A+ (Superior)" from "A- (Excellent)" with a negative outlook to reflect their revised pooled rating. There has not yet been any rating action on MUSIC from the other rating agencies.

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

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

NRSRO	Credit Rating	Long Term Credit Outlook
A.M. Best and Company	“a-”	Negative
S&P	“BBB”	Stable
Moody’s Investor Services	“Baa2”	Stable
Fitch	“A-”	Stable

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

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

We have many competitors and potential competitors.

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

We have less loss experience data than our larger competitors.

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

We depend on independent insurance agents and wholesale agency partners.

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

We face risks regarding our Flood business because of uncertainties regarding the funding of the National Flood Insurance Program ("NFIP").

We are the sixth largest insurance group participating in the WYO arrangement of the NFIP, which is managed by the Mitigation Division of Federal Emergency Management Agency in the U.S. Department of Homeland Security. For WYO participation, we receive an expense allowance, or servicing fee, for policies written and claims serviced. Currently, the expense allowance is 30.4%. The servicing fee is the combination of 1% of direct written premiums and 1.5% of incurred losses.

The NFIP is funded by Congress. In the last several years, funding of the program has continued through short extensions as part of continuing resolutions to temporarily maintain current spending. At present, the funding for the program has been extended to May 31, 2012. Some members of Congress have expressed a desire to explore a comprehensive revision of the program, its costs, and its administration. We are actively monitoring developments in Washington regarding reform proposals to the NFIP, particularly regarding any changes to the fee structure. We cannot predict whether proposals will be adopted or, if adopted, what impact their adoption could have on our business, financial condition, or results of operations.

As a WYO carrier, we are required to follow certain NFIP procedures when administering flood policies and claims. Some of these requirements may be different from our normal business practices and may present a reputational risk to our brand. Insurance companies are regulated by states, however, NFIP is a federal program and there may be instances where requirements placed on WYO carriers by NFIP are not consistent with the regulations of a particular state. Consequently, we have the risk that our regulator's position may conflict with NFIP's position on the same issue.

We are heavily regulated and changes in regulation may reduce our profitability and limit our growth.

Our Insurance Operations are heavily regulated by extensive laws and regulations that may change on short notice. The primary public policy behind insurance regulation is the protection of policyholders and claimants over all other constituencies, including shareholders. By virtue of the McCarran-Ferguson Act, Congress has largely ceded insurance regulation to the various states. However, we are subject to federal legislation and administrative policies,

such as disclosure under the securities laws, TRIA, OFAC, and various privacy laws, including the Gramm-Leach-Bliley Act, the Fair Credit Reporting Act, the Drivers Privacy Protection Act, the Health Insurance Portability and Accountability Act, and the policies of the Federal Trade Commission. As a result of issuing workers compensation policies, we also are subject to Mandatory Medicare Secondary Payer Reporting under the Medicare, Medicaid, and SCHIP Extension Act of 2007.

There is significant regulatory interest in insurance companies' enterprise risk management solutions and the NAIC is evaluating what standards, if any, to follow regarding a company's own risk and solvency assessment, which international insurance regulators have developed.

Solvency II, which sets out new, stronger European Union-wide requirements on capital adequacy and risk management for insurers, is scheduled to become effective in November 2012. The strengthened regime is intended to reduce the possibility of consumer loss or market disruption in insurance. Solvency II does not directly govern domestic United States' insurers, so it is unclear what effect, if any, it may have. The NAIC is expected to evaluate the effect of Solvency II and it is possible that some changes to United States' insurance regulation could be proposed.

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

The regulation of business and financial condition of our Insurance Subsidiaries is primarily delegated to the departments of insurance in the states in which they are organized and licensed. The passage of the Dodd-Frank act has not materially changed that delegation, but oversight of the insurance industry could change in the future. The broad regulatory, administrative, and supervisory powers of the various departments of insurance include the following:

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

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

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

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

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

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

- Repeal of the McCarran-Ferguson Act. While proposals for McCarran-Ferguson Act repeal recently have been primarily directed at health insurers, if enacted and applicable to property and casualty insurers, such repeal would significantly reduce our ability to compete and materially affect our results of operations because we rely on the anti-trust exemptions the law provides to obtain loss data from third party aggregators, such as the Insurance Service Office ("ISO"), to predict future losses.

- National Catastrophic Funds. Various legislative proposals have been introduced that would establish a federal reinsurance catastrophic fund as a federal backstop for future natural disasters. These bills generally encourage states to create catastrophe funds by creating a federal backstop for states that create the funds. While homeowners' insurance is primarily handled at the state level, there are important roles for the federal government to play, including the establishment of a national catastrophic fund.

- Reform of the NFIP. There have been legislative proposals to reform the NFIP by: (i) expanding coverage to include coverage for losses from wind damage; and (ii) forgiving the nearly $20 billion in debt amassed by the NFIP from the catastrophic storms of 2004 and 2005. We believe that the expansion of coverage to include wind losses would significantly increase the cost and availability of NFIP insurance.

- Healthcare reform. The enactment of the Patient Protection and Affordable Care Act of 2010 (the “Healthcare Act”) may have an impact on various aspects of our business, including our Insurance Operations. Lines of business that are impacted by costs and quality of medical care, such as workers compensation and personal auto Personal Injury Protection (PIP), are likely to be affected by this legislation. In addition, we will be impacted as a business enterprise by potential tax issues and changes in employee benefits. The Healthcare Act, portions of which will be subject to debate in Supreme Court in 2012, will be implemented over time and we will continue to monitor and assess its impact.

- Changes in Reinsurance Collateral requirements. The NAIC recently adopted a model law changing reinsurance collateral requirements for reinsurers not domiciled in the United States. The adoption of the model law by states in which we operate will likely impact our ability to obtain collateral from foreign reinsurers in the future.

We expect the debate about the role of the federal government in regulating insurance to continue. The continued soft economy has also raised the possibility of future legislative and regulatory actions intended to help the economy, in addition to the enactment of Emergency Economic Stabilization Act of 2008, which could further impact our business. We cannot predict whether any of these or any related proposal will be adopted, or what impact, if any, such proposals, could have on our results of operations, liquidity, financial condition, financial strength, and debt ratings if enacted.

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

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

- After-market parts;
- Urban homeowner insurance underwriting practices, including attempts by federal regulators to expand the Federal Housing Administrations guidelines to determine unfair discrimination;
- Credit scoring and predictive modeling pricing;
- Investment disclosure;
- Managed care practices;
- Timing and discounting of personal injury protection claims payments;
- Direct repair shop utilization practices; and

· Shareholder class action suits.

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

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

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

Risks Related to Our Investment Operations

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

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

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

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

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

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

Turbulent financial markets in 2011 were driven in part from the significant level of concern surrounding rising government debt levels across the globe. The sovereign debt crisis has been particularly concentrated in Europe where ratings agencies downgraded the debt of several Eurozone countries, with Greek debt at one point being moved to junk status. The crisis in Europe has made it difficult for certain European states to refinance their debts and has caused a significant devaluation of the Euro. Lack of confidence in the stability of the European Union and continued uncertainty about growth in global economies may have an adverse effect on the valuation of our investment portfolio. As of December 31, 2011, the Company had approximately $63.9 million, or 1.5%, invested in Eurozone government, corporate, and equity securities. Our Eurozone sovereign debt exposure in the portfolio totals less than $17.6 million

and is issued by Germany and Finland. For further information regarding our European exposure, see Item 7A. “Quantitative and Qualitative Disclosures About Market Risk.”

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

We are exposed to interest rate risk primarily related to the market price, and cash flow variability, associated with changes in interest rates. A rise in interest rates may decrease the fair value of our existing fixed maturity investments and declines in interest rates may result in an increase in the fair value of our existing fixed maturity investments. Our fixed income investment portfolio, which currently has a duration of 3.2 years excluding short term investments, contains interest rate sensitive instruments that may be adversely affected by changes in interest rates resulting from governmental monetary policies, domestic and international economic and political conditions, and other factors beyond our control. A rise in interest rates would decrease the net unrealized gain position of the investment portfolio, offset by our ability to earn higher rates of return on funds reinvested in new investments. Conversely, a decline in interest rates would increase the net unrealized gain position of the investment portfolio, offset by lower rates of return on funds reinvested and new investments. Changes in interest rates will also have an effect on the calculated duration of certain securities in the portfolio. We seek to mitigate our interest rate risk associated with holding fixed maturity investments by monitoring and maintaining the average duration of our portfolio with a view toward achieving an adequate after-tax return without subjecting the portfolio to an unreasonable level of interest rate risk. Although we take measures to manage the economic risks of investing in a changing interest rate environment, we may not be able to mitigate the interest rate risk of our assets relative to our liabilities.

The value of our investment portfolio is subject to credit risk from the issuers and/or guarantors of the securities in the portfolio, other counterparties in certain transactions and, for certain securities, insurers that guarantee specific issuer’s obligations. Defaults by the issuer or an issuer’s guarantor, insurer, or other counterparties regarding any of our investments, could reduce our net investment income and net realized investment gains or result in investment losses. We are also subject to the risk that the issuers, or guarantors, of fixed maturity securities we own may default on principal and interest payments due under the terms of the securities. At December 31, 2011, our fixed maturity securities portfolio represented approximately 88% of our total invested assets. The occurrence of a major economic downturn, acts of corporate malfeasance, widening credit spreads, budgetary deficits, or other events that adversely affect the issuers or guarantors of these securities could cause the value of our fixed maturity securities portfolio and our net income to decline and the default rate of our fixed maturity securities portfolio to increase.

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

We are exposed to risk in our municipal bond portfolio.

Approximately 35% of our fixed maturity securities are state or local municipality obligations. There have been widespread reports regarding the stress on state and local governments emanating from: (i) declining revenues; (ii) large unfunded liabilities; and (iii) entrenched cost structures. Debt-to-gross domestic product ratios for many states have been deteriorating due to, among other factors: (i) declines in federal monetary assistance provided as the United States is currently experiencing the largest deficit in its history; and (ii) lower levels of sales and property tax revenue as unemployment remains elevated and the housing market continues to remain unstable. Although we closely monitor this portfolio, we may not be able to mitigate the exposure in our municipal portfolio if state and local governments are unable to fulfill their obligations. In addition at December 31, 2011, 29% of our investment portfolio was invested in tax-exempt municipal obligations. As such, the value of our investment portfolio could be adversely affected by legislation that changes the current tax preference of municipal obligations.

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

We are exposed to significant financial and capital markets risks, primarily relating to interest rates, credit spreads, equity prices, and the change in market value of our alternative investment portfolio. A decline in both income and our investment portfolio asset values could occur as a result of, among other things, a decrease in market liquidity, falling interest rates, decreased dividend payment rates, negative market perception of credit risk with respect to types of securities in our portfolio, a decline in the performance of the underlying collateral of our structured securities, reduced returns on our alternative investment portfolio, or general market conditions. A global decline in asset values will be more amplified in our financial condition, as our statutory surplus is leveraged at a 3.8:1 ratio to our investment portfolio.

With economic uncertainty, the credit quality and ratings of securities in our portfolio could be adversely affected. The NAIC could potentially apply a more adverse class code on a security than was originally assigned, which could adversely affect statutory surplus because securities with NAIC class codes three through six require securities to be marked-to-market for statutory accounting purposes, as compared to securities with NAIC class codes of one or two that are carried at amortized cost.

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

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

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

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

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

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

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

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

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

Our other investments include investments in private limited partnerships that invest in various strategies such as private equity, mezzanine debt, distressed debt, and real estate. We are subject to risks arising from the fact that the determination of the fair value of these types of investments is inherently subjective. The general partner of each of these partnerships generally reports the change in the fair value of the interests in the partnership on a one quarter lag because of the nature of the underlying assets or liabilities. Since these partnerships' underlying investments consist primarily of assets or liabilities for which there are no quoted prices in active markets for the same or similar assets, the valuation of interests in these partnerships are subject to a higher level of subjectivity and unobservable inputs than substantially all of our other investments and as such, are subject to greater scrutiny and reconsideration from one reporting period to the next. These factors may result in significant changes in the fair value of these investments between reporting periods, which could lead to significant decreases in their fair value. Since we record our investments in these various partnerships under the equity method of accounting, any decreases in the valuation of these investments would negatively impact our results of operations. In addition, pursuant to the various limited partnership agreements of these partnerships, we are committed for the full life of each fund and cannot redeem our investment with the general partner. Liquidation is only triggered by certain clauses within the limited partnership agreements or at the funds' stated end date, at which time we will receive our final allocation of capital and any earned appreciation of the underlying investments. We also are subject to potential future capital calls in the aggregate amount of approximately $57 million as of December 31, 2011.

The valuation of our investments include methodologies, estimations, and assumptions that are subject to differing interpretations and could result in changes to investment valuations that may adversely affect our results of operations or financial condition.

Fixed maturity, equity, and short-term investments, which are reported at fair value on the Consolidated Balance Sheet, represented the majority of our total cash and invested assets as of December 31, 2011. As required under accounting rules, we have categorized these securities into a three-level hierarchy, based on the priority of the inputs to the respective valuation technique. The fair value hierarchy gives the highest priority to quoted prices in active markets for identical assets or liabilities (Level 1). The next priority is to quoted prices in markets that are not active or inputs that are observable either directly or indirectly, including quoted prices for similar assets or liabilities or in markets that are not active and other inputs that can be derived principally from, or corroborated by, observable market data for substantially the full term of the assets or liabilities (Level 2). The lowest priority in the fair value hierarchy is to unobservable inputs supported by little or no market activity and that reflect the reporting entity's own assumptions about the exit price, including assumptions that market participants would use in pricing the asset or

liability (Level 3).

An asset or liability's classification within the fair value hierarchy is based on the lowest level of significant input to its valuation. We generally use an independent pricing service and broker quotes to price our investment securities. At December 31, 2011, approximately 15% and 84% of these securities represented Level 1 and Level 2, respectively. However, prices provided by an independent pricing service and independent broker quotes can vary widely even for the same security. Rapidly changing and unprecedented credit and equity market conditions could materially impact the valuation of securities as reported within our Consolidated Financial Statements and the period-to-period changes in value could vary significantly. Decreases in value may result in an increase in non-cash OTTI charges, which could have a material adverse effect on our results of operations, liquidity, financial condition, financial strength, and debt ratings .

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

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

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

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

Changes in tax laws impacting marginal tax rates and/or the preferred tax treatment of municipal obligations could adversely impact our business.

Tax legislation that changes the tax preference of municipal obligations under current law could adversely affect the market value of municipal obligations. At December 31, 2011, 29% of our investment portfolio was invested in tax-exempt municipal obligations. As such, the value of our investment portfolio could be adversely affected by any such legislation. Additionally, any such changes in tax law could reduce the difference between tax-exempt interest rates and taxable rates, which can subject us to additional tax liability, reducing the overall net investment return of our portfolio.

Risks Related to Our General Operations

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

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

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

We depend on key personnel.

To a large extent, the success of our businesses is dependent on our ability to attract and retain key employees. Competition to attract and retain key personnel is intense. While we have employment agreements with certain key managers, all of our employees are at-will employees and we cannot ensure that we will be able to attract and retain key personnel. As of December 31, 2011, our workforce had an average age of approximately 46 and approximately 24% of our workforce was retirement eligible under our retirement and benefit plans.

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

We outsource certain business and administrative functions to third parties for efficiencies and cost savings, and may do so increasingly in the future. If we fail to develop and implement our outsourcing strategies or our third-party providers fail to perform as anticipated, we may experience operational difficulties, increased costs, and a loss of business that may have a material adverse effect on our results of operations or financial condition. By outsourcing certain business and administrative functions to third parties, we may be exposed to enhanced risk of data security breaches. Any breach of data security could damage our reputation and/or result in monetary damages, which, in turn, could have a material adverse effect on our results of operations, liquidity, financial condition, financial strength, and debt ratings.

We are subject to a variety of modeling risks, which could have a material adverse impact on our business results.

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

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

We have a net operating loss as of December 31, 2011 and have sufficient carryback capacity to absorb the net operating loss. We have no capital loss carryforward as of December 31, 2011. In the future, we would be required to establish a valuation allowance against our deferred tax assets if: (i) we do not have net operating loss and/or capital loss carryback capacity; (ii) it is determined that it is more likely than not that sufficient future income of the appropriate character will be generated; and (iii) there are no valid tax planning strategies to generate taxable income of the appropriate character (i.e. ordinary loss or capital loss). The establishment of a valuation allowance would have a material adverse effect on our results of operations, liquidity, financial condition, financial strength, and debt ratings.

Risks Related to Our Corporate Structure and Governance

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

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

Our transactions with our Insurance Subsidiaries and their ability to pay dividends or make loans or advances to us are subject to the approval or review of the insurance regulators in the states where the Insurance Subsidiaries are organized. The standards for review of such transactions are whether: (i) the terms and charges are fair and reasonable; and (ii) after the transaction, the Insurance Subsidiary's surplus for policyholders is reasonable in relation to its outstanding liabilities and financial needs. Although dividends and loans to us from our Insurance Subsidiaries historically have been approved, we can make no assurance that future dividends and loans will be approved.

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

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

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

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

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

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

Item 1B. Unresolved Staff Comments.

None.

Item 2. Properties.

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

Item 3. Legal Proceedings.

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

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

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PART II

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

(a) Market Information

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

	2011		2010	
	High	Low	High	Low
First quarter	$18.97	16.30	17.04	15.01
Second quarter	18.06	15.32	17.28	14.17
Third quarter	16.96	12.60	16.63	14.13
Fourth quarter	18.35	12.10	18.94	15.97

On February 17, 2012, the closing price of our common stock as reported on the NASDAQ Global Select Market was $18.04.

(b) Holders

As of February 15, 2012, there were approximately 2,322 holders of record of our common stock, including beneficial holders whose securities were held in the name of the registered clearing agency or its nominee.

(c) Dividends

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

Dividend Per Share	2011	2010
First quarter	$0.13	0.13

Second quarter	0.13	0.13
Third quarter	0.13	0.13
Fourth quarter	0.13	0.13

Our ability to declare dividends was restricted by covenants contained in our 8.87% senior notes that we issued on May 4, 2000 and that matured on May 4, 2010. All such covenants were met during 2010.

Our ability to receive dividends, loans, or advances from our Insurance Subsidiaries is subject to the approval or review of the insurance regulators in the respective domiciliary states of our Insurance Subsidiaries. Such approval and review is made under the respective domiciliary states' insurance holding company acts, which generally require that any transaction between related companies be fair and equitable to the insurance company and its policyholders. Although our dividends have historically been met with regulatory approval, there is no assurance that future dividends will be approved given current market conditions. We currently expect to continue to pay quarterly cash dividends on shares of our common stock in the future.

(d) Securities Authorized for Issuance Under Equity Compensation Plans

The following table provides information about our common stock authorized for issuance under equity compensation plans as of December 31, 2011:

Plan Category	(a) Number of securities to be issued upon exercise of outstanding options, warrants and rights	(b) Weighted-average exercise price of outstanding options, warrants and rights	(c) Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a))
Equity compensation plans approved by security holders	1,239,687	$ 18.77	7,807,647 [1]

[1] Includes 1,122,962 shares available for issuance under the Employee Stock Purchase Plan; 2,274,131 shares available for issuance under the Stock Purchase Plan for Independent Insurance Agencies; and 4,410,554 shares available for issuance under the Selective Insurance Group, Inc. 2005 Omnibus Stock Plan As Amended and Restated Effective as of May 1, 2010 (“Stock Plan”). Future grants under the Stock Plan can be made, among other things, as stock options, restricted stock units, or restricted stock.

(e) Performance Graph

The following chart, produced by Research Data Group, Inc., depicts our performance for the period beginning December 31, 2006 and ending December 31, 2011, as measured by total stockholder return on our common stock compared with the total return of the NASDAQ Composite Index and a select group of peer companies comprised of NASDAQ-listed companies in SIC Code 6330-6339, Fire, Marine, and Casualty Insurance.

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

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

The following table provides information regarding our purchases of our common stock in the fourth quarter of 2011:

Period	Total Number of **Shares Purchased**[1]	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Programs	Maximum Number of Shares that May Yet Be Purchased Under the Announced Programs
October 1 – 31, 2011	8,283	$ 16.33	-	-
November 1 – 30, 2011	6	18.18	-	-
December 1 – 31, 2011	4,041	16.84	-	-
Total	12,330	$ 16.50	-	-

[1]During the fourth quarter of 2011, 6 shares were purchased from employees in connection with the vesting of restricted stock units and 12,324 shares were purchased from employees in connection with stock option exercises. These repurchases were made to satisfy tax withholding obligations and/or option costs with respect to those employees. These shares were not purchased as part of the publicly announced program. The shares that were purchased in connection with the vesting of restricted stock units were purchased at fair market value as defined in the Stock Plan. The shares purchased in connection with the option exercises were purchased at the current market prices of our common stock on the dates the options were exercised.

Item 6. Selected Financial Data.

Five-Year Financial Highlights (All presentations are in accordance with GAAP unless noted otherwise, number of weighted average shares and dollars in thousands, except per share amounts)	2011		2010		2009		2008		2007
Net premiums written	$1,485,349		1,390,541		1,422,665		1,492,738		1,562,450
Net premiums earned	1,439,313		1,416,598		1,431,047		1,504,187		1,524,889
Net investment income earned	147,443		145,708		118,471		131,032		174,144
Net realized gains (losses)	2,240		(7,083	)	(45,970	)	(49,452	)	33,354
Total revenues	1,597,475		1,564,621		1,514,018		1,589,939		1,739,315
Catastrophe losses	118,769		56,465		8,519		31,740		14,899
Underwriting (loss) profit	(106,919	)	(22,167	)	2,385		132		30,966
Net income from continuing operations[1]	20,515		69,321		44,658		44,101		143,636
Total discontinued operations, net of tax[1]	(650	)	(3,780	)	(8,260	)	(343	)	2,862
Net income	19,865		65,541		36,398		43,758		146,498
Comprehensive income (loss)	55,135		85,025		126,984		(136,741	)	131,940
Total assets	5,736,369		5,231,772		5,114,827		4,945,556		5,007,158
Notes payable and debentures	307,360		262,333		274,606		273,878		295,067
Stockholders' equity	1,109,228		1,071,109		1,002,375		890,493		1,076,043
Statutory premiums to surplus ratio	1.4		1.3		1.5		1.7		1.5
Statutory combined ratio	106.7	%	101.6		100.5		99.2		97.5
Impact of catastrophe losses on statutory combined ratio	8.3	pts	4.0		0.6		2.1		1.0
Combined ratio	107.4	%	101.6		99.8		100.0		98.0
Yield on investment, before tax	3.7		3.8		3.2		3.6		4.8
Debt to capitalization	21.7		19.7		21.5		23.5		21.5
Return on average equity	1.8		6.3		3.8		4.5		13.6
Non-GAAP measures[2]:									
Operating income	$19,059		73,925		74,538		76,245		121,956
Operating return on average equity	1.7	%	7.1		7.9		7.8		11.3
Per share data:									
Net income from continuing operations[1]:									
Basic	$0.38		1.30		0.84		0.85		2.75
Diluted	0.37		1.27		0.83		0.83		2.54
Net income:									
Basic	$0.37		1.23		0.69		0.84		2.80
Diluted	0.36		1.20		0.68		0.82		2.59
Dividends to stockholders	$0.52		0.52		0.52		0.52		0.49
Stockholders' equity	$20.39		19.95		18.83		16.84		19.81

Price range of common stock:					
High	$18.97	18.94	23.28	30.40	29.07
Low	12.10	14.13	10.06	16.33	19.04
Close	17.73	18.15	16.45	22.93	22.99
Number of weighted average shares:					
Basic	54,095	53,359	52,630	52,104	52,382
Diluted	55,221	54,504	53,397	53,319	57,165

[1] In 2009, we sold our Selective HR Solutions operations. See Note 12. "Discontinued Operations" in Item 8. "Financial Statements and Supplementary Data." of this Form 10-K for additional information.

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

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

Forward-looking Statements

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

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

Introduction

We classify our business into two operating segments:

- Insurance Operations, which sells property and casualty insurance products and services; and
- Investments, which invests the premiums collected by our insurance operations.

Our Insurance Operations offers standard market insurance products and services through seven insurance subsidiaries and, in 2011, we began offering excess and surplus lines ("E&S") insurance products as the result of the following acquisition activity:

- The purchase of the renewal rights to an E&S book of business in August 2011. This renewal book had gross annual premiums of approximately $77 million in 2010.
- The purchase of Montpelier U.S. Insurance Company ("MUSIC") in December 2011. MUSIC had gross annual premiums of approximately $48 million in 2010.
- Our eight insurance subsidiaries are collectively referred to as the "Insurance Subsidiaries".

For addition information regarding our recent acquisitions, refer to Note 13. “Business Combinations” in Item 8. “Financial Statements and Supplementary Data.” of the Form 10-K.

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

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

- Critical Accounting Policies and Estimates;
- Financial Highlights of Results for Years Ended December 31, 2011, 2010, and 2009;
- Results of Operations and Related Information by Segment;
- Federal Income Taxes;
- Financial Condition, Liquidity, Short-term Borrowings, and Capital Resources;
- Off-Balance Sheet Arrangements;
- Contractual Obligations, Contingent Liabilities, and Commitments;
- Ratings; and
- Pending Accounting Pronouncements.

Critical Accounting Policies and Estimates

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

Reserves for Losses and Loss Expenses

Significant periods of time can elapse between the occurrence of an insured loss, the reporting of the loss to the insurer, and the insurer's payment of that loss. To recognize liabilities for unpaid losses and loss expenses, insurers establish reserves as balance sheet liabilities representing an estimate of amounts needed to pay reported and unreported net losses and loss expenses. As of December 31, 2011, we had accrued $3.1 billion of gross loss and loss expense reserves compared to $2.8 billion at December 31, 2010.

How reserves are established

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

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

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

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

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

Standard Market General Liability Line of Business

At December 31, 2011, our general liability line of business had recorded reserves, net of reinsurance, of $974 million, which represented 38% of our total net reserves. This line of business experienced favorable prior accident year loss development in 2009 through 2011. In 2011, this was driven by favorable development on the premises and operations coverages for accident years 2009 and prior. The favorable premises development was largely offset by increases for the products coverage in 2010 and prior. The broad nature of this line of business, and the longer tailed nature of the claims settlement process, makes it more susceptible to changes in litigation and the tort environment. This line of business also includes excess policies that provide additional limits above underlying automobile and general liability coverages, which is subject to catastrophic losses, and therefore influenced by the factors noted above to a greater degree.

Standard Market Workers Compensation Line of Business

At December 31, 2011, our workers compensation line of business recorded reserves, net of reinsurance, of $898 million, or 35% of our total net reserves. In 2010 and 2011, this line experienced unfavorable loss development. In 2011 this was driven by increases in the 2010 accident year, partially offset by various earlier accident years. In

addition to the uncertainties associated with actuarial assumptions and methodologies described above, the workers compensation line of business can be impacted by a variety of issues, such as unexpected changes in medical cost inflation, higher than anticipated claim severity, changes in overall economic conditions, and company specific initiatives. Variability in our historical workers compensation medical costs, along with uncertainty regarding future medical inflation, creates the potential for additional volatility in our reserves.

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

Additionally, the economy could impact the frequency and severity of claims in ways unanticipated by management. In 2010, we experienced an unusually high amount of audit and endorsement activity, resulting in return premium of $20.5 million, while in 2011, audit and endorsement activity resulted in additional premiums of $11.2 million. Some volatility in premium activity may continue into the future and, since premiums earned are used as a basis for setting initial reserves on the current accident year, our reserves could be impacted. The result could be favorable development if the reduction in payroll resulting in return premium is truly a reduction in exposure. The result could be adverse development if the reduction in payroll resulting in return premium indicates that remaining workers are now overworked and more prone to accidents.

Finally, in the past few years, the company implemented a multi-faceted workers compensation strategy that incorporated knowledge management, predictive modeling, and a new claims handling model. While the expectation is that these initiatives will bring benefits, they are also a potential source of uncertainty in the future. If the ongoing impact of these strategies exceeds our expectations, the result could be favorable development in the future. If our internal strategies are less effective than anticipated, and we experience higher than expected claim severity, the result could be adverse development in the future.

Standard Market Commercial Automobile Line of Business

At December 31, 2011, our commercial automobile line of business had recorded reserves, net of reinsurance, of $346 million, which represented 13% of our total net reserves. This line of business experienced favorable prior year loss development from 2005 through 2011. In 2011 this development was driven by accident years 2007 through 2009, which represents a continued trend driven by lower frequencies in these years. While management has not identified any new specific emerging trends related to this line, the variability of frequencies creates additional uncertainty in our analysis for the more recent accident years.

Claims Initiative and Inflation Impact on Standard Market Workers Compensation, General Liability and Commercial Automobile Lines of Business

In addition to the line of business specific issues mentioned above, these lines of business have been impacted by a number of initiatives undertaken by our claims department that have resulted in volatility in the average level of case reserves. This change in the average level of case reserves increases the uncertainty in the short run, but the longer-term benefit is a more refined management of the claims process. Additionally, although inflationary volatility is expected to be low in the near term, current United States’ monetary policy and global economic conditions bring additional uncertainty in the long-term given the long-tail nature of these lines of business. Uncertainty regarding future inflation or deflation creates the potential for additional volatility in our reserves for these lines of business.

Standard Market Personal Automobile Line of Business

At December 31, 2011, our personal automobile line of business had recorded reserves, net of reinsurance, of $134 million, which represented 5% of our total net reserves. The majority of the reserves are from business written in New

Jersey. Over the past several years we have been decreasing the amount of business written in New Jersey while increasing the amount of business written in other states. We review the reserves for states other than New Jersey on a combined basis so that there is a sufficient volume of data to ensure statistical credibility. However, the state mix of business changes over time, which may increase the uncertainty surrounding our personal automobile reserves.

Other Lines of Business

At December 31, 2011, no other individual line of business had recorded reserves of more than $90 million, net of reinsurance. We have not identified any recent trends that would create additional significant reserve uncertainty for these other lines of business.

The following tables provide case and IBNR reserves for losses and loss expense, and reinsurance recoverable on unpaid losses and loss expenses as of December 31, 2011 and 2010:

As of December 31, 2011				Reinsurance Recoverable on Unpaid Losses and Loss Expenses	
	Loss and Loss Expense Reserves				
($ in thousands)	Case Reserves	IBNR Reserves	Total		Net Reserves
Commercial automobile	$119,930	236,809	356,739	11,126	345,613
Workers compensation	475,498	569,050	1,044,548	146,912	897,636
General liability	202,704	870,711	1,073,415	98,952	974,463
Commercial property	53,701	8,383	62,084	8,338	53,746
Business owners' policies	32,826	63,714	96,540	6,593	89,947
Bonds	3,766	7,010	10,776	502	10,274
Other [1]	13,994	49,724	63,718	44,975	18,743
Total Commercial Lines	902,419	1,805,401	2,707,820	317,398	2,390,422
Personal automobile	108,570	93,422	201,992	68,222	133,770
Homeowners	32,014	33,645	65,659	5,374	60,285
Other	142,552	26,901	169,453	158,496	10,957
Total Personal Lines	283,136	153,968	437,104	232,092	205,012
Total	$1,185,555	1,959,369	3,144,924	549,490	2,595,434

As of December 31, 2010				Reinsurance Recoverable on Unpaid Losses and Loss Expenses	
	Loss and Loss Expense Reserves				
($ in thousands)	Case Reserves	IBNR Reserves	Total		Net Reserves
Commercial automobile	$121,191	246,119	367,310	9,703	357,607
Workers compensation	471,998	521,288	993,286	128,337	864,949
General liability	213,063	824,783	1,037,846	81,326	956,520
Commercial property	39,612	7,494	47,106	3,662	43,444
Business owners' policies	25,310	70,160	95,470	6,261	89,209
Bonds	2,346	8,549	10,895	308	10,587
Other	794	1,120	1,914	739	1,175
Total Commercial Lines	874,314	1,679,513	2,553,827	230,336	2,323,491
Personal automobile	111,484	83,423	194,907	62,589	132,318
Homeowners	22,878	29,890	52,768	2,028	50,740
Other	7,139	21,417	28,556	18,786	9,770
Total Personal Lines	141,501	134,730	276,231	83,403	192,828
Total	$1,015,815	1,814,243	2,830,058	313,739	2,516,319

[1] Includes our E&S business.

Range of reasonable reserves

We established a range of reasonably possible reserves for net claims of approximately $2,395 million to $2,716 million at December 31, 2011, and $2,356 million to $2,665 million at December 31, 2010. A low and high reasonable reserve selection was derived primarily by considering the range of indications calculated using generally accepted actuarial techniques. Such techniques assume that past experience, adjusted for the effects of current developments and anticipated trends, are an appropriate basis for predicting future events. Although this range reflects likely scenarios, it is possible that the final outcomes may fall above or below these amounts. Based on internal stochastic modeling, we believe that a reasonable estimate of the likelihood that the final outcome falls within the current range is approximately 75%. This range does not include a provision for potential increases or decreases associated with environmental reserves. Our best estimate is consistent with the actuarial central estimate. We do not discount to present value that portion of our loss reserves expected to be paid in future periods; however, the loss reserves take into account anticipated recoveries for salvage and subrogation claims.

Sensitivity Analysis: Potential impact on reserve volatility due to changes in key assumptions

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

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

The importance of any single assumption depends on several considerations, such as the line of business and the accident year. If the actual experience emerges differently than the assumptions used in the process to establish reserves, changes in our reserve estimate are possible and may be material to the results of operations in future periods. Set forth below is a discussion of the potential impact of using certain key assumptions that differ from those used in our latest reserve analysis. It is important to note that the following discussion considers each assumption individually, without any consideration of correlation between lines of business and accident years, and therefore, does not constitute an actuarial range. While the following discussion represents possible volatility from variations in key assumptions as identified by management, there is no assurance that the future emergence of our loss experience will be consistent with either our current or alternative set of assumptions. By the very nature of the insurance business, loss development patterns have a certain amount of normal volatility.

Standard Market General Liability Line of Business

In addition to the normal amount of volatility, general liability loss development factors have greater uncertainty due to the complexity of the coverages and the possibly significant periods of time that can elapse between the occurrence of an insured loss, the reporting of the loss to the insurer, and the insurer’s payment of that loss. In our judgment, it is possible that general liability loss development factors could be +/- 5% from those actually selected in our latest reserve analysis. If the loss development assumptions were changed by +/- 5%, that would increase/decrease our indicated general liability reserves by approximately $93 million for accident years 2010 and prior.

Standard Market Workers Compensation Line of Business

In addition to the normal amount of volatility, the combination of the sensitivity of workers compensation results to medical inflation, economic conditions including unemployment, and changes in underwriting could lead to actual experience emerging differently than the assumptions used in the process to establish reserves. In our judgment, it is possible that actual medical loss development factors could range from 6% below to 9% above those selected in our latest reserve analysis and expected loss ratios could range from 5% below to 8% above those selected in our latest reserve analysis. The combination of reducing the assumptions for medical loss development by 6% and the expected loss ratio by 5% could decrease our indicated workers compensation reserves by approximately $73 million for accident years 2010 and prior. Alternatively, the combination of increasing the medical loss development factors by 9% and the expected loss ratio by 8% could increase our indicated workers compensation reserves by approximately $114 million for accident years 2010 and prior.

Standard Market Commercial Automobile Line of Business

In addition to the normal amount of volatility, our commercial automobile line of business has realized significant favorable development in 2005 through 2011. In 2011, this development was driven by accident years 2007 through 2009, which represents a continued trend driven by lower frequencies in these years. The actual number of large claims has a high degree of volatility from year to year in terms of timing and ultimate final emergence. Even if large losses are ultimately consistent from year to year, if they are identified at different times than previous years, traditional loss development factors may overstate or understate actuarial indications. If the timing of large losses is significantly variable, it is our judgment that actual loss development factors could be +/- 5% different from those selected in our reserve review, which would increase/decrease our indicated commercial auto reserves by approximately $57 million for accident years 2010 and prior.

Claims Initiatives and Inflation Impact on Standard Market Workers Compensation, General Liability, and Commercial Automobile Lines of Business

As discussed in the major trend section above, the claims initiatives and inflationary uncertainty could impact reserves for the workers compensation, general liability, and commercial automobile lines of business. In our judgment, it is possible that the selected reserves for these lines of business in our latest reserve review could increase by $128 million or decrease by $118 million due to the combination of case reserve volatility in accident years 2009 through 2011 due to claims initiatives and unexpected inflation or deflation. These potential impacts would likely manifest themselves as changes in development patterns and expected loss ratios as described within the discussions of the separate lines of business. Therefore, these impacts may be embedded within the line of business figures, in whole or in part.

Standard Market Personal Automobile Line of Business

In addition to a normal amount of volatility, the uncertainty of personal automobile loss development factors is greater than usual due to the change in our state mix for business written outside of New Jersey. In our judgment, it is possible that personal auto bodily injury loss development factors could be +/- 4% different from those selected in our reserve review. This would increase/decrease our indicated personal auto reserves by approximately $33 million for accident years 2010 and prior.

Current Accident Year

For the 2011 accident year, the expected ultimate loss ratio by line of business is a key assumption. This assumption is based on a large number of inputs that are assessed periodically, such as historical loss ratios, projected future loss trend, and planned pricing amounts. In our judgment, it is possible that the actual ultimate loss ratio for the 2011 accident year could be +/-7 loss ratio points from the one selected in our latest reserve analysis for the combination of our four major long-tailed lines of business. The table below summarizes the possible impact on our reserves of varying our expected loss ratio assumption by +/-7 points by line of business for the 2011 accident year.

Reserve Impact of Changing Current Year Expected Ultimate Loss Ratio Assumption

($ in millions)	If Assumption was Reduced by 7 Points	If Assumption was Raised by 7 Points
Workers compensation	(18)	18
General liability	(24)	24
Commercial automobile liability	(15)	15
Personal automobile liability	(7)	7
Combined	(64)	64

Prior year reserve development

In light of the many uncertainties associated with establishing the estimates and making the assumptions necessary to establish reserve levels, we review our reserve estimates on a regular basis as described above and make adjustments in the period that the need for such adjustment is determined. These reviews could result in the identification of information and trends that would require us to increase some reserves and/or decrease other reserves for prior periods and could also lead to additional increases in loss and loss adjustment expense reserves, which could have a material adverse effect on our results of operations, equity, insurer financial strength, and debt ratings. In 2011, we experienced overall favorable loss development of approximately $39 million. This was driven by favorable loss development of $60 million in the 2006, 2008, and 2009 accident years, partially offset by unfavorable development in accident year 2010 of approximately $24 million.

In 2010, we experienced overall favorable loss development of approximately $44 million. This was driven by favorable emergence in accident years 2007 and prior of approximately $69 million, partially offset by unfavorable emergence in accident years 2008 and 2009 of approximately $24 million.

In 2009, we experienced favorable loss development of approximately $67 million in accident years 2004 through 2007, partially offset by unfavorable loss development in the 2008 accident year, as well as accident years prior to 2003, of approximately $38 million, netting to favorable prior year development of $29 million. For further discussion on the prior year development in loss and loss expense reserves, see the discussion on “Net Loss and Loss Expense Reserves” in Item 1. “Business” and Item 8. “Financial Statements and Supplementary Data,” Note 9 of this Form 10-K.

Asbestos and Environmental Reserves

Included in our loss and loss expense reserves are amounts for environmental claims, both asbestos and non-asbestos. Carried net loss and loss expense reserves for environmental claims were $38.4 million as of December 31, 2011 and $39.4 million as of December 31, 2010. Our asbestos and non-asbestos environmental claims have arisen primarily from insured exposures in municipal government, small commercial risks, and homeowners policies. The emergence of these claims is slow and highly unpredictable. In past years, we also experienced adverse development in our homeowners line of business as a result of unfavorable trends in claims for groundwater contamination caused by leakage of certain underground heating oil storage tanks in New Jersey. In addition, certain landfill sites are included on the National Priorities List ("NPL") by the United States Environmental Protection Agency ("USEPA"). Once on the NPL, the USEPA determines an appropriate remediation plan for these sites. A landfill can remain on the NPL for many years until final approval for the removal of the site is granted from the USEPA. The USEPA also has the authority to re-open previously closed sites and return them to the NPL. We currently have reserves for 13 insureds related to five sites on the NPL, one of which was reopened in 2009 related to a natural resources claim.

IBNR reserve estimation for environmental claims is often difficult because, in addition to other factors, there are significant uncertainties associated with critical assumptions in the estimation process, such as average clean-up costs, third-party costs, potentially responsible party shares, allocation of damages, insurer litigation costs, insurer coverage defenses, and potential changes to state and federal statutes.

Moreover, normal historically-based actuarial approaches are difficult to apply because relevant history is not available. While models can be applied, such models can produce significantly different results with small changes in assumptions. As a result, we do not calculate a specific environmental loss range, as we believe it would not be meaningful.

Deferred Policy Acquisition Costs

Policy acquisition costs, which include commissions, premium taxes, fees, and certain other costs of underwriting policies, are deferred and amortized over the same period in which the related premiums are earned. Deferred policy acquisition costs are limited to the estimated amounts recoverable after providing for losses and loss expenses that are expected to be incurred, based upon historical and current experience. Anticipated investment income is considered in determining whether a premium deficiency exists. The methods of making such estimates and establishing the deferred costs are continually reviewed, and any adjustments are made in the accounting period in which the adjustment arose.

We regularly conduct reviews for potential premium deficiencies at a level consistent with that used for our segment reporting in that we group our policies at the Insurance Operations level, considering the following:

- Our marketing efforts for all of our product lines within our Insurance Operations revolve around independent agencies and their touch points with our shared customers, the policyholders.

- We service our agency distribution channel through our field model, which includes AMSs, safety management specialists, CMSs, and our Underwriting and Claims Service Centers, all of which service the entire population of insurance contracts acquired through each agency.
- We measure the profitability of our business at the Insurance Operations level, which is evident in, among other items, the structure of our incentive compensation programs. We measure the profitability of our agents and calculate their compensation based on overall insurance results and all of our employees, including senior management, are incented based on overall insurance results.

We had deferred policy acquisition costs of $214.1 million at December 31, 2011 compared to $209.6 million at December 31, 2010. In October 2010, the Financial Accounting Standards Board issued accounting guidance regarding accounting for costs associated with acquiring or renewing insurance contracts effective January 1, 2012, which will result in a pre-tax impact on our deferred policy acquisition balance of $78.3 million. For further discussion regarding the impact of this new accounting guidance, see the "Pending Accounting Pronouncements" section below.

Premium Audit

We estimate the amount of premium that is anticipated to be either billed or returned on policies subsequent to expiration based on exposure levels (i.e., payroll or sales). This estimate of premiums that are earned but unbilled is based on historical trends adjusted for the uncertainty of future economic conditions. During 2011, 2010 and 2009, we had return audit premiums paid of $6.6 million, $31.1 million, and $27.7 million, respectively. Given the persistent uncertainty of the U.S. economy and the volatility in return premium over the last several years, we estimate our accrual for return audit premium on 2011 policies to be approximately $5 million. However, further economic instability could ultimately impact our estimates and assumptions, and consequently, changes in the liability estimate may be material to the results of operations in future periods.

Pension and Post-retirement Benefit Plan Actuarial Assumptions

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

The discount rate enables us to state expected future cash flows at their present value on the measurement date. The purpose of the discount rate is to determine the interest rates inherent in the price at which pension benefits could be effectively settled. Our discount rate selection is based on high-quality, long-term corporate bonds. A lower discount rate increases the present value of benefit obligations and increases pension expense. We decreased our discount rate to 5.16% for 2011, from 5.55% for 2010 reflecting ongoing pressure on market interest rates. To determine the expected long-term rate of return on the plan assets, we consider the current and expected asset allocation, as well as historical and expected returns on each plan asset class. A lower expected rate of return on pension plan assets would increase pension expense. Our long-term expected return on plan assets was lowered 25 basis points to 7.75% in 2011 as compared to 8.00% in 2010, reflecting the lower interest rate environment that is anticipated in the near term and our 2011 pension asset total return of 4%. We had a pension and post-retirement benefit plan obligation of $259.9 million at December 31, 2011 compared to $236.3 million at December 31, 2010.

As of December 31, 2011, our pension assets were $182.6 million, up from $173.3 million at the end of 2010. In 2011, we made $8.4 million in contributions to our plan assets to further improve the funded status of the pension plan. Volatility in the marketplace, coupled with changes in the discount rate assumption, could materially impact our pension valuation in the future.

For additional information regarding our pension and post-retirement benefit plan obligations, see Item 8. “Financial Statements and Supplementary Data,” Note 16(c) of this Form 10-K.

Other-Than-Temporary Investment Impairments

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

Fixed Maturity Securities and Short-Term Investments

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

- Whether the decline appears to be issuer or industry specific;
- The degree to which the issuer is current or in arrears in making principal and interest payments on the fixed maturity security;
- The issuer's current financial condition and ability to make future scheduled principal and interest payments on a timely basis;
- Evaluation of projected cash flows;

- Buy/hold/sell recommendations published by outside investment advisors and analysts; and
- Relevant rating history, analysis, and guidance provided by rating agencies and analysts.

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

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

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

Discounted Cash Flow Assumptions

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

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

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

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

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

Equity Securities

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

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

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

Other Investments

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

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

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

Reinsurance

Reinsurance recoverables on paid and unpaid losses and loss expenses represent estimates of the portion of such liabilities that will be recovered from reinsurers. Each reinsurance contract is analyzed to ensure that the transfer of risk exists to properly record the transactions in the financial statements. Amounts recovered from reinsurers are

recognized as assets at the same time and in a manner consistent with the paid and unpaid losses associated with the reinsured policies. An allowance for estimated uncollectible reinsurance is recorded based on an evaluation of balances due from reinsurers and other available information. This allowance totaled $3.9 million at December 31, 2011 and $3.4 million at December 31, 2010. We continually monitor developments that may impact recoverability from our reinsurers and have available to us contractually provided remedies if necessary. For further information regarding reinsurance, see the “Reinsurance” section below and Note 8. “Reinsurance” in Item 8. “Financial Statements and Supplementary Data.” of this Form 10-K.

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Financial Highlights of Results for Years Ended December 31, 2011, 2010, and 2009[1]

($ in thousands, except per share amounts)	2011		2010	2011 vs. 2010		2009	2010 vs. 2009	
GAAP measures:								
Revenues	$1,597,475		1,564,621	2	%	1,514,018	3	%
Pre-tax net investment income	147,443		145,708	1		118,471	23	
Pre-tax net income	7,065		76,141	(91	)	26,253	190	
Net income	19,865		65,541	(70	)	36,398	80	
Diluted net income per share	0.36		1.20	(70	)	0.68	76	
Diluted weighted-average outstanding shares	55,221		54,504	1		53,397	2	
GAAP combined ratio	107.4	%	101.6	5.8	pts	99.8	1.8	pts
Statutory combined ratio	106.7	%	101.6	5.1		100.5	1.1	
Return on average equity	1.8		6.3	(4.5	)	3.8	2.5	
Non-GAAP measures:								
Operating income	$19,059		73,925	(74	)%	74,538	(1	)%
Diluted operating income per share	0.34		1.35	(75	)	1.39	(3	)
Operating return on average equity	1.7	%	7.1	(5.4	)pts	7.9	(0.8	)pts

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

Our 2011 pre-tax net income decreased $69.1 million compared to 2010, primarily due to an increased level of catastrophe losses this year. In 2011, these losses amounted to $118.8 million, a historic level for us, which exceeded 2010 by $62.3 million. We were impacted by more than twenty storms in 2011, the most significant of which was Hurricane Irene which caused us to pierce the first layer of our catastrophe excess of loss treaty with losses of $40.2 million on a net basis ($47.1 million on a gross basis), including the reinstatement premium.

Our 2010 pre-tax net income increased $49.9 million compared to 2009, primarily due to an improvement in net realized losses. These losses were $7.1 million in 2010, a decrease of $38.9 million compared to 2009. Elevated losses in 2009 reflected non-cash OTTI charges of $55.4 million, compared to $17.7 million in 2010. For details regarding the OTTI charges, see Note 5, “Investments” in Item 8. “Financial Statements and Supplementary Data.” of this Form 10-K. Also included in the fluctuation from 2010 compared to 2009 is a $27.2 million increase in investment income driven by our alternative investment portfolio offset by a $24.6 million increase in underwriting losses driven by higher catastrophe losses partially offset by increased favorable prior year development.

The tax benefit from continuing operations was $12.5 million in 2011, compared to an expense of $12.6 million in 2010 and a benefit of $5.5 million in 2009. These fluctuations were primarily driven by the change in the components of pre-tax net income as discussed above.

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

($ in thousands, except per share amounts)	2011	2010	2009
Operating income	$19,059	73,925	74,538
Net realized gains (losses), net of tax	1,456	(4,604)	(29,880)
Loss on discontinued operations, net of tax	(650)	(3,780)	(8,260)
Net income	$19,865	65,541	36,398
Diluted operating income per share	$0.34	1.35	1.39
Diluted net realized gains (losses) per share	0.03	(0.08)	(0.56)
Diluted net loss on discontinued operations per share	(0.01)	(0.07)	(0.15)
Diluted net income per share	$0.36	1.20	0.68

The variances in operating income are reflective of the results discussed above. Refer to Exhibit 99.1 of this Form 10-K for a definition of operating income.

Results of Operations and Related Information by Segment

Insurance Operations

Our Insurance Operations offers standard market insurance products and services through seven insurance subsidiaries and, in 2011, we began offering excess and surplus lines ("E&S") insurance products as the result of the following acquisition activity:

- The purchase of the renewal rights to an E&S book of business in August 2011; and
- The purchase of Montpelier U.S. Insurance Company ("MUSIC") in December 2011.
- Our eight insurance subsidiaries are collectively referred to as the Insurance Subsidiaries.

Our standard market insurance products and services are sold primarily in 22 states in the Eastern and Midwestern U.S. through approximately 1,000 independent insurance agencies. Our recent E&S acquisitions provide us the opportunity to write contract binding authority E&S business in all 50 states and the District of Columbia through approximately 90 wholesale agents across the country.

Our Insurance Operations segment consists of two components: (i) Commercial Lines, which markets primarily to businesses and represents approximately 82% of NPW; and (ii) Personal Lines, which markets primarily to individuals and represents approximately 18% of NPW. The underwriting performance of these lines is generally measured by four different statutory ratios: (i) the loss and loss expense ratio; (ii) the underwriting expense ratio; (iii) the dividend ratio; and (iv) the combined ratio.

Summary of Insurance Operations
All Lines

($ in thousands)	2011	2010	2011 vs. 2010	2009	2010 vs. 2009
GAAP Insurance Operations Results:					
NPW	$1,485,349	1,390,541	7 %	1,422,655	(2)%
NPE	1,439,313	1,416,598	2	1,431,047	(1)
Less:					
Losses and loss expenses incurred	1,074,987	982,118	9	971,905	1
Net underwriting expenses incurred	465,961	452,769	3	453,117	-
Dividends to policyholders	5,284	3,878	36	3,640	7
Underwriting (loss) income	$(106,919)	(22,167)	(382)%	2,385	(1,029)%
GAAP Ratios:					
Loss and loss expense ratio	74.7 %	69.3	5.4 pts	67.9	1.4 pts
Underwriting expense ratio	32.3	32.0	0.3	31.6	0.4
Dividends to policyholders ratio	0.4	0.3	0.1	0.3	-
Combined ratio	107.4	101.6	5.8	99.8	1.8

Statutory Ratios:								
Loss and loss expense ratio	74.6		69.3	5.3		67.9	1.4	
Underwriting expense ratio	31.7		32.0	(0.3	)	32.3	(0.3	)
Dividends to policyholders ratio	0.4		0.3	0.1		0.3	-	
Combined ratio	106.7	%	101.6	5.1	pts	100.5	1.1	pts

- NPW increased in 2011 compared to 2010 primarily driven by the following: (i) Commercial Lines renewal pure price increases of 2.8% coupled with a one-point increase in retention to 83%; (ii) new E&S premiums of $24.1 million in association with our renewal rights purchase in August 2011; and (iii) improvements in audit and endorsement premiums. Audit and endorsement activity was driven by economic conditions over the past three years as evidenced below:

($ in millions)

For the Year Ended December 31,	Audit and Endorsement Additional (Return) Premium		
2011	$	14.8	
2010		(47.4	)
2009		(62.0	)

The decrease in NPW in 2010 compared to 2009 was driven by audit and endorsement activity as shown in the table above, coupled with a reduction in new business of $48.2 million, to $272.8 billion.

NPE increases over the three-year period are consistent with the fluctuation in NPW.

- The increase in the GAAP loss and loss expense ratio of 5.4 points in 2011 compared to 2010 was primarily attributable to higher property losses of $81.7 million, which included increased catastrophe losses of $62.3 million, or 4.3 points, to $118.8 million in 2011. In addition, favorable prior year casualty development was $30 million, or 2.1 points, in 2011 compared to $39 million, or 2.8 points, in 2010. For more information on the favorable prior year development on our casualty lines of business, see the "Review of Underwriting Results by Lines of Business" below.

The increase in the GAAP loss and loss expense ratio of 1.4 points in 2010 compared to 2009 was primarily attributable to an increase in property losses of $50.3 million, which included increased catastrophe losses of $47.9 million, or 3.4 points, to $56.5 million in 2010. Partially offsetting this increase was: (i) favorable casualty prior year development of approximately $39 million, or 2.8 points, in 2010, compared to approximately $29 million, or 2.0 points, in 2009; and (ii) a reduction of loss costs due to a change in the mix of our casualty lines of business.

- The increase in the GAAP underwriting expense ratio of 0.3 points in 2011 compared to last year was driven by expenses associated with our purchase of the E&S renewal book of business in 2011. The majority of those expenses are directly related to the acquisition, and will not impact the on-going results of this operation. However, as MUSIC unearned premiums as of the acquisition date were fully ceded, our underwriting expense ratio will be under pressure going forward until such time premiums that we write subsequent to the purchase are earned to support the expenses of these operations.

The increase in the GAAP underwriting expense ratio of 0.4 points in 2010 was primarily due to declines in earned premium coupled with benefits recognized in 2009 related to the elimination of retiree life insurance benefits for current employees amounting to a total benefit of $4.2 million, pre-tax.

Insurance Operations Outlook

Several record breaking tornado outbreaks during the spring of 2011 marked the beginning of one the most costly catastrophe loss year for the property and casualty insurance industry since 2005 when three hurricanes made a direct landfall in the United States. Hurricane Irene was the first hurricane to hit the United States coastline since 2008 and the first to strike the New York City area since Hurricane Gloria in 1985. A.M. Best estimates that catastrophe losses in the United States were approximately $44 billion, more than double the amount in 2010. As a result, A.M. Best is projecting an industry combined ratio of 107.5% in 2011, which includes more than 10 points of catastrophe losses. Consistent with the trend noted by A.M. Best as a driver of industry-wide results, our Insurance Operations segment incurred the worst catastrophe year in the existence of our company with losses of $118.8 million, or 8.3 points on our

combined ratio of 106.7%. As shown in the table below, catastrophe losses, by their nature, are volatile. In 2011 and 2010, we incurred elevated levels of catastrophe losses, and, conversely, 2009 was the period of lowest catastrophe losses during the last five years.

($ in thousands)

For the Year Ended December 31,	Catastrophe Losses Incurred	Impact on Loss Ratio	
2011	$ 118,769	8.3	pts
2010	56,465	4.0	
2009	8,519	0.6	
2008	31,740	2.1	
2007	14,899	1.0	

As a result of the unprecedented catastrophe losses, the industry has begun experiencing a modest level of commercial lines renewal price increases, particularly in the fourth quarter of 2011, according to the Commercial Lines Insurance Pricing Survey. As reflected by A.M. Best's February 2012 affirmation to maintain its negative outlook for the commercial lines industry, we believe these modest increases in rate are not sufficient, and a widespread hardening needs to materialize given: (i) the instability of the U.S. economy and the current low interest rate environment that has continued to put pressure on investment yields; (ii) an industry statutory combined ratio for 2011 of 107.5% as reported by A.M. Best; (iii) higher anticipated reinsurance costs (see the "Reinsurance" section below for more detail); and (iv) declining industry profitability as a result of elevated levels of catastrophe-related losses.

While industry pricing has just begun to improve, we are on our eleventh consecutive quarter of Commercial Lines renewal pure price increases, with 3.4% in the fourth quarter of 2011 and 2.8% for 2011. The price increases that we have obtained demonstrate the overall strength of the relationships that we have with our independent agents, even in difficult economic and competitive times. We believe that once the market as a whole becomes more successful at driving price, we will be able to further capitalize on our relationships with our agents to generate additional renewal price increases through the use of our granular pricing capabilities. The price increases we have been able to obtain, coupled with strong retention, have led to year-over-year NPW growth in our Commercial Lines for the first time since 2007 and an increase of 7% in 2011. We also expanded our underwriting appetite with new products in para-transit, technology, and communities of faith. Our recent acquisition of MUSIC broadens our E&S footprint to all 50 states and the District of Columbia, giving us a higher-margin product and the capability to drive NPW growth in the future. The MUSIC acquisition, coupled with our renewal rights purchase in August 2011, provides the potential for annual E&S premium volume of $120 million through 90 wholesale general agents as well as potential access to the $300 to $400 million of contract binding authority E&S business our independent retail agents currently write annually for our competitors. In 2011, we also invested in the consumer agent portal, along with the Independent Insurance Agents and Brokers of America and several other insurance companies, which will provide independent agents a more robust online presence on the Internet.

A.M. Best is maintaining a stable outlook for the personal lines industry, which implies their rating actions are expected to be widely affirmed with a fairly balanced distribution of negative and positive rating actions. The personal lines market has been more receptive to price increases, and our Personal Lines operations continue to experience NPW growth driven by ongoing rate increases that went into effect in 2010 and 2011. Rate increases that we were able to achieve in 2011 are expected to generate an additional $18.0 million in annual premium. In addition, we were able to generate Personal Lines renewal pure price increases of 6.2% in 2011, while retention increased one point to 86%. While underlying results show improvement in this line during the fourth quarter of 2011, they are still not where they need to be. The extreme volatility associated with the homeowners line due to continued weather related property losses led to $37.6 million, or 36.6 points, of catastrophe losses in 2011. We will continue to focus on driving rate and mix of business changes across our Personal Lines book to improve profitability.

We are expecting to generate a 2012 full year statutory combined ratio of 101.5% and a GAAP combined ratio of 102.5%, which includes a catastrophe loss assumption of 2.5 points. Combined ratios do not include any assumptions for reserve development, favorable or unfavorable. In addition, we expect that investment income will be approximately flat with 2011 levels. Weighted average shares at year-end 2012 are expected to be approximately 55.6 million.

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Review of Underwriting Results by Lines of Business

Commercial Lines

($ in thousands)	2011	2010	2011 vs. 2010	2009	2010 vs. 2009
GAAP Insurance Operations Results:					
NPW	$1,212,137	1,133,876	7 %	1,194,796	(5)%
NPE	1,174,861	1,174,282	-	1,214,952	(3)
Less:					
Losses and loss expenses incurred	835,532	790,369	6	809,430	(2)
Net underwriting expenses incurred	393,473	381,703	3	387,494	(1)
Dividends to policyholders	5,284	3,878	36	3,640	7
Underwriting (loss) income	$(59,428)	(1,668)	3,463 %	14,388	(112)%
GAAP Ratios:					
Loss and loss expense ratio	71.1 %	67.3	3.8 pts	66.6	0.7 pts
Underwriting expense ratio	33.6	32.5	1.1	31.9	0.6
Dividends to policyholders ratio	0.4	0.3	0.1	0.3	-
Combined ratio	105.1	100.1	5.0	98.8	1.3
Statutory Ratios:					
Loss and loss expense ratio	71.1	67.3	3.8	66.6	0.7
Underwriting expense ratio	32.8	33.2	(0.4)	32.9	0.3
Dividends to policyholders ratio	0.4	0.3	0.1	0.3	-
Combined ratio	104.3 %	100.8	3.5 pts	99.8	1.0 pts

- NPW increased 7% in 2011 compared to 2010, which reflects the following:
  - Renewal pure price increases of 2.8% coupled with strong retention with a one-point increase to 80%;
  - $24.1 million in E&S premium in 2011 resulting from our renewal rights acquisition in August 2011; and
  - $14.5 million in additional audit and endorsement premium, a $62.4 million improvement in 2011.

NPW decreased 5% in 2010 compared to 2009, which reflects the following:

  - $47.9 million in audit and endorsement return premiums; and
  - Net renewals of $1.0 billion in 2010, a $24.2 million reduction compared to 2009.

Partially offsetting these decreases was direct new business of $210.8 million in 2010.

- The 2010 NPW decrease was offset by the NPW increase in 2011 leaving NPE largely unchanged over the period. However, the decrease in NPW from 2009 to 2010 resulted in a NPE decrease in 2010.

- The variances in the GAAP loss and loss expense ratio in both periods were reflective of increased catastrophe losses, coupled with the impact of favorable prior year casualty development, a summary of which follows:

($ in thousands)

For the Year Ended December 31,	Catastrophe Losses Incurred	**Impact on Loss Ratio**	Favorable Prior Year Casualty Development	**Impact on Loss Ratio**	Total Loss Ratio Impact
2011	$ 75,207	6.4 pts	$ 29,000	(2.5)pts	3.9
2010	38,593	3.3	37,000	(3.2)	0.1
2009	5,791	0.5	27,000	(2.2)	(1.7)

Catastrophe losses included losses from Hurricane Irene, which pierced the first layer of our catastrophe excess of loss treaty. Hurricane Irene’s impact to Commercial Lines was $21.7 million, net of reinsurance, or 1.8 points.

Prior year casualty development was driven by the following:

($ in millions)	Favorable/(Unfavorable)		
Line of Business	2011	2010	2009
Commercial Auto Liability	$ 13	28	10
General Liability	12	26	8
Business Owners Property Liability	10	3	-
Workers Compensation	(7)	(22)	11
Other	1	2	(2)

The increase in the GAAP underwriting expense ratio of 1.1 points in 2011 compared to last year, was driven by expenses associated with our purchase of the E&S renewal book of business in 2011. The majority of these expenses, or $4.7 million, are directly related to the acquisition and will not impact the on-going results of this operation. However, as MUSIC unearned premiums as of the acquisition date were fully ceded, our underwriting expense ratio will be under pressure going forward until such time as premiums that we write subsequent to the purchase are earned to support the expenses of these operations.

The GAAP underwriting expense ratio increased in 2010 compared to 2009, which was primarily due to declines in premiums earned coupled with the one-time benefit recognized in 2009 for the elimination of retiree life insurance benefits for current employees.

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

General Liability

($ in thousands)	2011	2010	2011 vs. 2010	2009	2010 vs. 2009
Statutory NPW	$351,561	323,276	9 %	352,336	(8)%
Statutory NPE	344,682	336,475	2	362,479	(7)
Statutory combined ratio	100.7 %	96.4	5.5 pts	102.9	(6.5)pts
% of total statutory commercial NPW	29 %	29		29	

NPW increased in 2011 driven by improved economic conditions reflected in audit and endorsement premiums. During the three-year period, our premium subject to audit in this line was approximately 50%. At the end of the policy period, actual exposure units (usually sales or payroll) on policies with premium subject to audit are compared to beginning of period estimates and a return premium or additional premium transaction occurs. Audits and endorsements resulted in additional premium of $3.9 million in 2011 compared to return premium of $24.6 million in 2010. We also continued to see improvements in pricing in this line as our renewal pure price increase was 3.7% in 2011 coupled with increases of 4.2% and 1.6% in 2010 and 2009, respectively.

In 2010, the economic weakness and competitive nature of the insurance marketplace negatively impacted NPW on this line compared to 2009 as evidenced by the following:

- o Net renewals were down 5%, or $15.2 million, to $302.9 million despite our ability to achieve pure price as indicated above;
- o New business was down 21%, or $14.8 million, to $56.7 million; and
- o Continued pressure from audit and endorsement activity, which resulted in a return premium of $24.6 million in 2010 and $27.2 million in 2009.

The fluctuations in the statutory combined ratios were driven by favorable prior year development. Favorable prior year development in the general liability line of business is often volatile year to year and, therefore, requires a longer period of time before true trends are recognized and can be acted upon.

The impact of the prior year favorable development shown above was as follows:

- · 2011: 3.3 points, driven by favorable development on the premises and operations coverages for accident years 2009 and prior, largely offset by adverse development for the products coverage in 2010 and prior;
- · 2010: 7.9 points, driven by 2006 and prior accident years; and
- · 2009: 2.3 points.

Commercial Automobile

($ in thousands)	2011	2010	2011 vs. 2010	2009	2010 vs. 2009
Statutory NPW	$282,825	281,365	1 %	298,036	(6)%
Statutory NPE	279,610	291,495	(4)	300,562	(3)
Statutory combined ratio	94.2 %	90.2	4.0 pts	98.2	(8.0)pts
% of total statutory commercial NPW	23 %	25		25	

NPW remained relatively flat in 2011 compared to last year while NPW decreased in 2010 compared to 2009. NPE decreased throughout the three-year period which was a reflection of the economic factors that put pressure on NPW as exposure levels declined in 2010.

The fluctuations in the statutory combined ratio were driven by favorable prior year casualty development as shown above was as follows:

- 2011: 4.6 points, in 2011 driven by the 2007 through 2009 accident years, representing a continued trend driven by lower frequencies in those years;
- 2010: 9.6 points, driven by lower than anticipated severity primarily in accident years 2004 through 2009; and
- 2009: 3.2 points, driven by lower than anticipated severity primarily in accident year 2007.

Workers Compensation

($ in thousands)	2011	2010	2011 vs. 2010	2009	2010 vs. 2009
Statutory NPW	$261,348	237,409	10 %	251,121	(5)%
Statutory NPE	259,354	250,456	4	263,490	(5)
Statutory combined ratio	116.2 %	124.2	**(8.0)pts**	107.6	16.6 pts
% of total statutory commercial NPW	22 %	21		21	

As economic conditions have begun to stabilize and unemployment has leveled off, audit and endorsement premium in 2011 became more neutral resulting in additional premium of $11.2 million, compared to return premiums of $20.5 million in 2010 and $29.2 million in 2009, thus driving the increase in the current year. The decrease in 2010 as compared to 2009 reflects pressure on net renewals and new business, further reflecting economic conditions in those years.

The fluctuations in the statutory combined ratio were primarily attributable to the impact of prior year casualty development on current year results as shown above was as follows:

- 2011: unfavorable by 2.7 points, driven by the 2010 accident year, representing a continued trend related to increased severities in recent years, partially offset by various earlier accident years;
- 2010: unfavorable by 8.3 points, driven by increased severity in the 2008 and 2009 accident years; and
- 2009: favorable by 3.9 points, primarily driven by accident years 2005 to 2007, partially offset by adverse severity in accident year 2008.

Commercial Property

($ in thousands)	2011	2010	2011 vs. 2010	2009	2010 vs. 2009
Statutory NPW	$195,927	194,382	1 %	199,707	(3)%
Statutory NPE	192,989	199,252	(3)	197,665	1
Statutory combined ratio	109.9 %	93.7	**16.2 pts**	83.9	9.8 pts
% of total statutory commercial NPW	16 %	17		17	

NPW and NPE were relatively flat over the three-year period. However, the increase in the statutory combined ratios over the three-year period were largely due to the increases in catastrophe losses as shown below:

($ in thousands) For the Year Ended December 31,	Catastrophe Losses Incurred	Impact on Loss Ratio
2011	$ 59,662	30.9 pts
2010	31,824	16.0
2009	3,897	2.0

Business Owners Property

($ in thousands)	2011	2010	2011 vs. 2010	2009	2010 vs. 2009
Statutory NPW	$67,580	66,079	2 %	64,958	2 %
Statutory NPE	66,225	65,260	1	62,638	4
Statutory combined ratio	109.8 %	116.0	(6.2)pts	116.4	(0.4)pts
% of total statutory commercial NPW	6 %	6		5	

NPW and NPE were relatively flat over the three-year period. The decrease in the statutory combined ratio in 2011 compared to 2010 was largely due to lower estimates of current year loss costs, coupled with favorable prior year development. These items were partially offset by elevated catastrophe losses.

Favorable statutory prior year casualty development was as follows:

- 2011: 15.5 points driven by favorable development on liability coverage for accident years 2008 through 2010; and
- 2010: 5.0 points.

Catastrophe losses were as follows

- o 2011: $12.4 million, or 18.7 points;
- o 2010: $5.3 million, or 8.2 points; and
- o 2009: $1.4 million, or 2.2 points.

Personal Lines

($ in thousands)	2011	2010	2011 vs. 2010	2009	2010 vs. 2009
GAAP Insurance Operations Results:					
NPW	$273,212	256,665	6 %	227,859	13 %
NPE	264,452	242,316	9	216,095	12
Less:					
Losses and loss expenses incurred	239,455	191,749	25	162,475	18
Net underwriting expenses incurred	72,488	71,066	2	65,623	8
Underwriting loss	$(47,491)	(20,499)	(132)%	(12,003)	(71)%
GAAP Ratios:					
Loss and loss expense ratio	90.5 %	79.1	11.4 pts	75.2	3.9 pts
Underwriting expense ratio	27.5	29.4	(1.9)	30.4	(1.0)
Combined ratio	118.0	108.5	9.5	105.6	2.9
Statutory Ratios:					
Loss and loss expense ratio	90.5	79.2	11.3	75.2	4.0
Underwriting expense ratio	26.8	27.2	(0.4)	29.2	(2.0)
Combined ratio	117.3 %	106.4	10.9 pts	104.4	2.0 pts

· The increase in NPW in 2011 compared to 2010 was primarily due to:

o Rate increases of 6.8%, or $17.9 million, that went into effect across our Personal Lines footprint during 2011; and

o Improved retention of one-point to 86%; and

o New business direct premiums written of $50.2 million compared to $62.0 million in 2010.

The increase in NPW in 2010 compared to 2009 was primarily due to:

o Rate increases of 6.3%, or $14.8 million, that went into effect across our Personal Lines footprint during 2010;

o Improved retention of two points to 85%; and

o New business direct premium written of $62.0 million compared to $55.2 million in 2009.

· NPE over the three-year period was consistent with the NPW increases in 2011 compared to 2010 and 2009 as discussed above.

· The 11.4-point increase in the GAAP loss and loss expense ratio in 2011 compared to 2010 was primarily attributable to an increase in property losses of $42.4 million, or 12.7 points, which includes an increase in catastrophe losses of $25.7 million, or 9.1 points. The unprecedented level of catastrophe losses in 2011 we incurred included losses from Hurricane Irene of $17.9 million, or 6.8 points. Partially offsetting these losses were claims handling fees earned on our flood book of business that increased $4.4 million, or 1.6 points, from 2010. These claims handling fees reflect the significant flooding activity during the year throughout the Northeast and Mid-Atlantic states.

The 3.9-point increase in the GAAP loss and loss expense ratio in 2010 compared to 2009 was also driven by elevated property losses of $27.0 million, or 7.7 points, which included an increase in catastrophe losses of $15.1 million, or 6.1 points.

- The decrease in the GAAP underwriting expense ratio in 2011 and 2010 as compared to the respective prior years reflects the impact of premiums outpacing expenses, driven by the rate increases we have been able to obtain over the three-year period. On a statutory basis, the impact of this trend is recognized immediately in the expense ratio while on a GAAP basis, the impact is recognized over the course of one year, which is generally the term of our Personal Lines policies.

Reinsurance

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

- *Property Reinsurance* – includes our Property Excess of Loss treaties purchased for protection against large individual property losses and our Property Catastrophe treaty purchased to provide protection for the overall property portfolio against severe catastrophic events. Facultative reinsurance is also used for property risks that are in excess of our treaty capacity.
- *Casualty Reinsurance* – purchased to provide protection for both individual large casualty losses and catastrophic casualty losses involving multiple claimants or insureds. Facultative reinsurance is also used for casualty risks that are in excess of our treaty capacity.
- *Terrorism Reinsurance* – available as a federal backstop related to terrorism losses as provided under the TRIA. For further information regarding this legislation, see Item 1A. “Risk Factors.” of this Form 10-K.
- *Flood Reinsurance* – as a servicing carrier in the WYO Program, we receive a fee for writing flood business, for which the related premiums and losses are ceded to the federal government.
- *Other Reinsurance* – includes other treaties that we do not consider core to our reinsurance program, such as our Surety and Fidelity Excess of Loss, NWCRP and our Equipment Breakdown Coverage treaties, which do not fall within the categories above.

In addition to the above categories, we have entered into several reinsurance agreements with Montpelier Re Insurance Ltd. as part of the acquisition of MUSIC. Together, these agreements provide protection for losses on policies written prior to the acquisition and any development on reserves established by MUSIC as of the date of acquisition. The reinsurance recoverables under these treaties are 100% collateralized.

Information regarding the terms and related coverage associated with each of our categories of reinsurance above can be found in Item 1. “Business.” of this Form 10-K.

We regularly reevaluate our overall reinsurance program and try to develop effective ways to manage transfer of risk. Our analysis is based on a comprehensive process that includes periodic analysis of modeling results, aggregation of exposures, exposure growth, diversification of risks, limits written, projected reinsurance costs, financial strength of reinsurers, and projected impact on earnings and statutory surplus. We strive to balance sometimes opposing considerations of reinsurer credit quality, price, terms, and our appetite for retaining a certain level of risk.

Property Reinsurance

The Property Catastrophe treaty, which covers both our standard market and E&S business, renewed effective January 1, 2012 at an increase in premium of 19% for the same coverage, which reflected increased exposure change and recent market trends due to increased global catastrophe losses. The current treaty structure provides coverage of $435 million in excess of $40 million and the annual aggregate limit net of our co-participation continues to be

approximately $790 million for 2012.

We continue to assess our property catastrophe exposure aggregations, modeled results, and effects of growth on our property portfolio, and strive to manage our exposure to individual large events balanced against the cost of reinsurance protections.

Although we model various catastrophic perils, due to our geographic spread, the risk of hurricane continues to be the most significant natural catastrophe peril to which our portfolio is exposed. Below is a summary of the largest four actual hurricane losses that we experienced in the past 22 years:

Hurricane Name	**Actual Gross Loss ($ in millions)**	**Accident Year**
Hurricane Irene	$ 46.5 [1]	2011
Hurricane Hugo	26.0	1989
Hurricane Floyd	14.5	1999
Hurricane Isabel	13.4	2003

[1] This amount represents reported and unreported gross losses estimated as of December 31, 2011.

We use the results of the Risk Management Solutions ("RMS") and AIR Worldwide ("AIR") models in our review of exposure to hurricane risk. Each of these third party models provides two views of the modeled results. A long-term view closely relates modeled event frequency to historical hurricane activity, while a near-term view adjusts historical frequencies to reflect expectations of elevated hurricane activity in the North Atlantic Basin in the short to medium term. It is our view that modeled estimates provide a range of potential outcomes and multiple estimates should be reviewed for purposes of understanding catastrophic risk. The RMS v. 11.0 model substantially increased vulnerability of construction assumptions and increased wind hazards further inland for our book of business. Other changes included storm surge, demand surge, and hurricane frequency. Reinsurance brokers indicate that the RMS version change created significant increases in modeled losses across portfolios with different geographic and business mix attributes. The following table provides long-term and near-term views of blended RMS v.11.0 and AIR v.13.0 modeled hurricane results based on the Insurance Subsidiaries' combined property book as of July 2011, adjusted to include our recent E&S acquisitions:

($ in thousands)	Long-Term Basis			Near-Term Basis		
Occurrence Exceedence Probability	Gross Losses	Net **Losses[1]**	Net Losses as a Percent of **Equity[2]**	Gross Losses	Net **Losses[1]**	Net Losses as a Percent of **Equity[2]**
4.0% (1 in 25 year event)	$94,167	25,435	2 %	$119,825	25,856	2 %
2.0% (1 in 50 year event)	187,903	30,159	3	227,160	32,429	3
1.0% (1 in 100 year event)	333,264	37,858	3	395,028	42,239	4
0.4% (1 in 250 year event)	667,243	173,004	16	768,144	233,804	21

[1] Losses are after tax and include applicable reinstatement premium.

[2] Equity as of December 31, 2011.

Our current catastrophe reinsurance program covers up to a 1 in 159 year return period, or events with 0.6% probability, based on a multi-model view of hurricane risk.

The Property Excess of Loss treaty ("Property Treaty"), which covers our standard market business, was renewed on July 1, 2011 and is effective through June 30, 2012, with the same terms as the expiring treaty. This treaty provides a per risk coverage of $28.0 million in excess of a $2.0 million retention.

- The per occurrence cap on the total program is $64.0 million.
- The first layer continues to have unlimited reinstatements. The annual aggregate limit for the second, $20.0 million in excess of $10.0 million, layer remains at $80.0 million.
- Consistent with the prior year treaty, the Property Treaty excludes nuclear, biological, chemical, and radiological terrorism losses.

Casualty Reinsurance

The Casualty Excess of Loss treaty ("Casualty Treaty"), which covers our standard market business, was renewed on July 1, 2011 and is effective through June 30, 2012, with the same terms as the expiring treaty. The current program provides the following coverage:

- Six layers provide coverage for 100% of up to $88.0 million in excess of a $2.0 million retention.
- Consistent with the prior year, the Casualty Treaty excludes nuclear, biological, chemical, and radiological terrorism losses.
- Annual aggregate terrorism limits, net of co-participation, increased to $201.0 million.

Investments

Our investment philosophy includes certain return and risk objectives for the fixed maturity, equity, and other investment portfolios. The primary fixed maturity portfolio return objective is to maximize after-tax investment yield and income while balancing risk. A secondary objective is to meet or exceed a weighted-average benchmark of public fixed income indices. Within the equity portfolio, the high dividend yield strategy, which we implemented in 2011, is designed to generate consistent dividend income while maintaining a minimal tracking error to the S&P 500 Index. Additional equity strategies are focused on meeting or exceeding strategy specific benchmarks of public equity indices. Although yield and income generation remain the key drivers to our investment strategy, our overall philosophy is to invest with a long-term horizon along with predominately a "buy-and-hold" approach. The return objective of the other investment portfolio, which includes alternative investments, is to meet or exceed the S&P 500 Index.

Total Invested Assets

($ in thousands)	2011	2010	Change	
Total invested assets	$4,112,421	3,925,722	5	%
Unrealized gain – before tax	149,612	82,874	81	
Unrealized gain – after tax	97,248	53,868	81	

This increase in our investment portfolio was driven primarily by: (i) operating cash flows generated from Insurance Operations; (ii) proceeds from a borrowing with the Federal Home Loan Bank of Indiana ("FHLBI"); and (iii) valuation improvements on securities in our AFS portfolio. The cash generated from our Insurance Operations was used to invest in our high dividend yield equities strategy and to purchase AFS fixed maturity securities. We increased our outstanding borrowing with the FHLBI from $13.0 million to $58.0 million in the fourth quarter of 2011 to borrow funds at favorable interest rates in connection with our year-end acquisition of MUSIC. We acquired $40.5 million in short-term investments and $7.9 million in fixed maturity securities as part of the MUSIC acquisition.

We structure our portfolio conservatively with a focus on: (i) asset diversification; (ii) investment quality; (iii) liquidity, particularly to meet the cash obligations of our Insurance Operations segment; (iv) consideration of taxes; and (v) preservation of capital. We believe that we have a high quality and liquid investment portfolio. The breakdown of our investment portfolio is as follows:

As of December 31,	2011		2010	
U.S. government obligations	9	%	11	%
Foreign government obligations	1		1	
State and municipal obligations	30		36	
Corporate securities	31		27	

Mortgage-backed securities ("MBS")	15	14
ABS	2	2
Total fixed maturity securities	88	91
Equity securities	4	2
Short-term investments	5	4
Other investments	3	3
Total	100 %	100 %

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Fixed Maturity Securities

The average duration of the fixed maturity securities portfolio as of December 31, 2011 was 3.2 years compared to the Insurance Subsidiaries' liability duration of approximately 3.8 years, which was relatively consistent with the prior year. The current duration of the fixed maturity securities portfolio is within our historical range, and is monitored and managed to maximize yield and limit interest rate risk. We are currently experiencing pressure on our yields within our fixed maturity securities portfolio, as higher yielding bonds that are either maturing or have been sold are being replaced with the lower yielding bonds that are currently available in the marketplace. We manage liquidity with a laddered maturity structure and an appropriate level of short-term investments to avoid liquidation of AFS fixed maturities in the ordinary course of business. We typically have a long investment time horizon, and every purchase or sale is made with the intent of improving future investment returns while balancing capital preservation. During 2011, we continued to migrate from state and municipal obligations to investment-grade corporate bonds as part of our overall investment strategy, due to the more attractive risk/return characteristics of the corporate sector.

The weighted average credit rating on our fixed maturity portfolio migrated to AA- at December 31, 2011, from AA at December 31, 2010. This slightly lower average rating is largely the result of: (i) the S&P downgrade of U.S. sovereign debt in August 2011; and (ii) our recent increased allocation to investment-grade corporate bonds. The following table presents the credit ratings of our fixed maturity securities portfolio:

Fixed Maturity Rating	December 31, 2011		December 31, 2010	
Aaa/AAA	14	%	42	%
Aa/AA	52		28	
A/A	24		21	
Baa/BBB	9		8	
Ba/BB or below	1		1	
Total	100	%	100	%

For further details on how we manage overall credit quality and the various risks to which our portfolio is subject, see Item 7A. "Quantitative and Qualitative Disclosures About Market Risk." of this Form 10-K.

Equity Securities

In line with our high dividend yield equities strategy mentioned above, we increased the holdings in our equity portfolio to 4% of invested assets in 2011 from 2% of invested assets in 2010. This high dividend yield equities strategy more than doubled our dividend income in 2011 compared to 2010.

Other Investments

As of December 31, 2011, alternative investments represented 3% of our total invested assets. The following table outlines a summary of our other investment portfolio by strategy and the remaining commitment amount associated with each strategy:

Other Investments			2011
	Carrying Value		Remaining
($ in thousands)	December 31, 2011	December 31, 2010	Commitment
Alternative Investments:			
Secondary private equity	$30,114	26,709	9,507
Energy/power generation	25,913	35,560	10,608
Private equity	21,736	21,601	5,368
Distressed debt	16,953	20,432	3,136
Real estate	13,767	14,192	10,569
Mezzanine financing	8,817	10,230	15,256
Venture capital	7,248	6,386	900
Total alternative investments	124,548	135,110	55,344
Other securities	3,753	2,755	1,521
Total other investments	$128,301	137,865	56,865

In addition to the capital that we have already invested to date, we are contractually obligated to invest up to an additional $56.9 million in our other investment portfolio through commitments that currently expire at various dates through 2022. At this time, our alternative investment strategies do not invest in hedge funds. For further discussion of our seven alternative investment strategies outlined above, as well as redemption, restrictions, and fund liquidations, see Note 5. “Investments” in Item 8. “Financial Statements and Supplementary Data.” of this Form 10-K.

Net Investment Income

The components of net investment income earned were as follows:

($ in thousands)	2011	2010	2009
Fixed maturity securities	$129,710	130,990	141,882
Equity securities	4,535	2,238	2,348
Trading securities	-	-	262
Short-term investments	160	437	1,273
Other investments	20,539	20,313	(21,726)
Miscellaneous income	133	139	343
Investment expenses	(7,634)	(8,409)	(5,911)
Net investment income earned – before tax	147,443	145,708	118,471
Net investment income tax expense	36,355	34,649	22,746
Net investment income earned – after tax	$111,088	111,059	95,725
Effective tax rate	24.7 %	23.8	19.2
Annual after-tax yield on fixed maturity securities	2.8	2.9	3.5
Annual after-tax yield on investment portfolio	2.8	2.9	2.6

While net investment income remained relatively flat in 2011 compared to 2010, its components reflect increased dividend income from the high dividend yield equities strategy that we implemented during the year, partially offset by lower yields on our fixed maturity securities. In 2011, bonds that matured or were sold, valued at $481.9 million, had yields that averaged 3.8%, pre-tax, while new purchases of $490.8 million had an average yield of 2.7%.

Income from our other investments, specifically our alternative investment portfolio, was the primary driver of the increase in investment income during 2010 compared to 2009. This increase reflects the improved equity and credit markets in 2010 compared to the prior year. Partially offsetting these improved returns was a $10.9 million reduction in income on our fixed maturity securities portfolio reflecting the currently low interest rate environment. In 2010, bonds that matured or were sold, valued at $808.3 million, had average pre-tax yields of 3.8%, while new purchases of $1.0 billion had an average yield of 2.8%.

For further discussion of net investment income, see Note 5. “Investments” in Item 8. “Financial Statements and Supplementary Data.” of this Form 10-K.

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Realized Gains and Losses

Realized Gains and Losses (excluding OTTI)

Realized gains and losses, by type of security, excluding OTTI charges, are determined on the basis of the cost of specific investments sold and are credited or charged to income. The components of net realized gains (losses) were as follows:

Realized Gains (Losses) Excluding OTTI ($ in thousands)	2011	2010	2009
HTM fixed maturity securities			
Gains	$4	569	225
Losses	(564)	(894)	(1,049)
AFS fixed maturity securities			
Gains	9,385	8,161	20,899
Losses	(70)	(7,619)	(13,889)
AFS equity securities			
Gains	6,671	16,698	33,355
Losses	-	(1,156)	(28,056)
Other investments			
Gains	-	-	-
Losses	-	(5,184)	(2,039)
Total other net realized investment gains	15,426	10,575	9,446
Total OTTI charges recognized in earnings	(13,186)	(17,658)	(55,416)
Total net realized gains (losses)	$2,240	(7,083)	(45,970)

For a discussion of realized gains and losses, see Note 5. “Investments” in Item 8. “Financial Statements and Supplementary Data.” of this Form 10-K.

There were no securities sold at a loss during 2011. The following table presents the period of time that securities sold at a loss were continuously in an unrealized loss position prior to sale for 2010 and 2009:

Period of Time in an Unrealized Loss Position	2010		2009	
($ in thousands)	Fair Value on Sale Date	Realized Loss	Fair Value on Sale Date	Realized Loss
Fixed maturities:				
0 – 6 months	$11,462	463	54,287	6,951
7 – 12 months	-	-	38,292	3,424

Greater than 12 months	10,257	7,098	39,241	3,420
Total fixed maturities	21,719	7,561	131,820	13,795
Equities:				
0 – 6 months	13,914	739	29,567	20,620
7 – 12 months	3,173	417	8,230	7,436
Greater than 12 months	-	-	-	-
Total equity securities	17,087	1,156	37,797	28,056
Other Investments:				
0 – 6 months	16,357	5,184	-	-
7 – 12 months	-	-	4,816	1,189
Total other investments	16,357	5,184	4,816	1,189
Total	$55,163	13,901	174,433	43,040

During 2010, we sold certain AFS fixed maturity securities that were in an unrealized loss position that our new external investment managers had recommended that we sell during their review of the portfolio. This recommendation was due to ongoing credit concerns of the underlying investments coupled with strategically positioning the portfolio to generate maximum yield while balancing risk objectives. In addition, as part of our transition to the newly hired external investment managers, in the third quarter of 2010, we changed our intent regarding certain equity holdings that we sold to lower our equity exposure and pursue a more index-neutral position for this asset class in the near term, providing greater sector and sponsor diversification. In the fourth quarter of 2010, we sold certain limited partnerships within our other investments at a loss to reduce our exposure in the mezzanine financing, private equity, secondary private equity, and real estate sectors of our alternative investment portfolio, as well as to reduce certain vintage year and sponsor concentrations.

Our general philosophy for sales of securities is to reduce our exposure to securities and sectors based on economic evaluations and when the fundamentals for that security or sector have deteriorated. We typically have a long investment time horizon and every purchase or sale is made with the intent of improving future investment returns while balancing capital preservation. For additional discussions, see Note 5. “Investments” in Item 8. “Financial Statements and Supplementary Data.” of this Form 10-K.

Other-than-Temporary Impairments

The following table provides information regarding our OTTI charges recognized in earnings:

($ in thousands)	2011	2010	2009
HTM securities			
ABS	$-	31	2,482
CMBS	-	4,215	11,777
RMBS	-	419	-
Total HTM securities	-	4,665	14,259
AFS securities			
Corporate securities	244	-	1,271
Obligations of state and political subdivisions	17	197	-
ABS	721	128	-
CMBS	694	2,200	-
RMBS	145	7,925	37,779
Total fixed maturity AFS securities	1,821	10,450	39,050
Equity securities	11,365	2,543	2,107
Total AFS securities	13,186	12,993	41,157
Total OTTI charges recognized in earnings	$13,186	17,658	55,416

We regularly review our entire investment portfolio for declines in fair value. If we believe that a decline in the value of a particular investment is other than temporary, we record it as an OTTI, through realized losses in earnings for the credit-related portion and through unrealized losses in OCI for the non-credit related portion for fixed maturity securities. If there is a decline in fair value of an equity security that we do not intend to hold, or if we determine the decline is other than temporary, we write down the cost of the investment to fair value and record the charge through earnings as a component of realized losses.

For a discussion of our OTTI methodology, see Note 2. “Summary of Significant Accounting Policies” in Item 8. “Financial Statements and Supplementary Data.” of this Form 10-K. In addition, for significant inputs used to measure OTTI and qualitative information regarding these charges, see Note 5. “Investments” in Item 8. “Financial Statements and Supplementary Data.” of this Form 10-K.

Unrealized/Unrecognized Losses

The following table summarizes the aggregate fair value and gross pre-tax unrealized/unrecognized losses recorded, by asset class and by length of time, for all securities that have continuously been in an unrealized/unrecognized loss position at December 31, 2011 and December 31, 2010:

December 31, 2011	Less than 12 months		12 months or longer	
($ in thousands)	Fair Value	Unrealized **Losses**[1]	Fair Value	Unrealized **Losses**[1]
AFS securities:				
Foreign government	$ 8,299	(556)	-	-
Obligations of states and political subdivisions	517	(1)	1,740	(45)
Corporate securities	157,510	(4,415)	14,084	(881)
ABS	15,808	(14)	702	(32)
CMBS	4,822	(48)	14,564	(1,619)
RMBS	29,803	(625)	15,007	(1,142)
Total fixed maturity securities	216,759	(5,659)	46,097	(3,719)
Equity securities	743	(88)	-	-
Subtotal	$ 217,502	(5,747)	46,097	(3,719)

	Less than 12 months			12 months or longer		
($ in thousands)	Fair Value	Unrealized **Losses**[1]	Unrecognized **Gains**[3]	Fair Value	Unrealized **Losses**[1]	Unrecognized **Gains**[3]
HTM securities:						
Obligations of states and political subdivisions	$7,244	(94)	78	9,419	(519)	324
ABS	-	-	-	2,816	(1,009)	737
CMBS	-	-	-	2,794	(1,447)	761
Subtotal	$7,244	(94)	78	15,029	(2,975)	1,822
Total AFS and HTM	$224,746	(5,841)	78	61,126	(6,694)	1,822

December 31, 2010	Less than 12 months		12 months or longer	
($ in thousands)	Fair Value	Unrealized Losses[1]	Fair Value	Unrealized Losses[1]
AFS securities:				
U.S. government and government agencies[2]	$3,956	(147)	-	-
Foreign government	10,776	(349)	-	-
Obligations of states and political subdivisions	40,410	(650)	-	-
Corporate securities	362,502	(8,784)	-	-
ABS	30,297	(273)	880	(66)
CMBS	5,453	(271)	11,115	(2,652)
RMBS	70,934	(1,098)	20,910	(1,145)
Total fixed maturity securities	524,328	(11,572)	32,905	(3,863)
Equity securities	-	-	-	-
Subtotal	$524,328	(11,572)	32,905	(3,863)

	Less than 12 months			12 months or longer		
($ in thousands)	Fair Value	Unrealized (Losses) Gains[1]	Unrecognized Gains (Losses)[3]	Fair Value	Unrealized Losses[1]	Unrecognized Gains[3]
HTM securities:						
Obligations of states and political subdivisions	$21,036	(381)	45	27,855	(1,969)	670
Corporate securities	1,985	(434)	420	-	-	-
ABS	507	(546)	(440)	2,931	(1,095)	747
CMBS	3,621	15	(17)	5,745	(3,933)	833
RMBS	-	-	-	95	(38)	1
Subtotal	$27,149	(1,346)	8	36,626	(7,035)	2,251
Total AFS and HTM	$551,477	(12,918)	8	69,531	(10,898)	2,251

1 Gross unrealized losses include non-OTTI unrealized amounts and OTTI losses recognized in AOCI. In addition, this column includes remaining unrealized gain or loss amounts on securities that were transferred to a HTM designation in the first quarter of 2009 for those securities that are in a net unrealized/unrecognized loss position.

2 U.S. government includes corporate securities fully guaranteed by the Federal Deposit Insurance Corporation (“FDIC”).

3 Unrecognized holding gains/(losses) represent market value fluctuations from the later of: (i) the date a security is designated as HTM; or (ii) the date that an OTTI charge is recognized on an HTM security.

As evidenced by the table below, our unrealized/unrecognized loss positions improved $10.9 million as of December 31, 2011 compared to last year as follows:

($ in thousands)

December 31, 2011			December 31, 2010		
Number of Issues	% of Market/Book	Unrealized Unrecognized Loss	Number of Issues	% of Market/Book	Unrealized Unrecognized Loss
140	80% - 99%	$ 10,166	193	80% - 99%	$ 16,310
-	60% - 79%	-	2	60% - 79%	1,125
1	40% - 59%	469	2	40% - 59%	2,160
-	20% - 39%	-	1	20% - 39%	986
-	0% - 19%	-	1	0% - 19%	976
		$ 10,635			$ 21,557

We have reviewed the securities in the tables above in accordance with our OTTI policy as discussed previously in "Critical Accounting Policies and Estimates" of this Form 10-K. For qualitative information regarding our conclusions as to why these impairments are deemed temporary, see Note 5. "Investments" in Item 8. "Financial Statements and Supplementary Data." of this Form 10-K.

The following table presents amortized cost and fair value regarding our AFS fixed maturities that were in an unrealized loss position at December 31, 2011 by contractual maturity:

Contractual Maturities ($ in thousands)	Amortized Cost	Fair Value
One year or less	$ 29,862	28,631
Due after one year through five years	179,276	173,276
Due after five years through ten years	60,930	59,088
Due after ten years	2,166	1,861
Total	$ 272,234	262,856

The following table presents information regarding our HTM fixed maturities that were in an unrealized/unrecognized loss position at December 31, 2011 by contractual maturity:

Contractual Maturities ($ in thousands)	Amortized Cost	Fair Value
One year or less	$ 266	266
Due after one year through five years	22,989	21,821
Due after five years through ten years	-	-
Due after ten years	187	186
Total	$ 23,442	22,273

Investments Outlook

The sluggish pace of the 2011 economic recovery continued during the second half of the year with third quarter real gross domestic product at 1.8%. The labor market reflected some improvement toward the end of the year with the Bureau of Labor Statistics report indicating that the December 2011 unemployment rate was 8.5%, the lowest reading of the year. However, commodity price increases, domestic housing market overhang, inflation expectations, sovereign debt stability, and slower global growth rates remain as 2012 begins. The equity and bond markets were volatile in the last half of 2011 and are likely to remain so for the first half of 2012. The Federal Reserve continues to maintain an accommodative monetary policy. Yields remain low and the Federal Reserve has indicated their expectation that this will continue through 2014. The outlook for 2012 reflects the continuing challenge for the fixed income portfolio in overcoming the spread between maturing assets and the reinvestment rate available, while maintaining credit quality.

Our fixed income strategy remains focused on maintaining sufficient liquidity while maximizing yield within acceptable risk tolerances. We will continue to invest in high quality instruments, including investment-grade corporate bonds with diversified maturities to manage incremental interest rate risk, and may opportunistically invest in below investment grade and/or municipal fixed maturity securities to take advantage of risk adjusted return opportunities.

The allocation to a high dividend yield equities strategy is being maintained, and has improved diversification in the equity portfolio while providing additional yield. The strategy is relatively sector-neutral, provides broad based exposure to the domestic equity market, and provides attractive current income yields.

Our current outlook for alternative investments remains positive, and private markets continue to offer attractive risk adjusted returns.

Federal Income Taxes

The following table provides information regarding federal income taxes from continuing operations:

($ in millions)	2011	2010	2009
Federal income tax (benefit) expense from continuing operations	(12.5)	12.6	(5.5)
Effective tax rate	(154)%	15	(14)

The reduction in federal income tax and effective tax rate in 2011 from 2010 was primarily due to an increase in underwriting losses driven by the extreme level of catastrophe events. The increase in 2010 compared to 2009 was primarily due to lower net realized losses from improved non-cash OTTI charges. For a reconciliation of our effective tax rate to the statutory rate of 35%, see Note 15. "Federal Income Tax" in Item 8. "Financial Statements and Supplementary Data." of this Form 10-K.

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

Capital resources and liquidity reflect our ability to generate cash flows from business operations, borrow funds at competitive rates, and raise new capital to meet operating and growth needs.

Liquidity

We manage liquidity with a focus on generating sufficient cash flows to meet the short-term and long-term cash requirements of our business operations. Our cash and short-term investment position was $218 million at December 31, 2011, which was comprised of $35 million at Selective Insurance Group, Inc. (the "Parent") and $183 million at the Insurance Subsidiaries. Additionally in 2011, the Parent has begun to build a portfolio, which amounted to approximately $20 million as of December 31, 2011, of high-quality, highly-liquid government and corporate fixed maturity investments to generate additional yield. The Insurance Subsidiaries' short-term position included $40.5 million in short-term investments acquired through our December 31, 2011 purchase of MUSIC. The Insurance Subsidiaries were also carrying additional short-term funds to provide liquidity associated with paying claims related to the historic levels of catastrophe losses that occurred during 2011, the remaining case and IBNR reserves of which amounted to approximately $29 million as of December 31, 2011. Short-term investments are generally maintained in AAA rated money market funds approved by the National Association of Insurance Commissioners.

Sources of cash for the Parent have historically consisted of dividends from the Insurance Subsidiaries, borrowings under lines of credit and the Federal Home Loan Bank of Indianapolis (FHLBI) through our Indiana-domiciled Insurance Subsidiaries' ("Indiana Subsidiaries") loan agreements, and the issuance of stock and debt securities. We continue to monitor these sources, giving consideration to our long-term liquidity and capital preservation strategies.

The Insurance Subsidiaries paid $63 million in dividends to the Parent in 2011 compared to our allowable ordinary dividend amount of approximately $110 million. Our maximum ordinary dividend amount in 2012 will be approximately $104 million. Any dividends to the Parent continue to be subject to the approval and/or review of the insurance regulators in the respective domiciliary states under insurance company holding acts, and are generally payable only from earned surplus as reported in the statutory annual statements of those subsidiaries as of the preceding December 31. Although past dividends have historically been met with regulatory approval, there is no assurance that future dividends that may be declared will be approved. For additional information regarding dividend restrictions, refer to Note 10. "Indebtedness" and Note 6. "Stockholders' Equity and Other Comprehensive Income (Loss)" in Item 8. "Financial Statements and Supplementary Data." of this Form 10-K.

The Parent had no private or public issuances of stock or debt during 2011 and there were no borrowings under its $30 million line of credit ("Line of Credit"). The Indiana Subsidiaries' membership in the FHLBI provides these companies with access to additional liquidity. The Indiana Subsidiaries' aggregate investment of $2.9 million provides them with the ability to borrow up to 20 times the total amount of the FHLBI common stock purchased, at comparatively low borrowing rates. The Parent's Line of Credit agreement permits collateralized borrowings by the Indiana Subsidiaries from the FHLBI so long as the aggregate amount borrowed does not exceed 10% of the respective Indiana Subsidiary's admitted assets from the preceding calendar year. For additional information regarding the Parent's Line of Credit, refer to the section below entitled "Short-term Borrowings." All borrowings from FHLBI are required to be secured by certain investments. For additional information regarding the required collateral, refer to Note 5, "Investments" in Item 8. "Financial Statements and Supplementary Data." of this Form 10-K. The Indiana Department of Insurance has approved lending agreements from the Indiana Subsidiaries to the Parent for up to 10% of the admitted assets of the Indiana Subsidiaries. We increased our outstanding borrowing with the FHLBI from $13.0 million to $58.0 million in the fourth quarter of 2011 to borrow funds at favorable interest rates in connection with our year-end acquisition of MUSIC. These funds were loaned to the Parent under the approved lending agreements. Following this transaction, the Indiana Subsidiaries have the ability to borrow approximately $26 million more from the FHLBI until the Line of Credit maximum borrowings of 10% of admitted assets is reached. In addition, pursuant to the lending agreement between the Indiana Subsidiaries and the Parent, additional borrowings by the Parent are limited to approximately $15 million.

The Insurance Subsidiaries also generate liquidity through insurance float, which is created by collecting premiums and earning investment income before losses are paid. The period of the float can extend over many years. Our investment portfolio consists of maturity dates that are laddered to continually provide a source of cash flows for claims payments in the ordinary course of business. The duration of the fixed maturity portfolio, excluding short-term investments, was 3.2 years as of December 31, 2011, while the liabilities of the Insurance Subsidiaries have a duration of 3.8 years. In addition, the Insurance Subsidiaries purchase reinsurance coverage for protection against any significantly large claims or catastrophes that may occur during the year.

The liquidity generated from the sources discussed above is used, among other things, to pay dividends to our shareholders. Dividends on shares of the Parent's common stock are declared and paid at the discretion of the Board of Directors based on our operating results, financial condition, capital requirements, contractual restrictions, and other relevant factors.

Our ability to meet our interest and principal repayment obligations on our debt, as well as our ability to continue to pay dividends to our stockholders is dependent on liquidity at the Parent coupled with the ability of the Insurance Subsidiaries to pay dividends, if necessary, and/or the availability of other sources of liquidity to the Parent. Our next principal repayments of $13 million and $45 million are due in 2014 and 2016, respectively. Subsequent to 2016, our next principal repayment is due in 2034. Restrictions on the ability of the Insurance Subsidiaries to declare and pay dividends, without alternative liquidity options, could materially affect our ability to service debt and pay dividends on common stock.

Short-term Borrowings

Our Line of Credit was renewed on June 13, 2011 with Wells Fargo Bank, National Association, as administrative agent, and Branch Banking and Trust Company (BB&T), with a borrowing capacity of $30 million, which can be increased to $50 million with the approval of both lending partners. The Line of Credit provides the Parent an additional source of short-term liquidity. The interest rate on our Line of Credit varies and is based on, among other factors, the Parent's debt ratings. The Line of Credit expires on June 13, 2014. There were no balances outstanding under this credit facility as of December 31, 2011 or at any time during 2011.

The Line of Credit agreement contains representations, warranties, and covenants that are customary for credit facilities of this type, including, without limitation, financial covenants under which we are obligated to maintain a minimum consolidated net worth, minimum combined statutory surplus, and maximum ratio of consolidated debt to total capitalization, as well as covenants limiting our ability to: (i) merge or liquidate; (ii) incur debt or liens; (iii) dispose of assets; (iv) make investments and acquisitions; and (v) engage in transactions with affiliates. The Line of Credit permits collateralized borrowings by the Indiana Subsidiaries from the FHLBI so long as the aggregate amount borrowed does not exceed 10% of the respective Indiana Subsidiary's admitted assets from the preceding calendar year.

The table below outlines information regarding certain of the covenants in the Line of Credit:

	Required as of December 31, 2011	**Actual as of December 31, 2011**
Consolidated net worth	$793 million	$1,109 million
Statutory surplus	Not less than $750 million	$1,063 million[1]
Debt-to-capitalization ratio[2]	Not to exceed 35%	20.3%
A.M. Best financial strength rating	Minimum of A-	A+

[1] Statutory surplus includes the effect of the MUSIC acquisition.

[2] Calculated in accordance with Line of Credit agreement.

Capital Resources

Capital resources provide protection for policyholders, furnish the financial strength to support the business of underwriting insurance risks, and facilitate continued business growth. At December 31, 2011, we had statutory surplus and GAAP stockholders' equity of $1.1 billion. We had total debt of $307.4 million at December 31, 2011, which equates to a debt-to-capital ratio of approximately 21.7%.

Our cash requirements include, but are not limited to, principal and interest payments on various notes payable, dividends to stockholders, payment of claims, payment of commitments under limited partnership agreements and capital expenditures, as well as other operating expenses, which include agents' commissions, labor costs, premium taxes, general and administrative expenses, and income taxes. For further details regarding our cash requirements, refer to the section below entitled, "Contractual Obligations, Contingent Liabilities, and Commitments."

We continually monitor our cash requirements and the amount of capital resources that we maintain at the holding company and operating subsidiary levels. As part of our long-term capital strategy, we strive to maintain capital metrics, relative to the macroeconomic environment, that support an "A+" (Superior) financial strength A.M. Best rating. Based on our analysis and market conditions, we may take a variety of actions, including, but not limited to, contributing capital to our subsidiaries in our Insurance Operations, issuing additional debt and/or equity securities, repurchasing shares of the Parent's common stock, and increasing stockholders' dividends.

Our capital management strategy is intended to protect the interests of the policyholders of the Insurance Subsidiaries and our stockholders, while enhancing our financial strength and underwriting capacity.

Book value per share increased to $20.39 as of December 31, 2011 from $19.95 as of December 31, 2010, primarily driven by: (i) unrealized gains on our investment portfolio, which led to an increase in book value per share of $0.80; and (ii) net income of $0.37 per share. Partially offsetting these increases were: (i) dividends paid to shareholders of $0.52; and (ii) an after-tax equity charge of $10.9 million, or $0.15, due to the annual revaluation of our retirement income plan pension liability.

Off-Balance Sheet Arrangements

At December 31, 2011 and 2010, we did not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or for other contractually narrow or limited purposes. As such, we are not exposed to any financing, liquidity, market, or credit risk that could arise if we had engaged in such relationships.

Contractual Obligations, Contingent Liabilities, and Commitments

As discussed in "Net Loss and Loss Expense Reserves" in Item 1. "Business." of this Form 10-K, we maintain case reserves and estimates of reserves for losses and loss expense IBNR, in accordance with industry practice. Using generally accepted actuarial reserving techniques, we project our estimate of ultimate losses and loss expenses at each reporting date. Included within the estimate of ultimate losses and loss expenses are case reserves, which are analyzed on a case-by-case basis by the type of claim involved, the circumstances surrounding each claim, and the policy provisions relating to the type of losses. The difference between: (i) projected ultimate loss and loss expense reserves; and (ii) case loss reserves and loss expense reserves thereon are carried as the IBNR reserve. A range of possible reserves is determined annually and considered in addition to the most recent loss trends and other factors in establishing reserves for each reporting period. Based on the consideration of the range of possible reserves, recent loss trends and other factors, IBNR is established and the ultimate net liability for losses and loss expenses is determined. Such an assessment requires considerable judgment given that it is frequently not possible to determine whether a change in the data is an anomaly until sometime after the event. Even if a change is determined to be permanent, it is not always possible to reliably determine the extent of the change until sometime later. As a result, there is no precise method for subsequently evaluating the impact of any specific factor on the adequacy of reserves because the eventual deficiency or redundancy is affected by many factors.

Given that the loss and loss expense reserves are estimates, as described above and in more detail under the "Critical Accounting Policies and Estimates" in this Form 10-K, the payment of actual losses and loss expenses is generally not fixed as to amount or timing. Due to this uncertainty, financial accounting standards prohibit us from discounting these reserves to their present value. Additionally, estimated losses as of the financial statement date do not consider the impact of estimated losses from future business. Therefore, the projected settlement of the reserves for net loss and loss expenses will differ, perhaps significantly, from actual future payments.

The projected paid amounts in the table below by year are estimates based on past experience, adjusted for the effects of current developments and anticipated trends, and include considerable judgment. There is no precise method for evaluating the impact of any specific factor on the projected timing of when loss and loss expense reserves will be paid and as a result, the timing and amounts of the actual payments will be affected by many factors. Care must be taken to avoid misinterpretation by those unfamiliar with this information or familiar with other data commonly reported by the insurance industry.

Our future cash payments associated with contractual obligations pursuant to operating leases for office space and equipment, notes payable, interest on debt obligations, and loss and loss expenses as of December 31, 2011 are summarized below:

Contractual Obligations	Payment Due by Period				
		Less than	1-3	3-5	More than
($ in millions)	Total	1 year	Years	years	5 years
Operating leases	$25.4	9.0	10.0	4.6	1.8

Notes payable	308.0	-	13.0	45.0	250.0
Interest on debt obligations	659.0	18.8	37.5	36.8	565.9
Subtotal	992.4	27.8	60.5	86.4	817.7
Gross loss and loss expense payments	3,144.9	893.2	912.3	458.2	881.2
Ceded loss and loss expense payments	549.5	199.4	91.5	51.6	207.0
Net loss and loss expense payments	2,595.4	693.8	820.8	406.6	674.2
Total	$3,587.8	721.6	881.3	493.0	1,491.9

See the “Short-term Borrowings” section above for a discussion of our syndicated Line of Credit agreement.

At December 31, 2011, we also have contractual obligations that expire at various dates through 2022 that may require us to invest up to an additional $56.9 million in alternative and other investments. There is no certainty that any such additional investment will be required. We have issued no material guarantees on behalf of others and have no trading activities involving non-exchange traded contracts accounted for at fair value. We have no material transactions with related parties other than those disclosed in Note 18. “Related Party Transactions” included in Item 8. “Financial Statements and Supplementary Data.” of this Form 10-K.

Ratings

We are rated by major rating agencies that issue opinions on our financial strength, operating performance, strategic position, and ability to meet policyholder obligations. We believe that our ability to write insurance business is most influenced by our rating from A.M. Best, which was reaffirmed in the second quarter of 2011 as "A+ (Superior)," their second highest of 15 ratings, with a "negative" outlook. They cited our strong capitalization, solid level of operating profitability, and established presence within our targeted regional markets. The negative outlook reflects the ongoing challenges to improve underwriting performance given the competitive nature of the marketplace coupled with elevated catastrophe losses through April 2011. Following the acquisition of MUSIC, the newly-acquired company was included in our Insurance Subsidiaries' intercompany pooling agreement. As a result, on January 12, 2012, A.M. Best upgraded the financial strength rating of MUSIC to "A+ (Superior)" from "A- (Excellent)" with a negative outlook to reflect their revised pooled rating. We have been rated "A" or higher by A.M. Best for the past 81 years, with our current rating of "A+ (Superior)" being in place for the last 50 consecutive years. The financial strength reflected by our A.M. Best rating is a competitive advantage in the marketplace and influences where independent insurance agents place their business. A downgrade from A.M. Best to a rating below "A-" could: (i) affect our ability to write new business with customers and/or agents, some of whom are required (under various third-party agreements) to maintain insurance with a carrier that maintains a specified A.M. Best minimum rating; or (ii) be an event of default under our Line of Credit.

Our standard lines Insurance Subsidiaries' ratings by other major rating agencies are as follows:

- S&P Insurance Rating Services - S&P cites our strong competitive position in Mid-Atlantic markets, effective use of well-developed predictive modeling and agency interface technology, strong financial flexibility, and strong capital adequacy in support of our "A" financial strength rating and outlook of stable.

- Moody's Investor Service – Our financial strength rating of "A2" and outlook of stable was reaffirmed in the first quarter of 2011. Moody's cited our strong regional franchise with established independent agency support, along with good risk adjusted capitalization and moderate financial leverage. Their outlook reflects the expectation that we will continue to employ our technologically-based risk management process to identify and manage underperforming segments, while maintaining pricing discipline and reserve adequacy.

- Fitch Ratings – Our "A+" rating and outlook of stable was reaffirmed in the second quarter of 2011, citing our disciplined underwriting culture, conservative balance sheet with very good capitalization and reserve strength, strong independent agency relationships, and improved diversification through our continued efforts to reduce our concentration in New Jersey.

Our S&P and Moody's financial strength ratings affect our ability to access capital markets. There can be no assurance that our ratings will continue for any given period of time or that they will not be changed. It is possible that positive or negative ratings actions by one or more of the rating agencies may occur in the future.

Pending Accounting Pronouncements

In October 2010, the FASB issued ASU 2010-26, *Financial Services-Insurance (Topic 944): Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts* ("ASU 2010-26"). This guidance requires that only costs that are incremental or directly related to the successful acquisition of new or renewal insurance contracts are to be capitalized as a deferred acquisition cost. This would include, among other items, sales commissions paid to agents, premium taxes, and the portion of employee salaries and benefits directly related to time spent on acquired contracts. We have adopted this guidance retrospectively on January 1, 2012, with a resulting $51 million after-tax impact to stockholders' equity.

For information regarding our adoption of ASU 2010-26 as well as restated financial statement information, see Note 3. "Adoption of Accounting Pronouncements" in Item 8. "Financial Statements and Supplementary Data." of this Form 10-K.

Item 7A. Quantitative and Qualitative Disclosures About Market Risk.

Market Risk

The fair value of our assets and liabilities are subject to market risk, primarily interest rate, credit risk, and equity price risk related to our investment portfolio as well as fluctuations in the value of our alternative investment portfolio. Our investment portfolio is currently comprised of securities categorized as AFS and HTM. We do not hold derivative or commodity investments. Foreign investments are made on a limited basis, and all fixed maturity transactions are denominated in U.S. currency. We have minimal foreign currency fluctuation risk on certain equity securities and expenses.

Our investment philosophy includes setting certain return objectives relating to the equity and fixed maturity portfolios as well as risk objectives relating to the overall portfolio. Within the equity portfolio, the high dividend yield strategy, which we implemented in 2011, is designed to generate consistent dividend income while maintaining a minimal tracking error to the S&P 500 Index. Additional equity strategies are focused on meeting or exceeding strategy specific benchmarks of public equity indices. The primary return objective of our fixed maturity portfolio is to maximize after-tax investment yield and income while balancing risk. A secondary objective is to meet or exceed a weighted-average benchmark of public fixed income indices. Although yield and income generation remain the key drivers to our investment strategy, our overall philosophy is to invest with a long-term horizon along with a "buy-and-hold" principle. The return objective for other investments, which includes our alternative investments, is to meet or exceed the S&P 500 Index. The allocation of our portfolio was 88% fixed maturity securities, 4% equity securities, 5% short-term investments, and 3% other investments as of December 31, 2011.

We manage our investment portfolio to mitigate risks associated with various financial market scenarios. We will, however, take prudent risk to enhance our overall long-term results while managing a conservative, well-diversified investment portfolio to support our underwriting activities.

Interest Rate Risk

We invest in interest rate-sensitive securities, mainly fixed maturity securities. Our fixed maturity portfolio is comprised of primarily investment grade (investments receiving S&P or an equivalent rating of BBB- or above) corporate securities, U.S. government and agency securities, municipal obligations, and mortgage-backed securities. Our strategy to manage interest rate risk is to purchase intermediate-term fixed maturity investments that are attractively priced in relation to perceived credit risks. Our fixed maturity securities include both AFS and HTM securities. Fixed maturity securities that are not classified as either HTM securities or trading securities are classified as AFS securities and reported at fair value, with unrealized gains and losses excluded from earnings and reported as a separate component of stockholders' equity. Those fixed maturity securities that we have the ability and positive intent to hold to maturity are classified as HTM and carried at either: (i) amortized cost; or (ii) market value at the date the

security was transferred into the HTM category, adjusted for subsequent amortization.

Our exposure to interest rate risk relates primarily to the market price and cash flow variability associated with changes in interest rates. A rise in interest rates may decrease the fair value of our existing fixed maturity investments and declines in interest rates may result in an increase in the fair value of our existing fixed maturity investments. However, new and reinvested money used to purchase fixed maturity securities would benefit from rising interest rates and would be negatively impacted by falling interest rates. We seek to mitigate our interest rate risk associated with holding fixed maturity investments by monitoring and maintaining the average duration of our portfolio with a view toward achieving an adequate after-tax return without subjecting the portfolio to an unreasonable level of interest rate risk. As our fixed income investment portfolio contains interest rate-sensitive instruments, it may be adversely affected by changes in interest rates resulting from governmental monetary policies, domestic and international economic and political conditions, and other factors beyond our control. During extended periods of suppressed interest rates, net investment income on our fixed maturity portfolio is pressured as higher-yielding securities are rolling over into lower-yielding replacements. In 2011, bonds that matured or were sold, valued at $481.9 million, had yields that averaged 3.8%, pre-tax, while new purchases of $490.8 million had an average yield of 2.7%. We expect this downward trend to continue into 2012, putting pressure on our ability to grow investment income.

The fixed maturity portfolio duration at December 31, 2011 was 3.2 years, excluding short-term investments, compared to 3.7 years a year ago. Given the state of municipal finances, we reduced our municipal exposure while increasing our allocation to corporate bonds. This, combined with some portfolio rebalancing, caused the slight decline in duration. The Insurance Subsidiaries' liability duration is approximately 3.8 years. We manage our liquidity with a laddered maturity structure and an appropriate level of short-term investments to avoid liquidation of AFS fixed maturities in the ordinary course of business.

We use interest rate sensitivity analysis to measure the potential loss or gain in future earnings, fair values, or cash flows of market sensitive fixed maturity securities. The sensitivity analysis hypothetically assumes an instant parallel 200 basis point shift in interest rates up and down in 100 basis point increments from the date of the Consolidated Financial Statements. We use fair values to measure the potential loss. This analysis is not intended to provide a precise forecast of the effect of changes in market interest rates and equity prices on our income or stockholders' equity. Further, the calculations do not take into account any actions we may take in response to market fluctuations.

The following table presents the sensitivity analysis of interest rate risk as of December 31, 2011:

	2011				
	Interest Rate Shift in Basis Points				
($ in thousands)	[1]-200	-100	0	100	200
HTM fixed maturity securities					
Fair value of HTM fixed maturity securities portfolio	$779,809	776,422	758,043	733,581	708,093
Fair value change	21,766	18,379		(24,462)	(49,950)
Fair value change from base (%)	2.87%	2.42%		(3.23)%	(6.59)%
AFS fixed maturity securities					
Fair value of AFS fixed maturity securities portfolio	$2,989,460	2,968,593	2,897,373	2,799,120	2,696,282
Fair value change	92,087	71,220		(98,253)	(201,091)
Fair value change from base (%)	3.18%	2.46%		(3.39)%	(6.94)%

[1]Given the low interest rate environment, an interest rate decline of 200 basis points is deemed unreasonable for certain securities in our portfolio, as the decline would generate a zero or negative yield, therefore the interest rate decline for purposes of the sensitivity analysis is floored at one basis point for such securities.

Credit Risk

The financial markets were volatile in the second half of 2011 and are likely to remain so for the first half of 2012. We saw an increase in our overall investment portfolio, including a $66.7 million increase in unrealized gains to $149.6

million at December 31, 2011. We continue to closely monitor our $1.3 billion municipal bond portfolio given the widely reported uncertainty about states and municipalities and the ability of such issuers to fulfill their obligations in light of ongoing budget constraints. The credit quality of our fixed maturity securities portfolio migrated to "AA-" in 2011, from "AA" in 2010. This slightly lower average rating is largely the result of: (i) the S&P downgrade of U.S. sovereign debt in August 2011; and (ii) our recent increased allocation to investment grade corporate bonds. Exposure to non-investment grade bonds represents only 1% of the total fixed maturity securities portfolio.

The following table summarizes the fair value, net unrealized gain (loss) balances, and the weighted average credit qualities of our AFS fixed maturity securities at December 31, 2011 and December 31, 2010:

($ in millions)	December 31, 2011			December 31, 2010		
	Fair Value	**Unrealized Gain (Loss)**	**Average Credit Quality**	Fair Value	Unrealized Gain (Loss)	Average Credit Quality
AFS Fixed Maturity Portfolio:						
U.S. government obligations[1]	$353.8	20.3	AA+	$320.5	8.1	AAA
Foreign government obligations	34.2	0.5	AA	19.0	-	AA
State and municipal obligations	622.7	44.4	AA	533.9	21.9	AA+
Corporate securities	1,213.3	44.9	A	993.7	19.9	A
MBS	594.5	19.2	AA	426.9	6.7	AA+
ABS	78.9	1.2	AAA	48.7	0.2	AAA
Total AFS fixed maturity portfolio	$2,897.4	130.5	AA-	$2,342.7	56.8	AA
State and Municipal Obligations:						
General obligations	$282.6	22.1	AA+	$289.6	11.1	AA+
Special revenue obligations	340.1	22.3	AA	244.3	10.8	AA
Total state and municipal obligations	$622.7	44.4	AA	$533.9	21.9	AA+
Corporate Securities:						
Financial	$379.0	3.7	A	$289.9	4.5	A+
Industrials	86.9	6.1	A-	77.0	3.6	A-
Utilities	75.6	3.5	BBB+	56.5	0.2	BBB+
Consumer discretion	104.3	4.9	BBB+	98.9	1.1	A-
Consumer staples	137.3	6.9	A	101.6	2.1	A-
Healthcare	145.0	8.3	AA-	138.0	4.1	AA-
Materials	66.5	2.5	A-	57.0	0.8	A-
Energy	77.9	3.3	A-	49.5	1.2	A
Information technology	74.3	2.6	A	51.5	0.4	A+
Telecommunications services	50.9	1.5	BBB+	50.5	0.2	A-
Other	15.6	1.6	AA+	23.3	1.7	AA+
Total corporate securities	$1,213.3	44.9	A	$993.7	19.9	A
MBS:						
Government guaranteed agency commercial MBS (“CMBS”)	$72.9	5.0	AA+	$71.9	3.3	AAA
Non-agency CMBS	39.7	(0.3)	A-	32.6	(2.1)	A-
Government guaranteed agency residential MBS (“RMBS”)	98.2	4.7	AA+	91.1	3.0	AAA
Other agency RMBS	339.1	10.8	AA+	183.6	3.8	AAA
Non-agency RMBS	37.1	(1.0)	BBB	38.3	(1.0)	BBB
Alternative-A (“Alt-A”) RMBS	7.5	-	AA+	9.4	(0.3)	AAA
Total MBS	$594.5	19.2	AA	$426.9	6.7	AA+

ABS:						
ABS	$77.5	1.3	AAA	$47.8	0.2	AAA
Alt-A ABS[3]	0.7	-	D	-	-	-
Sub-prime ABS[2, 3]	0.7	(0.1)	D	0.9	-	D
Total ABS	$78.9	1.2	AAA	$48.7	0.2	AAA

[1] U.S. government includes corporate securities fully guaranteed by the FDIC.

[2] We define sub-prime exposure as exposure to direct and indirect investments in non-agency residential mortgages with average FICO® scores below 650.

[3] Alt-A ABS and subprime ABS each consist of one security whose issuer is currently expected by rating agencies to default on its obligations.

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The following table provides information regarding our HTM fixed maturity securities and their credit qualities at December 31, 2011 and December 31, 2010:

December 31, 2011 ($ in millions)	**Fair Value**	**Carry Value**	**Unrecognized Holding Gain (Loss)**	**Unrealized Gain (Loss) in AOCI**	**Total Unrealized/ Unrecognized Gain (Loss)**	**Average Credit Quality**
HTM Portfolio:						
Foreign government obligations	$5.5	5.6	(0.1)	0.3	0.2	AA+
State and municipal obligations	657.4	626.0	31.4	11.9	43.3	AA
Corporate securities	69.5	62.6	6.9	(2.2)	4.7	A
MBS	17.7	11.5	6.2	(3.0)	3.2	AA-
ABS	7.9	6.6	1.3	(1.4)	(0.1)	A
Total HTM portfolio	$758.0	712.3	45.7	5.6	51.3	AA
State and Municipal Obligations:						
General obligations	$214.8	205.3	9.5	6.3	15.8	AA
Special revenue obligations	442.6	420.7	21.9	5.6	27.5	AA
Total state and municipal obligations	$657.4	626.0	31.4	11.9	43.3	AA
Corporate Securities:						
Financial	$20.7	18.5	2.2	(1.5)	0.7	A-
Industrials	20.3	17.8	2.5	(0.7)	1.8	A
Utilities	15.4	13.7	1.7	(0.1)	1.6	A+
Consumer discretion	5.9	5.6	0.3	0.1	0.4	AA-
Consumer staples	5.1	5.0	0.1	-	0.1	A
Materials	2.1	2.0	0.1	-	0.1	BBB
Total corporate securities	$69.5	62.6	6.9	(2.2)	4.7	A
MBS:						
Non-agency CMBS	$17.7	11.5	6.2	(3.0)	3.2	AA-
Total MBS	$17.7	11.5	6.2	(3.0)	3.2	AA-
ABS:						
ABS	$5.6	5.0	0.6	(0.5)	0.1	BBB+
Alt-A ABS	2.3	1.6	0.7	(0.9)	(0.2)	AAA
Total ABS	$7.9	6.6	1.3	(1.4)	(0.1)	A

December 31, 2010 ($ in millions)	Fair Value	Carry Value	Unrecognized Holding Gain	Unrealized Gain (Loss) in AOCI	Total Unrealized/ Unrecognized Gain (Loss)	Average Credit Quality
HTM Portfolio:						
U.S. government obligations	$103.1	98.1	5.0	4.7	9.7	AAA
Foreign government obligations	5.6	5.6	-	0.3	0.3	AA+
State and municipal obligations	912.3	896.6	15.7	22.2	37.9	AA
Corporate securities	82.1	72.7	9.4	(4.0)	5.4	A-
MBS	141.3	130.8	10.5	(6.3)	4.2	AAA
ABS	11.9	10.5	1.4	(2.4)	(1.0)	A
Total HTM portfolio	$1,256.3	1,214.3	42.0	14.5	56.5	AA
State and Municipal Obligations:						
General obligations	$240.3	236.8	3.5	9.7	13.2	AA
Special revenue obligations	672.0	659.8	12.2	12.5	24.7	AA
Total state and municipal obligations	$912.3	896.6	15.7	22.2	37.9	AA
Corporate Securities:						
Financial	$23.5	20.0	3.5	(2.5)	1.0	A-
Industrials	22.8	19.4	3.4	(1.2)	2.2	A
Utilities	16.9	16.1	0.8	(0.1)	0.7	BBB
Consumer discretion	7.7	7.1	0.6	0.2	0.8	AA-
Consumer staples	5.4	4.9	0.5	(0.1)	0.4	A
Materials	2.1	1.9	0.2	(0.1)	0.1	BBB-
Energy	3.7	3.3	0.4	(0.2)	0.2	BB+
Total corporate securities	$82.1	72.7	9.4	(4.0)	5.4	A-
MBS						
Government guaranteed agency CMBS	$9.2	8.9	0.3	-	0.3	AAA
Other agency CMBS	3.6	3.6	-	-	-	AAA
Non-agency CMBS	42.1	35.0	7.1	(7.4)	(0.3)	AA+
Government guaranteed agency RMBS	4.5	4.0	0.5	(0.1)	0.4	AAA
Other agency RMBS	81.8	79.2	2.6	1.2	3.8	AAA
Non-agency RMBS	0.1	0.1	-	-	-	BBB
Total MBS	$141.3	130.8	10.5	(6.3)	4.2	AAA
ABS:						
ABS	$9.1	8.0	1.1	(0.9)	0.2	A-
Alt-A ABS	2.8	2.5	0.3	(1.5)	(1.2)	AA-
Total ABS	$11.9	10.5	1.4	(2.4)	(1.0)	A

A portion of our AFS and HTM municipal bonds contain insurance enhancements. The following table provides information regarding these insurance-enhanced securities as of December 31, 2011:

Insurers of Municipal Bond Securities ($ in thousands)	Fair Value	Ratings with Insurance	Ratings without Insurance
National Public Finance Guarantee Corporation, a subsidiary of MBIA, Inc.	$ 336,392	AA-	A+
Assured Guaranty	232,561	AA	A
Ambac Financial Group, Inc.	91,827	AA-	AA-
Other	17,192	AA	AA-
Total	$ 677,972	AA-	A

To manage and mitigate exposure, we perform analyses on MBS both at the time of purchase and as part of the ongoing portfolio evaluation. This analysis includes review of average FICO® scores, loan-to-value ratios, geographic spread of the assets securing the bond, delinquencies in payments for the underlying mortgages, gains/losses on sales, evaluations of projected cash flows, as well as other information that aids in determination of the health of the underlying assets. We also consider the overall credit environment, economic conditions, total projected return on the investment, and overall asset allocation of the portfolio in our decisions to purchase or sell structured securities.

The following table details the top 10 state exposures of the municipal bond portion of our fixed maturity portfolio at December 31, 2011:

State Exposures of Municipal Bonds	General Obligation		Special	Fair	**Average** **Credit**
($ in thousands)	Local	State	Revenue	Value	Quality
Texas	$85,479	1,101	55,930	142,510	AA+
Washington	46,238	-	38,133	84,371	AA
Arizona	7,083	-	60,795	67,878	AA
New York	-	-	66,291	66,291	AA+
Florida	-	-	53,587	53,587	A+
Ohio	13,611	7,255	30,408	51,274	AA+
Illinois	20,356	-	28,386	48,742	AA-
Colorado	29,319	1,812	17,241	48,372	AA-
Minnesota	5,038	36,926	6,390	48,354	AA+
North Carolina	14,032	3,775	24,169	41,976	AA
Other	115,455	68,261	360,074	543,790	AA
	336,611	119,130	741,404	1,197,145	AA
Advanced refunded/escrowed to maturity bonds	29,175	12,405	41,319	82,899	AA+
Total	$365,786	131,535	782,723	1,280,044	AA

There have recently been widely reported concerns regarding the stress on state and local governments emanating from declining revenues, large unfunded liabilities, and entrenched cost structures. Overall, we are comfortable with the quality, composition, and diversification of our $1.3 billion municipal bond portfolio. In 2011, we did not reinvest proceeds of maturities and calls into this sector, and as a result, municipal bonds as a percentage of invested assets have declined to 31% from 36% a year ago. However, given some more recent positive signs for municipalities, in 2012 we intend to selectively add to our municipal bond portfolio to slightly extend the duration of our fixed maturity securities portfolio. Our municipal bond portfolio is very high quality with an average AA rating, and is laddered with 42% maturing within three years and another 40% maturing between three and five years. The weightings of the municipal bond portfolio are: 61% of high-quality revenue bonds that have dedicated revenue streams, 29% of local general obligation bonds, and 10% of state general obligation bonds. In addition, approximately 6% of the municipal bond portfolio has been refunded in advance. Our largest state exposure is to Texas, at 11%, excluding the impact of advanced refunded bonds. Of the $85 million in local Texas general obligation bonds, $41 million represents investments in Texas Permanent School Fund bonds, which are considered to be lower risk.

Special revenue fixed income securities of municipalities (referred to as “special revenue bonds”) generally do not have the “full faith and credit” backing of the municipal or state governments, as do general obligation bonds, but special revenue bonds have a dedicated revenue stream for repayment which can, in many instances, provide a higher quality credit profile than general obligation bonds. As such, we believe our special revenue bond portfolio is appropriate for the current environment.

The following table provides further quantitative details on our special revenue bonds:

December 31, 2011 ($ in thousands)	**Fair Value**	**% of Special Revenue Bonds**	**Average Rating**
Essential Services:			
Water and sewer	$158,262	21	AA
Transportation	152,906	21	AA-
Electric	102,111	14	AA-
Total essential services	413,279	56	AA
Education	127,672	17	AA
Special tax	96,905	13	AA-
Housing	54,934	7	AA+
Other:			
Leasing	12,205	2	AA-
Hospital	11,471	2	AA-
Other	24,938	3	A+
Total other	48,614	7	A+
Total special revenue bonds	$741,404	100	AA

Essential Services

A large portion of our special revenue bond portfolio is, by design, invested in sectors that are conventionally deemed as "essential services" and thus are not considered cyclical in nature. The essential services category (as reflected in the above table) is comprised of transportation, water and sewer, and electric.

Education

The education portion of the portfolio includes school districts and higher education, including state-wide university systems.

Special Tax

This group includes special revenue bonds with a wide range of attributes. However, similar to other revenue bonds, these are backed by a dedicated lien on a tax or other revenue repayment source.

Housing

Despite the turmoil in the housing sector, these bonds continue to be highly rated, much of it with the support of U.S. housing agencies. The need for affordable housing continues to grow, especially in light of current delinquencies and defaults, and as such, political support for these programs remains high. These attributes, when combined, tend to mute this sector's cyclicality.

Based on the above attributes, we remain confident in the collectability of our special revenue bond portfolio and have not acquired any bond insurance in the secondary market covering any of our special revenue bonds.

We continue to evaluate underlying credit quality within this portfolio and as long-term, income-oriented investors, we remain comfortable with the credit risk in these securities.

European Sovereign Debt Crisis

Uncertainty about the ability of sovereign issuers to fully repay their debt triggered significant turbulence in global financial markets in 2011. The sovereign debt crisis has been particularly concentrated in the Eurozone and a number of member countries were downgraded. The crisis has placed strains on the stability of the currency as the European Central Bank struggled to supply liquidity to member nations and their banks. As of December 31, 2011, we had no direct exposure to Italy, Greece, or Portugal, three of the more economically troubled nations in the Eurozone. We do

not own any derivative exposures such as credit default swaps. Our Eurozone exposure is listed in the table below:

December 31, 2011 ($ in millions)	Corporate Securities	Government Securities	Equity Securities	Total Exposure
Country:				
Netherlands	$ 20.8	-	-	20.8
Germany	5.1	9.5	-	14.6
France	12.2	-	-	12.2
Luxembourg	7.7	-	-	7.7
Spain	4.5	-	-	4.5
Finland	-	3.0	-	3.0
Ireland	-	-	1.1	1.1
Total	$ 50.3	12.5	1.1	63.9

Of the $50.3 million in Eurozone corporate securities, $30.9 million is in the banking and financial sector. Outside of the effect foreign currency exchange rates have on the underlying investments, we have minimal exposure to Euro depreciation/appreciation.

In addition to exposure in our investment portfolio, the European sovereign debt crisis may adversely impact some of our reinsurers, exposing us to counterparty credit risk. Some of the world's largest reinsurers are domiciled in Europe, and due to the global nature of reinsurance, many write business and invest in various currencies and countries. We seek to diversify our reinsurance relationships with highly rated, well established reinsurers. Our Insurance Subsidiaries remain liable to policyholders to the extent that the reinsurer becomes unable to meet their contractual obligations. The following table represents our largest unsecured reinsurance balances, excluding federal and state operated reinsurance pools, as of December 31, 2011:

($ in thousands) Reinsurer Name (Country of Parent's domicile; Rating)	Reinsurance Balances
Hannover Ruckversicherungs AG (Germany; A.M. Best rated "A")	$ 50,636
Munich Re Group (Germany; A.M. Best rated "A+")	34,902
Swiss Re Group (Switzerland; A.M. Best rated "A+")	28,634
AXIS Reinsurance Company (Bermuda; A.M. Best rated "A")	26,172
Partner Reinsurance Company of the U.S. (Bermuda; A.M. Best rated "A+")	19,105
All other reinsurers	62,714
Total	$ 222,163

Equity Price Risk

Our equity securities are classified as AFS. Our equity securities portfolio is exposed to equity price risk arising from potential volatility in equity market prices. We attempt to minimize the exposure to equity price risk by maintaining a diversified portfolio and limiting concentrations in any one company or industry. The following table presents the hypothetical increases and decreases in 10% increments in market value of the equity portfolio as of December 31, 2011:

	Change in Equity Values in Percent						
($ in thousands)	-30%	-20%	-10%	0%	10%	20%	30%
Fair value of AFS equity portfolio	$110,148	125,884	141,619	157,355	173,091	188,826	204,562
Fair value change	(47,207)	(31,471)	(15,736)		15,736	31,471	47,207

In addition to our equity securities, we invest in certain other investments that are also subject to price risk. Our other investments include alternative investments in private limited partnerships that invest in various strategies such as private equity, mezzanine debt, distressed debt, and real estate. As of December 31, 2011, these types of investments represented 3% of our total invested assets and 12% of our stockholders' equity. These investments are subject to the risks arising from the fact that the determination of their value is inherently subjective. The general partner of each of

these partnerships usually reports the change in the value of the interests in the partnership on a one quarter lag because of the nature of the underlying assets or liabilities. Since these partnerships' underlying investments consist primarily of assets or liabilities for which there are no quoted prices in active markets for the same or similar assets, the valuation of interests in these partnerships are subject to a higher level of subjectivity and unobservable inputs than substantially all of our other investments. Each of these general partners is required to determine fair value by the price obtainable for the sale of the interest at the time of determination. Valuations based on unobservable inputs are subject to greater scrutiny and reconsideration from one reporting period to the next and therefore, the changes in the fair value of these investments may be subject to significant fluctuations, which could lead to significant decreases in their fair value from one reporting period to the next. As we record our investments in these various partnerships under the equity method of accounting, any decreases in the valuation of these investments would negatively impact our results of operations.

For additional information regarding these alternative investment strategies, see Note 5, “Investments” in Item 8. “Financial Statements and Supplementary Data.” of this Form 10-K.

Indebtedness

(a) Long-Term Debt.

As of December 31, 2011, the Parent had outstanding long-term debt of $307.4 million that matures as shown in the following table:

($ in thousands)	Year of Maturity	2011 Carrying Amount	Fair Value
Financial liabilities			
Notes payable			
7.25% Senior Notes	2034	$49,908	$51,111
6.70% Senior Notes	2035	99,452	113,195
7.50% Junior Notes	2066	100,000	100,360
2.90% borrowings from FHLBI	2014	13,000	13,759
1.25% borrowings from FHLBI	2016	45,000	44,629
Total notes payable		$307,360	$323,054

The weighted average effective interest rate for the Parent's outstanding long-term debt is 6.12%. The Parent is not exposed to material changes in interest rates because the interest rates are fixed on its long-term indebtedness.

(b) Short-Term Debt.

The Parent has a $30 million line of credit that is syndicated between Wachovia Bank, National Association, a subsidiary of Wells Fargo & Company, as administrative agent, and Branch Banking and Trust Company (BB&T). The terms of this agreement allow us to increase our borrowings to $50 million with the approval of both lending parties. We monitor current news regarding the banking industry in general, and our lending partners in particular, as, according to the syndicated line of credit agreement, the obligations of the lenders to make loans and to make payments are several and not joint. The Parent did not access the facility during 2011 and, as such, at December 31, 2011, no balances were outstanding.

Item 8. Financial Statements and Supplementary Data.

Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders

Selective Insurance Group, Inc.:

We have audited the accompanying consolidated balance sheets of Selective Insurance Group, Inc. and its subsidiaries (the “Company”) as of December 31, 2011 and 2010, and the related consolidated statements of income, stockholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2011. In connection with our audits of the consolidated financial statements, we also have audited financial statement schedules I to V. These consolidated financial statements and financial statement schedules are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements and financial statement schedules based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Selective Insurance Group, Inc. and its subsidiaries as of December 31, 2011 and 2010, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2011, in conformity with U.S. generally accepted accounting principles. Also in our opinion, the related financial statement schedules, when considered in relation to the basic consolidated financial statements taken as a whole, present fairly, in all material respects, the information set forth therein.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Selective Insurance Group, Inc.'s internal control over financial reporting as of December 31, 2011, based on criteria established in *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated February 24, 2012 expressed

an unqualified opinion on the effectiveness of the Company's internal control over financial reporting.

/s/ KPMG LLP

New York, New York

February 24, 2012

Consolidated Balance Sheets

December 31, ($ in thousands, except share amounts)	2011	2010
ASSETS		
Investments:		
Fixed maturity securities, held-to-maturity – at carrying value (fair value: $758,043 – 2011; $1,256,294 – 2010)	$712,348	1,214,324
Fixed maturity securities, available-for-sale – at fair value (amortized cost: $2,766,856 – 2011; $2,285,988 – 2010)	2,897,373	2,342,742
Equity securities, available-for-sale – at fair value (cost of: $143,826 – 2011; $58,039 – 2010)	157,355	69,636
Short-term investments (at cost which approximates fair value)	217,044	161,155
Other investments	128,301	137,865
Total investments (Note 5)	4,112,421	3,925,722
Cash	762	645
Interest and dividends due or accrued	35,842	37,007
Premiums receivable, net of allowance for uncollectible accounts of: $3,768 – 2011; $4,691 – 2010	466,294	414,105
Reinsurance recoverable, net	561,855	318,752
Prepaid reinsurance premiums (Note 8)	147,686	110,327
Current federal income tax (Note 15)	731	11,200
Deferred federal income tax (Note 15)	92,686	93,234
Property and equipment – at cost, net of accumulated depreciation and amortization of: $160,294 – 2011; $151,704 – 2010	43,947	41,775
Deferred policy acquisition costs	214,069	209,627
Goodwill (Notes 11)	7,849	7,849
Other assets	52,227	61,529
Total assets	$5,736,369	5,231,772
LIABILITIES AND STOCKHOLDERS' EQUITY		
Liabilities:		
Reserve for losses and loss expenses (Note 9)	$3,144,924	2,830,058
Unearned premiums	906,991	823,596
Notes payable (Note 10)	307,360	262,333
Accrued salaries and benefits	119,297	100,933
Other liabilities	148,569	143,743
Total liabilities	$4,627,141	4,160,663
Stockholders' Equity:		
Preferred stock of $0 par value per share:		
Authorized shares 5,000,000; no shares issued or outstanding	$-	-
Common stock of $2 par value per share		
Authorized shares: 360,000,000 (Note 6)		
Issued: 97,246,711 – 2011; 96,362,667 – 2010	194,494	192,725
Additional paid-in capital	257,370	244,613
Retained earnings	1,167,219	1,176,155
Accumulated other comprehensive income (Note 6)	42,294	7,024
Treasury stock – at cost (shares: 42,836,201 – 2011; 42,686,204 – 2010)	(552,149)	(549,408)
Total stockholders' equity (Note 6)	1,109,228	1,071,109

Commitments and contingencies (Notes 19 and 20)		
Total liabilities and stockholders’ equity	$5,736,369	5,231,772

See accompanying notes to consolidated financial statements.

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Consolidated Statements of Income December 31, ($ in thousands, except per share amounts)	2011	2010	2009
Revenues:			
Net premiums earned	$1,439,313	1,416,598	1,431,047
Net investment income earned	147,443	145,708	118,471
Net realized gains (losses):			
Net realized investment gains	15,426	10,575	9,446
Other-than-temporary impairments	(11,998)	(16,225)	(64,184)
Other-than-temporary impairments on fixed maturity securities recognized in other comprehensive income	(1,188)	(1,433)	8,768
Total net realized gains (losses)	2,240	(7,083)	(45,970)
Other income	8,479	9,398	10,470
Total revenues	1,597,475	1,564,621	1,514,018
Expenses:			
Losses and loss expenses incurred	1,074,987	982,118	971,905
Policy acquisition costs	469,739	458,045	457,424
Interest expense	18,259	18,616	19,386
Other expenses	26,425	23,886	26,117
Total expenses	1,589,410	1,482,665	1,474,832
Income from continuing operations, before federal income tax	8,065	81,956	39,186
Federal income tax (benefit) expense:			
Current	(228)	5,323	3,585
Deferred	(12,222)	7,312	(9,057)
Total federal income tax (benefit) expense	(12,450)	12,635	(5,472)
Net income from continuing operations	20,515	69,321	44,658
Loss from discontinued operations, net of tax of $(4,042) – 2009	-	-	(7,086)
Loss on disposal of discontinued operations, net of tax of $(350) – 2011; $(2,035) – 2010; $(631) – 2009	(650)	(3,780)	(1,174)
Total discontinued operations, net of tax	(650)	(3,780)	(8,260)
Net income	$19,865	65,541	36,398
Earnings per share:			
Basic net income from continuing operations	0.38	1.30	0.84
Basic net loss from discontinued operations	(0.01)	(0.07)	(0.15)
Basic net income	$0.37	1.23	0.69
Diluted net income from continuing operations	0.37	1.27	0.83
Diluted net loss from discontinued operations	(0.01)	(0.07)	(0.15)
Diluted net income	$0.36	1.20	0.68
Dividends to stockholders	$0.52	0.52	0.52

See accompanying notes to consolidated financial statements.

Consolidated Statements of Stockholders' Equity

December 31, ($ in thousands, except share amounts)	2011		2010		2009	
Common stock:						
Beginning of year	$192,725		191,646		190,527	
Dividend reinvestment plan (shares: 100,383 – 2011; 106,437 – 2010; 123,880 – 2009)	201		213		248	
Stock purchase and compensation plans (shares: 783,661 – 2011; 433,271 – 2010; 435,571 – 2009)	1,568		866		871	
End of year	194,494		192,725		191,646	
Additional paid-in capital:						
Beginning of year	244,613		231,933		217,195	
Dividend reinvestment plan	1,417		1,465		1,514	
Stock purchase and compensation plans	11,340		11,215		13,224	
End of year	257,370		244,613		231,933	
Retained earnings:						
Beginning of year	1,176,155		1,138,978		1,128,149	
Cumulative-effect adjustment due to adoption of other- than-temporary impairment guidance under ASC 320, net of deferred income tax	-		-		2,380	
Net income	19,865	19,865	65,541	65,541	36,398	36,398
Dividends to stockholders ($0.52 per share – 2011, 2010, and 2009)	(28,801)		(28,364)		(27,949)	
End of year	1,167,219		1,176,155		1,138,978	
Accumulated other comprehensive income (loss):						
Beginning of year	7,024		(12,460)		(100,666)	
Cumulative-effect adjustment due to adoption of other- than-temporary impairment guidance under ASC 320, net of deferred income tax	-		-		(2,380)	
Other comprehensive income (loss), increase (decrease) in:						
Unrealized gains (losses) on investment securities:						
Non-credit portion of other-than-temporary impairment losses recognized in other comprehensive income, net of deferred income tax	1,093		3,416		(5,629)	
Other net unrealized gains on investment securities, net of deferred income tax	42,287		21,113		92,183	
Total unrealized gains on investment securities	43,380	43,380	24,529	24,529	86,554	86,554
Defined benefit pension plans, net of deferred income tax	(8,110)	(8,110)	(5,045)	(5,045)	4,032	4,032

End of year	42,294	7,024	(12,460)
Comprehensive income	55,135	85,025	126,984
Treasury stock:			
Beginning of year	(549,408)	(547,722)	(544,712)
Acquisition of treasury stock (shares: 149,997 – 2011; 107,425 – 2010; 191,858 – 2009)	(2,741)	(1,686)	(3,010)
End of year	(552,149)	(549,408)	(547,722)
Total stockholders' equity	$1,109,228	1,071,109	1,002,375

Selective Insurance Group, Inc. also has authorized, but not issued, 5,000,000 shares of preferred stock, without par value, of which 300,000 shares have been designated Series A junior preferred stock, without par value.

See accompanying notes to consolidated financial statements.

Consolidated Statements of Cash Flow December 31, ($ in thousands, except share amounts)	2011	2010	2009
Operating Activities			
Net Income	$19,865	65,541	36,398
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	34,645	31,770	28,593
Loss on disposal of discontinued operations	650	3,780	1,174
Stock-based compensation expense	7,422	8,017	11,256
Undistributed (income) losses of equity method investments	(323)	(8,712)	21,726
Net realized (gains) losses	(2,240)	7,083	45,970
Postretirement life curtailment benefit	-	-	(4,217)
Unrealized gain on trading securities	-	-	(262)
Goodwill impairment on discontinued operations	-	-	12,214
Changes in assets and liabilities:			
Increase in reserves for losses and loss expenses, net of reinsurance recoverables	56,905	41,526	60,619
Increase (decrease) in unearned premiums, net of prepaid reinsurance and advance premiums	46,334	(26,661)	(8,028)
(Increase) decrease in net federal income taxes	(1,403)	15,809	(3,718)
(Increase) decrease in premiums receivable	(45,116)	32,472	34,317
(Increase) decrease in deferred policy acquisition costs	(4,442)	8,974	(6,282)
Decrease (increase) in interest and dividends due or accrued	633	(2,361)	1,918
Increase (decrease) in accrued salaries and benefits	1,521	(14,913)	(15,240)
(Decrease) increase in accrued insurance expenses	(636)	(4,470)	2,240
Sale of trading securities	-	-	2,831
Other-net	9,142	1,330	6,050
Net adjustments	103,092	93,644	191,161
Net cash provided by operating activities	122,957	159,185	227,559
Investing Activities			
Purchase of fixed maturity securities, held-to-maturity	-	-	(158,827)
Purchase of fixed maturity securities, available-for-sale	(487,813)	(1,007,679)	(1,041,277)
Purchase of equity securities, available-for-sale	(150,551)	(71,192)	(79,455)
Purchase of other investments	(16,033)	(20,673)	(16,298)
Purchase of short-term investments	(1,448,782)	(1,741,738)	(1,956,164)
Purchase of subsidiary, net of cash acquired	(51,728)	-	-
Sale of subsidiary	1,152	978	(12,538)
Sale of fixed maturity securities, held-to-maturity	-	-	5,820
Sale of fixed maturity securities, available-for-sale	146,435	190,438	538,769
Sale of short-term investments	1,433,441	1,794,434	1,940,427
Redemption and maturities of fixed maturity securities, held-to-maturity	177,350	319,835	282,310
Redemption and maturities of fixed maturity securities, available-for-sale	162,796	298,171	122,403
Sale of equity securities, available-for-sale	60,071	98,015	137,244
Distributions from other investments	25,622	22,406	25,596

Sale of other investments	16,357	-	-
Purchase of property, equipment, and other assets	(11,824)	(6,522)	(8,207)
Net cash used in investing activities	(143,507)	(123,527)	(220,197)
Financing Activities			
Dividends to stockholders	(26,513)	(26,056)	(26,296)
Acquisition of treasury stock	(2,741)	(1,686)	(3,010)
Principal payment of notes payable	-	(12,300)	(12,300)
Proceeds from borrowings	45,000	-	13,000
Net proceeds from stock purchase and compensation plans	5,011	4,962	4,612
Excess tax benefits from share-based payment arrangements	(90)	(744)	(1,200)
Net cash provided by (used in) financing activities	20,667	(35,824)	(25,194)
Net increase (decrease) in cash and cash equivalents	117	(166)	(17,832)