

COMMERCE GROUP INC /MA
Form 10-Q
November 08, 2006

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2006

or

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

For the transition period from _____ to _____.

Commission File Number 001-13672

The Commerce Group, Inc.

(Exact name of registrant as specified in its charter)

Massachusetts
(State or other jurisdiction of
incorporation or organization)

04-2599931
(IRS Employer Identification No.)

211 Main Street, Webster, Massachusetts
(Address of principal executive offices)

01570
(Zip Code)

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one.)

Large accelerated filer

Accelerated filer

Non-accelerated filer

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

As of October 31, 2006, the number of shares outstanding of the Registrant's common stock (excluding Treasury Shares) was 67,785,768.

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The Commerce Group, Inc.

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Part I - Financial Information

Item 1. Financial Statements

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The Commerce Group, Inc. and Subsidiaries
 Consolidated Balance Sheets
 September 30, 2006 and December 31, 2005

| (Thousands of Dollars) | 2006 | 2005 |
|--|--------------------|--------------------|
| | (Unaudited) | |
| ASSETS | | |
| Investments and cash (Note 4): | | |
| Fixed maturities, at market (amortized cost: \$2,069,087 and \$2,037,127) | \$2,088,103 | \$2,029,173 |
| Preferred stocks, at market (amortized cost: \$450,147 and \$395,099) | 454,487 | 393,681 |
| Common stocks, at market (cost: \$110,385 and \$103,472) | 116,113 | 102,344 |
| Preferred stock mutual funds, at equity (cost: \$119,601 and \$88,859) | 133,810 | 96,332 |
| Mortgage loans on real estate and collateral notes receivable (less allowance for possible loan losses of \$56 and \$55) | 18,405 | 17,746 |
| Cash and cash equivalents | 128,527 | 97,942 |
| Other investments (cost: \$41,132 and \$28,976) | 45,818 | 28,111 |
| Total investments and cash | 2,985,263 | 2,765,329 |
| Accrued investment income | 23,006 | 22,267 |
| Premiums receivable (less allowance for doubtful receivables of \$2,254 and \$2,254) | 511,578 | 475,112 |
| Deferred policy acquisition costs | 186,032 | 174,415 |
| Property and equipment, net of accumulated depreciation | 67,186 | 61,625 |
| Residual market receivable | 166,259 | 191,309 |
| Due from reinsurers | 49,155 | 142,923 |
| Deferred income taxes | 38,438 | 68,926 |
| Current income taxes | 19,253 | - |
| Other assets | 42,953 | 25,104 |
| Total assets | \$4,089,123 | \$3,927,010 |

LIABILITIES & STOCKHOLDERS' EQUITY

| | | |
|---|------------|------------|
| Liabilities: | | |
| Unpaid losses and loss adjustment expenses (Note 5) | \$ 957,043 | \$ 989,196 |
| Unearned premiums | 985,989 | 933,160 |
| Bonds payable (\$300,000 face less discount) (Note 6) | 298,538 | 298,388 |
| Current income taxes | - | 9,601 |
| Deferred income | 10,864 | 8,757 |
| Accrued agents' profit sharing | 197,752 | 187,760 |

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| | | |
|--|--------------------|--------------------|
| Other liabilities and accrued expenses | 155,262 | 189,122 |
| Total liabilities | 2,605,448 | 2,615,984 |
| Minority interest | 6,723 | 5,957 |
| Commitments and contingencies (Note 8) | - | - |
| Stockholders' equity: | | |
| Preferred stock, authorized 5,000,000 shares at \$1.00 par value, none issued | - | - |
| Common stock, authorized 100,000,000 shares at \$.50 par value, 81,927,916 and 81,831,546 shares issued (Note 1) | 40,964 | 20,458 |
| Paid-in capital | 135,033 | 148,130 |
| Net accumulated other comprehensive gain (loss), net of income taxes (benefits) of \$10,150 and \$(3,649) | 18,849 | (6,810) |
| Retained earnings | 1,496,515 | 1,363,507 |
| Total stockholders' equity before treasury stock | 1,691,361 | 1,525,285 |
| Treasury stock, 14,142,148 and 14,525,142 shares, at cost | (214,409) | (220,216) |
| Total stockholders' equity | 1,476,952 | 1,305,069 |
| Total liabilities, minority interest and stockholders' equity | \$4,089,123 | \$3,927,010 |

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

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The Commerce Group, Inc. and Subsidiaries
Consolidated Statements of Earnings and Comprehensive Income
Three and Nine Months Ended September 30, 2006 and 2005
(Unaudited)

| (Thousands of Dollars, Except Per Share Data) | Three Months | | Nine Months | |
|---|--------------|-----------|-------------|-------------|
| | 2006 | 2005 | 2006 | 2005 |
| Revenues: | | | | |
| Direct premiums written | \$479,156 | \$479,076 | \$1,444,956 | \$1,470,088 |
| Assumed premiums | 32,645 | 18,435 | 78,377 | 107,679 |

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| | | | | |
|---|------------------|------------------|-------------------|-------------------|
| Ceded premiums | 37,776 | (76,084) | (94,716) | (211,347) |
| Net premiums written | 549,577 | 421,427 | 1,428,617 | 1,366,420 |
| (Increase) decrease in unearned premiums | (89,629) | 6,870 | (125,728) | (87,129) |
| Earned premiums | 459,948 | 428,297 | 1,302,889 | 1,279,291 |
| Net investment income | 34,417 | 30,040 | 104,065 | 90,360 |
| Premium finance and service fees | 7,282 | 7,199 | 21,353 | 21,459 |
| Net realized investment gains (Note 4) | 7,830 | 196 | 7,665 | 20,800 |
| Total revenues | 509,477 | 465,732 | 1,435,972 | 1,411,910 |
| Expenses: | | | | |
| Losses and loss adjustment expenses (Note 5) | 272,486 | 240,279 | 778,852 | 790,174 |
| Policy acquisition costs | 151,836 | 134,715 | 381,494 | 346,766 |
| Interest expense and amortization of bond fees | 4,584 | 4,584 | 13,746 | 13,711 |
| Total expenses | 428,906 | 379,578 | 1,174,092 | 1,150,651 |
| Earnings before income taxes and minority interest | 80,571 | 86,154 | 261,880 | 261,259 |
| Income taxes | 23,819 | 26,084 | 79,088 | 80,146 |
| Earnings before minority interest | 56,752 | 60,070 | 182,792 | 181,113 |
| Minority interest in net earnings of subsidiary | (217) | (240) | (683) | (683) |
| Net earnings | \$ 56,535 | \$ 59,830 | \$ 182,109 | \$ 180,430 |
| Comprehensive income (Note 2) | \$104,925 | \$ 45,029 | \$ 207,768 | \$ 162,351 |
| Net earnings per common share (Note 3): | | | | |
| Basic | \$ 0.83 | \$ 0.89 | \$ 2.69 | \$ 2.69 |

| | | | | |
|--|-------------------|-------------------|-------------------|-------------------|
| Diluted | \$ 0.83 | \$ 0.88 | \$ 2.68 | \$ 2.67 |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| Cash dividends paid per common share | \$ 0.25 | \$ 0.19 | \$ 0.725 | \$ 0.545 |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| Weighted average number of common shares outstanding (Note 3): | | | | |
| Basic | 67,754,791 | 67,262,180 | 67,675,649 | 67,126,326 |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| Diluted | 68,182,710 | 67,751,592 | 68,036,253 | 67,686,084 |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |

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

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The Commerce Group, Inc. and Subsidiaries
Consolidated Statements of Cash Flows
Nine Months Ended September 30, 2006 and 2005
(Unaudited)

| (Thousands of Dollars) | 2006 | 2005 |
|--|-------------------|-------------------|
| Operating activities: | <u> </u> | <u> </u> |
| Premiums collected | \$1,334,936 | \$1,291,886 |
| Net investment income received | 103,911 | 87,809 |
| Premium finance and service fees received | 21,353 | 21,455 |
| Losses and loss adjustment expenses paid | (758,588) | (770,488) |
| Policy acquisition costs paid | (380,936) | (312,673) |
| Federal income taxes | (91,253) | (89,309) |
| Interest paid | (8,925) | (8,925) |
| | <u> </u> | <u> </u> |
| Cash from operating activities | 220,498 | 219,755 |
| | <u> </u> | <u> </u> |
| Investing activities: | | |
| Investment sales, repayments and maturities | 1,487,622 | 1,530,385 |
| Mortgage loans and collateral notes receipts | 3,193 | 3,472 |
| Investment purchases | (1,616,855) | (1,820,554) |
| Mortgage loans and collateral notes originated | (3,853) | (6,049) |

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| | | |
|--|-------------------|-------------------|
| Property and equipment purchases | (11,975) | (11,306) |
| Other investing activities | 1,846 | 2,924 |
| | <u> </u> | <u> </u> |
| Cash for investing activities | (140,022) | (301,128) |
| | <u> </u> | <u> </u> |
| Financing activities: | | |
| Dividends paid to stockholders | (49,101) | (36,625) |
| Capital stock issued | 130 | 2,437 |
| Outstanding checks payable | (920) | 2,761 |
| | <u> </u> | <u> </u> |
| Cash for financing activities | (49,891) | (31,427) |
| | <u> </u> | <u> </u> |
| Increase (decrease) in cash and cash equivalents | 30,585 | (112,800) |
| Cash and cash equivalents at beginning of period | 97,942 | 140,462 |
| | <u> </u> | <u> </u> |
| Cash and cash equivalents at end of period | \$ 128,527 | \$ 27,662 |
| | <u> </u> | <u> </u> |

Reconciliation of net earnings to cash from operating activities:

| | | |
|--|-------------------|-------------------|
| Net earnings | \$ 182,109 | \$ 180,430 |
| Adjustments to reconcile net earnings to cash from operating activities: | | |
| Premiums receivable | (36,466) | (50,146) |
| Deferred policy acquisition costs | (11,617) | (21,550) |
| Residual market receivable | 25,050 | (9,247) |
| Due from reinsurers | 93,768 | (12,504) |
| Unpaid losses and loss adjustment expenses | (32,153) | 10,737 |
| Unearned premiums | 52,829 | 100,144 |
| Current income taxes | (28,854) | (11,632) |
| Deferred income taxes | 30,488 | (8,059) |
| Deferred income | 2,107 | (61) |
| Accrued agents' profit sharing | 9,992 | 44,129 |
| Other assets, liabilities and accrued expenses | (63,599) | (8,109) |
| Net realized investment gains | (7,665) | (20,800) |
| Other - net | 4,509 | 26,423 |
| | <u> </u> | <u> </u> |
| Cash from operating activities | \$ 220,498 | \$ 219,755 |
| | <u> </u> | <u> </u> |

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

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

1. Organization and Interim Financial Statements

Unless otherwise stated, "we," "our" or "us" means The Commerce Group, Inc. and its subsidiaries. Our consolidated financial statements include the accounts of The Commerce Group, Inc. and its subsidiaries. The Commerce Group, Inc. is a holding company and our operations are conducted through subsidiaries, the principal ones being The Commerce Insurance Company (Commerce), Citation Insurance Company (Citation), American Commerce Insurance Company (American Commerce or ACIC), and Commerce West Insurance Company (Commerce West). Dollar amounts are in thousands, except per share data and as otherwise noted. We have eliminated significant intercompany accounts and transactions in consolidating these financial statements. Also, we have reclassified certain 2005 amounts to conform with 2006 presentations.

We have prepared these financial statements in accordance with accounting principles generally accepted in the United States of America (GAAP). In preparing these financial statements in conformity with GAAP, we are required to make estimates and assumptions that affect the reported amounts of assets and liabilities at reporting dates and the reported amounts of revenues and expenses during the reporting periods. Actual results will differ from these estimates and assumptions. We employ significant estimates and assumptions in the determination of unpaid losses and loss adjustment expenses (LAE), the potential impairment of investments for other-than-temporary declines in market value and accrued agents' profit sharing. Our significant accounting policies are presented in the notes to our consolidated financial statements in our annual report on Form 10-K for the year ended December 31, 2005.

Our interim financial statements do not include all of the disclosures required by GAAP for annual financial statements. The year-end condensed balance sheet was derived from audited financial statements, but does not include all disclosures required by GAAP. In our opinion, we have included all adjustments, consisting of normal, recurring adjustments, considered necessary for a fair statement of the results for the interim periods. Operating results for the nine month period ended September 30, 2006 are not necessarily indicative of the results that may be expected for the year ending December 31, 2006. We have historically experienced greater claim losses in the first quarter of the year than during the other quarters of the year due to the winter weather, although in 2006 we experienced unusually mild winter weather conditions and fewer than usual claim losses. These unaudited consolidated financial statements should be read in conjunction with our consolidated financial statements in our annual report on Form 10-K for the year ended December 31, 2005.

On May 19, 2006, the Board of Directors approved a two-for-one stock split of our \$0.50 par value common stock effective on June 9, 2006. As a result of the split, 40,915,773 additional shares were issued, and additional paid-in capital was reduced by \$20,458. All references in the accompanying financial statements to the number of shares and per-share amounts for 2005 have been restated to reflect the stock split.

2. Comprehensive Income

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

| Three Months | | Nine Months | |
|--------------|------|-------------|------|
| 2006 | 2005 | 2006 | 2005 |
| | | | |

| | | | | |
|---|-----------|-----------|-----------|-----------|
| Net earnings | \$ 56,535 | \$ 59,830 | \$182,109 | \$180,430 |
| Other comprehensive income (loss), net of taxes: | | | | |
| Unrealized holding gains (losses) arising during the period ^(a) | 46,867 | (13,909) | 20,909 | (10,999) |
| Reclassification adjustment for investment (gains) losses included in net earnings ^(b) | 1,523 | (892) | 4,750 | (7,080) |
| Other comprehensive income (loss), net of taxes | 48,390 | (14,801) | 25,659 | (18,079) |
| Comprehensive income | \$104,925 | \$ 45,029 | \$207,768 | \$162,351 |

(a) Unrealized holding gains (losses) are net of income tax expense (benefits) of \$25,236 and \$(7,489) for the three months ended September 30, 2006 and 2005, respectively, and \$11,259 and \$(5,923) for the nine months ended September 30, 2006 and 2005, respectively.

(b) Reclassification adjustments are net of income tax expense (benefits) of \$820 and \$(480) for the three months ended September 30, 2006 and 2005, respectively and \$2,540 and \$(3,812) for the nine months ended September 30, 2006 and 2005, respectively.

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3. Net Earnings Per Common Share (EPS)

Basic EPS is based on the weighted average number of common shares outstanding. Diluted EPS is based on the weighted average number of common shares outstanding adjusted by the number of additional common shares that would have been outstanding had potentially dilutive common shares been issued and reduced by the number of common shares we could have purchased from the proceeds of the potentially dilutive shares. Our only dilutive instruments are stock options outstanding. We had 4,963,434 and 4,830,926 stock options outstanding at September 30, 2006 and 2005, respectively. Our outstanding stock options at September 30, 2006 and 2005 consisted of 16,084 and 22,576 stock options, respectively, that were granted to our employees under our Incentive Compensation Plan; the remainder of the total outstanding stock options consisted of American Commerce agents' options. Basic and diluted EPS for the three and nine months ended September 30 follow:

| | Three Months | | Nine Months | |
|--|--------------|----------|-------------|-----------|
| | 2006 | 2005 | 2006 | 2005 |
| Net earnings for basic and diluted EPS | \$56,535 | \$59,830 | \$182,109 | \$180,430 |

| | | | | |
|--|------------|------------|------------|------------|
| Common share information: | | | | |
| Average shares outstanding for basic EPS | 67,754,791 | 67,262,180 | 67,675,649 | 67,126,326 |
| Dilutive effect of stock options | 427,919 | 489,412 | 360,604 | 559,758 |
| Average shares outstanding for diluted EPS | 68,182,710 | 67,751,592 | 68,036,253 | 67,686,084 |
| Basic EPS | \$ 0.83 | \$ 0.89 | \$ 2.69 | \$ 2.69 |
| Diluted EPS | \$ 0.83 | \$ 0.88 | \$ 2.68 | \$ 2.67 |

Diluted EPS excludes stock options with exercise prices greater than the average market price of our common stock during the periods, because their inclusion would be anti-dilutive. For the three and nine months ended September 30, 2006, there were 1,250,000 and 2,200,000 anti-dilutive options, respectively. There were 800,000 anti-dilutive options for the three and nine months ended September 30, 2005.

Outstanding share and option amounts for 2005 were adjusted to reflect the June 9, 2006 two-for-one stock split.

4. Investments

Realized Investment Gains and Losses

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

| | Three Months | | Nine Months | |
|---|--------------|----------|-------------|----------|
| | 2006 | 2005 | 2006 | 2005 |
| Transaction net gains (losses): | | | | |
| Fixed maturity securities | \$(2,433) | \$ 1,882 | \$(1,317) | \$19,899 |
| Equity securities | (410) | 1,123 | (1,071) | 3,093 |
| Venture capital funds | 4,812 | 217 | 6,243 | 1,826 |
| Other investments | - | (726) | 16 | (396) |
| Total transaction net gains | 1,969 | 2,496 | 3,871 | 24,422 |
| Other-than-temporary impairment losses: | | | | |
| Fixed maturity securities | - | (146) | (1,103) | (305) |

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| | | | | |
|--|-------------------|-------------------|-------------------|-------------------|
| Equity securities | (1,839) | (743) | (1,839) | (4,547) |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| Total other-than-temporary impairment losses | (1,839) | (889) | (2,942) | (4,852) |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| Equity in earnings (losses) of closed-end preferred stock mutual funds | 7,700 | (1,411) | 6,736 | 1,230 |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| Net realized investment gains | \$ 7,830 | \$ 196 | \$ 7,665 | \$20,800 |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |

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Unrealized Investment Gains and Losses

The change in net unrealized gain (loss) on our fixed maturity and equity securities, excluding the impact of minority interest, from December 31, 2005 to September 30, 2006 follows:

| | September 30, 2006 | December 31, 2005 | Change |
|----------------------------|-----------------------|----------------------|-------------------|
| | <u> </u> | <u> </u> | <u> </u> |
| Fixed maturity securities | \$19,018 | \$ (7,954) | \$26,972 |
| Equity securities | 10,067 | (2,546) | 12,613 |
| | <u> </u> | <u> </u> | <u> </u> |
| Net unrealized gain (loss) | \$29,085 | \$(10,500) | \$39,585 |
| | <u> </u> | <u> </u> | <u> </u> |

Gross unrealized losses on our fixed maturity and equity securities at September 30, 2006 by duration of unrealized loss follow:

| | Total | 0-6 Months | 7-12 Months | 13-24 Months | Over 24 Months |
|---|-------------------|-------------------|-------------------|-------------------|-------------------|
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| Total fixed maturity and equity securities: | | | | | |
| Number of positions | 281 | 48 | 65 | 150 | 18 |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| Total fair market value | \$1,137,220 | \$196,563 | \$249,493 | \$638,824 | \$52,340 |
| Total amortized cost | 1,153,945 | 197,953 | 252,492 | 649,451 | 54,049 |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| Unrealized loss | \$ (16,725) | \$ (1,390) | \$ (2,999) | \$ (10,627) | \$ (1,709) |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> | <u> </u> |

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| | | | | | |
|---|-------------|-----------|------------|------------|------------|
| Unrealized loss percentage to fair market value | 1.5% | 0.7% | 1.2% | 1.7% | 3.3% |
| Fixed maturity securities: | | | | | |
| Number of positions | 235 | 25 | 49 | 143 | 18 |
| Total fair market value | \$ 980,891 | \$119,122 | \$210,421 | \$599,008 | \$52,340 |
| Total amortized cost | 995,185 | 119,741 | 212,676 | 608,719 | 54,049 |
| Unrealized loss | \$ (14,294) | \$ (619) | \$ (2,255) | \$ (9,711) | \$ (1,709) |
| Unrealized loss percentage to fair market value | 1.5% | 0.5% | 1.1% | 1.6% | 3.3% |
| Equity securities: | | | | | |
| Number of positions | 46 | 23 | 16 | 7 | - |
| Total fair market value | \$ 156,329 | \$ 77,441 | \$ 39,072 | \$ 39,816 | - |
| Total cost | 158,760 | 78,212 | 39,816 | 40,732 | - |
| Unrealized loss | \$ (2,431) | \$ (771) | \$ (744) | \$ (916) | - |
| Unrealized loss percentage to fair market value | 1.6% | 1.0% | 1.9% | 2.3% | - |

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Gross unrealized losses on our fixed maturity and equity securities at December 31, 2005 by duration of unrealized loss follow:

| | Total | 0-6 Months | 7-12 Months | 13-24 Months | Over 24 Months |
|---|-------------|---------------|----------------|-----------------|-------------------|
| Total fixed maturity and equity securities: | | | | | |
| Number of positions | 408 | 198 | 135 | 70 | 5 |
| Total fair market value | \$1,605,321 | \$846,546 | \$522,189 | \$230,542 | \$6,044 |
| Total amortized cost | 1,636,336 | 860,721 | 532,839 | 236,592 | 6,184 |

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| | | | | | |
|---|-------------|-------------|-------------|------------|----------|
| Unrealized loss | \$ (31,015) | \$ (14,175) | \$ (10,650) | \$ (6,050) | \$ (140) |
| Unrealized loss percentage to fair market value | 1.9% | 1.7% | 2.0% | 2.6% | 2.3% |
| Fixed maturity securities: | | | | | |
| Number of positions | 349 | 157 | 121 | 67 | 4 |
| Total fair market value | \$1,376,493 | \$663,824 | \$480,500 | \$226,974 | \$5,195 |
| Total amortized cost | 1,399,933 | 671,633 | 490,016 | 232,975 | 5,309 |
| Unrealized loss | \$ (23,440) | \$ (7,809) | \$ (9,516) | \$ (6,001) | \$ (114) |
| Unrealized loss percentage to fair market value | 1.7% | 1.2% | 2.0% | 2.6% | 2.2% |
| Equity securities: | | | | | |
| Number of positions | 59 | 41 | 14 | 3 | 1 |
| Total fair market value | \$ 228,828 | \$182,722 | \$ 41,689 | \$ 3,568 | \$ 849 |
| Total cost | 236,403 | 189,088 | 42,823 | 3,617 | 875 |
| Unrealized loss | \$ (7,575) | \$ (6,366) | \$ (1,134) | \$ (49) | \$ (26) |
| Unrealized loss percentage to fair market value | 3.3% | 3.5% | 2.7% | 1.4% | 3.1% |

We determined that the impairments of the securities represented in the above gross unrealized loss tables are temporary, based on a review of the credit quality, duration and severity of the unrealized losses for our impaired securities. Gross unrealized losses for equity and fixed maturity securities have decreased from December 31, 2005 primarily due to general market conditions in a falling interest rate environment. As of September 30, 2006, we have the intent and ability to hold either to recovery or maturity all of our temporarily impaired securities.

During the second quarter of 2006, we purchased additional shares of the preferred stock mutual fund, John Hancock Preferred Dividend Fund, bringing our total ownership above 20%. In accordance with APB 18, *The Equity Method of Accounting for Investments in Common Stock*, this investment is now accounted for under

the equity method of accounting. A net adjustment of \$164 to increase the carrying value to the equity method value was recorded in the second quarter. We did not adjust prior periods due to the immateriality of the amounts.

5. Unpaid Losses and LAE

Liabilities for unpaid losses and loss adjustment expenses at September 30, 2006 and December 31, 2005 follow:

| | September 30, 2006 | December 31, 2005 |
|--|-----------------------------|-----------------------------|
| | <u> </u> | <u> </u> |
| Net voluntary unpaid losses and LAE | \$809,113 | \$ 806,552 |
| Voluntary salvage and subrogation recoverable | (93,816) | (102,878) |
| Assumed unpaid losses and LAE reserves from CAR ^(a) | 135,005 | 152,506 |
| Assumed salvage and subrogation recoverable from CAR | (21,481) | (21,481) |
| | <u> </u> | <u> </u> |
| Total voluntary and assumed unpaid losses and LAE reserves | 828,821 | 834,699 |
| Adjustment for ceded unpaid losses and LAE reserves | 137,222 | 163,497 |
| Adjustment for ceded salvage and subrogation recoverable | (9,000) | (9,000) |
| | <u> </u> | <u> </u> |
| Total unpaid losses and LAE | <u>\$957,043</u> | <u>\$ 989,196</u> |

(a) Commonwealth Automobile Reinsurers

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

| | 2006 | 2005 |
|---|-----------------------------|-----------------------------|
| | <u> </u> | <u> </u> |
| Incurred losses and LAE: | | |
| Provision for insured events of the current year | \$842,198 | \$ 853,273 |
| Decrease in provision for insured events of prior years | (63,346) | (63,099) |
| | <u> </u> | <u> </u> |
| Total incurred losses and LAE | <u>778,852</u> | <u>790,174</u> |

Payments:

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| | | |
|---|-----------------------------|-----------------------------|
| Losses and LAE attributable to insured events of the current year | (458,317) | (471,933) |
| Losses and LAE attributable to insured events of prior years | (326,413) | (310,177) |
| | <u> </u> | <u> </u> |
| Total payments | (784,730) | (782,110) |
| | <u> </u> | <u> </u> |
| Change in loss and LAE reserves during the year | (5,878) | 8,064 |
| Loss and LAE reserves prior to the effect of ceded reinsurance recoverable, beginning of year | 834,699 | 830,126 |
| | <u> </u> | <u> </u> |
| Loss and LAE reserves prior to the effect of ceded reinsurance recoverable, end of period | 828,821 | 838,190 |
| Ceded reinsurance recoverable | 128,222 | 162,807 |
| | <u> </u> | <u> </u> |
| Unpaid losses and LAE | \$957,043 | \$1,000,997 |
| | <u> </u> | <u> </u> |

As a result of changes in estimates of insured events in prior years, the provision for loss and LAE decreased \$63,346 for the nine months ended September 30, 2006. The favorable development, also called redundancies, is due primarily to lower than anticipated losses related to the personal automobile liability and the automobile physical damage lines of business. Conditions and trends that have affected development in the past may not necessarily occur in the future. Accordingly, it may not be appropriate to extrapolate future redundancies or deficiencies based upon these developments. The amounts we will ultimately incur from loss and loss adjustment expenses could differ materially in the near term from the amounts recorded.

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

6. Bonds Payable

On December 9, 2003, we issued \$300,000 face value of senior unsecured and unsubordinated debt (the Senior Notes) which matures December 9, 2013. The Senior Notes were issued at 99.3% to yield 6.04%, and bear a coupon interest rate of 5.95%, payable semi-annually on June 9 and December 9 beginning in 2004. The fair market value of the Senior Notes at September 30, 2006 was estimated to be \$299,400.

7. Reinsurance

Ceded reinsurance recoverable amounts, which include amounts ceded to CAR and other unaffiliated reinsurers, are included in unpaid losses and loss adjustment expenses and unearned premiums. At September 30, 2006 and December 31, 2005, \$128,222 and \$154,497 were included in unpaid losses and loss adjustment expense amounts, respectively. At September 30, 2006 and December 31, 2005, \$63,069 and \$135,969 were included in the unearned premium liability amounts, respectively. The decreases in ceded reinsurance

recoverable amounts in unpaid loss and LAE and unearned premiums were primarily the result of the termination of the quota share agreements noted below.

On June 9, 2006, we entered into a series of agreements with participating reinsurers that provide catastrophe reinsurance for our insurance subsidiaries' other than automobile property lines of business for the contract year effective July 1, 2006 through June 30, 2007 (the "Catastrophe Reinsurance Program"). This new Catastrophe Reinsurance Program replaces the Company's terminated 75% quota share program, which had covered our other than automobile property and liability lines of business, except for umbrella (the "Previous Reinsurance Program") and our expiring one-year catastrophe treaty, which covered six percent of our exposure to Massachusetts FAIR Plan losses in excess of \$100 million up to a total Massachusetts FAIR Plan losses of \$1 billion (the "Previous Catastrophe Program"). The material terms and conditions of the Previous Reinsurance Program and the Previous Catastrophe Program are described in our Form 10-K for the year ended December 31, 2005.

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Effective July 1, 2006, we switched to a pure catastrophe reinsurance program across five layers as outlined below. The Catastrophe Reinsurance Program provides for reinsurance recovery of a maximum of \$492.5 million in the event of a \$600 million or greater occurrence, including all states' FAIR Plan losses. The total annual cost of the program is approximately \$31.1 million and includes one reinstatement premium (pro-rated based on loss recoveries) for a maximum additional cost of approximately \$31.1 million. The catastrophe program is based on \$192 million of estimated subject premiums, which vary based on actual subject premiums. This program covers all FAIR Plan-type participation but does not cover comprehensive automobile.

| Layer | Coverage | Percentage of Coverage Purchased for each Layer | Maximum Recovery per Layer |
|-----------------|--|---|----------------------------------|
| 1 st | \$25 million excess of \$25 million | 30% | \$7,500 |
| 2 nd | \$50 million excess of \$50 million | 50% | 25,000 |
| 3 rd | \$150 million excess of \$100 million | 80% | 120,000 |
| 4 th | \$300 million excess of \$250 million | 100% | 300,000 |
| 5 th | \$50 million excess of \$550 million | 80% | 40,000 |
| | | | <hr/> \$492,500 <hr/> |

The lines of business classified as property and covered under the new Catastrophe Reinsurance Program include fire, allied lines, homeowners, inland marine, special multi-peril and business owner policies. The Catastrophe Reinsurance Program covers losses occurring throughout the United States, except for the fourth and fifth layers which cover losses only in Massachusetts, New Hampshire, Rhode Island and Connecticut.

We will have no additional reinsurance recoveries for a single event catastrophe in excess of a total loss of \$600 million. Our average estimated combined total loss for the Commerce, Citation and ACIC insurance subsidiaries, on other than automobile business, was calculated using two prominent catastrophe modeling companies. The average estimated "100 year loss" is \$317 million and the "250 year loss" is \$583 million.

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

8. Commitments and Contingencies

During the second quarter of 2006, we entered into an agreement to fund a commercial loan participation of \$10,000. As of September 30, 2006, \$1,185 of this commitment has been funded and is included in other investments on the consolidated balance sheet. The remaining commitment will be funded through ordinary operating cash flows over the next two years.

Member companies of CAR have joint and several liabilities for the obligations of CAR, the Massachusetts-mandated personal automobile reinsurance mechanism that enables us and other Servicing Carriers to reinsure in CAR any risk. If one member of CAR fails to pay its assessments, the remaining members of CAR will be required to pay the pro-rata share of the member who fails to pay its obligations. As of September 30, 2006, we were not aware of any CAR member company which has failed to meet its obligations.

CAR Regulatory Reform

On January 5, 2005, we filed an action against the Insurance Commissioner in Massachusetts Superior Court appealing a December 31, 2004 order by the Commissioner adopting new rules that, among other things, would replace the current loss-pooling residual market entity, CAR, with an assigned risk plan. We contended that the Commissioner's new rules are inconsistent with existing Massachusetts insurance laws. Following a hearing on May 2, 2005, the Superior Court ruled, on June 20, 2005, that the Commissioner did not have the statutory authority to implement an assigned risk plan. The court's ruling annulled the Commissioner's order and vacated the new rules adopted pursuant to the order. The Commissioner appealed the Superior Court's decision to the Massachusetts Appeals Court. We and the Commissioner both petitioned for direct appellate review by the Massachusetts Supreme Judicial Court (the SJC). The SJC agreed on October 26, 2005 to hear the appeal directly. The parties submitted briefs to the SJC and the SJC heard oral arguments on May 4, 2006. On August 23, 2006, the SJC issued its decision ruling that the Commissioner has the authority to implement these new rules, including an assigned risk plan.

On August 23, 2006, the SJC issued its decision ruling that the Commissioner has the authority to implement these new rules, including an assigned risk plan.

In a notice issued by the Commissioner on October 18, 2006, the Commissioner gave notice of a hearing which will take place on November 10, 2006. The purpose of this hearing is to afford all interested parties the opportunity to provide testimony regarding proposed changes to the transition rules and the Massachusetts Automobile Insurance Plan (MAIP) rules. In the notice, the Commissioner indicated that even though the SJC ratified her authority to promulgate the assigned risk plan, called the MAIP, and affirmed her proposed changes in the 2004 Decision and Order to the CAR transition rules, that due to occurrences in the marketplace since December 31, 2004 some aspects of the transition rules and rules of the proposed MAIP are either no longer necessary or advisable. In addition, some of the deadlines set in the 2004 Decision and Order for

implementation of the MAIP had already passed. To address these issues, the Commissioner has revised the transition rules to eliminate provisions that are no longer necessary, integrate retained provisions of the transition rules into the current CAR rules, set a new timetable for implementation of the MAIP and revise the MAIP rules to conform to the SJC's remand regarding the "clean in three" provision. An implementation schedule has been proposed wherein new business would be written through the MAIP effective April 1, 2007 and renewal business effective July 1, 2007. The proposed revised transition rules and proposed MAIP rules can be viewed on CAR's website at <http://commauto.com>. We are currently reviewing the proposed changes and, if necessary, will revise any business strategies in response to the above but are unable to quantify any impact of these changes at this time.

9. Segments

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

| | Assets | Three Months | | Nine Months | |
|------------------------------------|-------------------|-------------------|-------------------|-------------------|-------------------|
| | | Revenue | Earnings | Revenue | Earnings |
| 2006: | | | | | |
| Property and casualty insurance: | | | | | |
| Massachusetts | \$3,646,841 | \$450,789 | \$83,925 | \$1,276,519 | \$275,460 |
| Other than Massachusetts | 401,540 | 58,667 | 10,976 | 159,498 | 23,500 |
| Real estate and commercial lending | 18,644 | 218 | 218 | 617 | 617 |
| Corporate and other | 22,098 | (197) | (14,765) | (662) | (38,380) |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| Consolidated | \$4,089,123 | \$509,477 | \$80,354 | \$1,435,972 | \$261,197 |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| 2005: | | | | | |
| Property and casualty insurance: | | | | | |
| Massachusetts | \$3,481,472 | \$410,367 | \$82,199 | \$1,238,877 | \$265,981 |
| Other than Massachusetts | 362,728 | 56,819 | 15,050 | 175,019 | 27,126 |
| Real estate and commercial lending | 17,726 | 184 | 184 | 461 | 461 |
| Corporate and other | 41,140 | (1,638) | (11,519) | (2,447) | (32,992) |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| Consolidated | \$3,903,066 | \$465,732 | \$85,914 | \$1,411,910 | \$260,576 |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> | <u> </u> |

Premium Results

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

| | 2006 | 2005 | \$ Change | % Change |
|--|------|------|-----------|----------|
|--|------|------|-----------|----------|

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| | | | | |
|--|-----------|-----------|---------|---------|
| Direct Premiums Written: | | | | |
| Massachusetts: | | | | |
| Personal automobile | \$345,247 | \$345,100 | \$ 147 | - |
| Commercial automobile | 21,609 | 21,305 | 304 | 1.4 % |
| Homeowners | 43,066 | 40,551 | 2,515 | 6.2 |
| Other lines | 10,119 | 10,382 | (263) | (2.5) |
| | | | | |
| Massachusetts direct premiums written | 420,041 | 417,338 | 2,703 | 0.6 |
| | | | | |
| Other than Massachusetts: | | | | |
| Personal automobile | 44,517 | 46,946 | (2,429) | (5.2) |
| Commercial automobile | 2,089 | 2,631 | (542) | (20.6) |
| Homeowners | 12,061 | 11,841 | 220 | 1.9 |
| Other lines | 448 | 320 | 128 | 40.0 |
| | | | | |
| Other than Massachusetts direct premiums written | 59,115 | 61,738 | (2,623) | (4.2) % |
| | | | | |
| Total direct premiums written | \$479,156 | \$479,076 | \$ 80 | - |

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| | 2006 | 2005 | \$ Change | % Change |
|---|-----------|-----------|-----------|----------|
| Direct Earned Premiums: | | | | |
| Massachusetts: | | | | |
| Personal automobile | \$338,198 | \$339,838 | \$(1,640) | (0.5) % |
| Commercial automobile | 25,192 | 23,978 | 1,214 | 5.1 |
| Homeowners | 35,530 | 32,784 | 2,746 | 8.4 |
| Other lines | 9,582 | 9,667 | (85) | (0.9) |
| | | | | |
| Massachusetts direct earned premiums | 408,502 | 406,267 | 2,235 | 0.6 |
| | | | | |
| Other than Massachusetts: | | | | |
| Personal automobile | 42,130 | 48,027 | (5,897) | (12.3) |
| Commercial automobile | 2,266 | 2,473 | (207) | (8.4) |
| Homeowners | 10,561 | 11,015 | (454) | (4.1) |
| Other lines | 393 | 321 | 72 | 22.4 |
| | | | | |
| Other than Massachusetts direct earned premiums | 55,350 | 61,836 | (6,486) | (10.5) |

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| | | | | |
|------------------------------|-----------|-----------|-----------|---------|
| Total direct earned premiums | \$463,852 | \$468,103 | \$(4,251) | (0.9) % |
|------------------------------|-----------|-----------|-----------|---------|

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

| | 2006 | 2005 | \$ Change | % Change |
|--|-------------|-------------|------------|----------|
| Direct Premiums Written: | | | | |
| Massachusetts: | | | | |
| Personal automobile | \$1,060,076 | \$1,079,907 | \$(19,831) | (1.8) % |
| Commercial automobile | 78,349 | 72,100 | 6,249 | 8.7 |
| Homeowners | 108,403 | 100,829 | 7,574 | 7.5 |
| Other lines | 29,179 | 30,082 | (903) | (3.0) |
| Massachusetts direct premiums written | 1,276,007 | 1,282,918 | (6,911) | (0.5) |
| Other than Massachusetts: | | | | |
| Personal automobile | 128,454 | 144,945 | (16,491) | (11.4) |
| Commercial automobile | 6,553 | 7,737 | (1,184) | (15.3) |
| Homeowners | 32,720 | 33,524 | (804) | (2.4) |
| Other lines | 1,222 | 964 | 258 | 26.8 |
| Other than Massachusetts direct premiums written | 168,949 | 187,170 | (18,221) | (9.7) |
| Total direct premiums written | \$1,444,956 | \$1,470,088 | \$(25,132) | (1.7) % |
| Direct Earned Premiums: | | | | |
| Massachusetts: | | | | |
| Personal automobile | \$1,006,928 | \$1,001,434 | \$ 5,494 | 0.5 % |
| Commercial automobile | 73,729 | 71,030 | 2,699 | 3.8 |
| Homeowners | 104,301 | 94,602 | 9,699 | 10.3 |
| Other lines | 28,756 | 29,145 | (389) | (1.3) |
| Massachusetts direct earned premiums | 1,213,714 | 1,196,211 | 17,503 | 1.5 |
| Other than Massachusetts: | | | | |
| Personal automobile | 125,101 | 145,530 | (20,429) | (14.0) |
| Commercial automobile | 7,039 | 7,086 | (47) | (0.7) |
| Homeowners | 30,871 | 32,297 | (1,426) | (4.4) |
| Other lines | 1,135 | 933 | 202 | 21.7 |

| | | | | |
|---|-------------|-------------|------------|---------|
| Other than Massachusetts direct earned premiums | 164,146 | 185,846 | (21,700) | (11.7) |
| Total direct earned premiums | \$1,377,860 | \$1,382,057 | \$ (4,197) | (0.3) % |

10. Recent Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board (FASB) issued Statement No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans - an amendment of FASB Statements No. 87, 88, 106 and 132(R)*. This Statement improves financial reporting by requiring an employer to recognize the overfunded or underfunded status of a defined benefit plan as an asset or liability in its financial statements and to recognize changes in that funded status in the years in which the changes occur through comprehensive income. This Statement also requires measurement of funded status as of the fiscal year-end, with limited exceptions. The Statement is effective for publicly traded companies for fiscal years ending after December 15, 2006. We do not expect the adoption of this Statement to have a material impact on our results of operations or financial position.

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

In September 2006, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements* (SAB 108). SAB 108 establishes an approach that requires quantification of financial statement errors based on the effects of the error on each of the company's financial statements and related disclosures. This model is referred to as the dual approach, as it requires errors to be quantified for their impact on both the income statement (including reversing effect of prior year misstatements) and the period-end balance sheet. SAB 108 is effective for fiscal year ends after November 15, 2006. We do not expect the adoption of SAB 108 to have a material impact on our results of operations or financial position.

In July 2006, the FASB released FIN 48, *Accounting for Uncertainty in Income Taxes - an interpretation of SFAS 109*. This interpretation clarifies the accounting for uncertainty in income taxes recognized in accordance with SFAS 109. This interpretation prescribes a recognition threshold and measurement attribute for financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. It also provides guidance on derecognition, classification, interest and penalties, interim periods and disclosure. FIN 48 is effective for fiscal years beginning after December 15, 2006. We will adopt FIN 48 as of January 1, 2007 and we do not expect the adoption to have a material impact on our results of operation or financial position.

In March 2006, the FASB issued Statement No. 156, *Accounting for Servicing of Financial Assets, an amendment of Statement No. 14* (SFAS 156). SFAS 156 requires all separately recognized servicing assets and servicing liabilities to be initially measured at fair value, if practicable, and permits an entity to subsequently measure those servicing assets and servicing liabilities at fair value. SFAS 156 is effective for fiscal years beginning after September 15, 2006. We do not expect the adoption of SFAS 156 to have a material impact on

our results of operations or financial position.

In February 2006, the FASB issued Statement No. 155, *Accounting for Certain Hybrid Financial Instruments - an amendment of FASB Statements No. 133 and 140*. The Statement permits fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation. The new Statement also requires companies to identify interests in securitized financial assets that are freestanding derivatives or contain embedded derivatives that would have to be accounted for separately and that interest-only and principal-only strips are not subject to Statement No. 133. This new Statement is effective for fiscal years beginning after September 15, 2006 with early adoption permitted. Although we do not currently have any financial instruments subject to this new Statement, we elected to adopt this Statement effective January 1, 2006.

In June 2005, the FASB issued Statement No. 154, *Accounting Changes and Error Corrections - A Replacement of APB Opinion No. 20 and FASB Statement No. 3* (FAS 154). The Statement applies to all voluntary changes in accounting principles and requires that such changes be applied retrospectively to prior periods unless doing so is impracticable. The Statement does not change the transition method for new accounting standards where the new pronouncements address transition provisions. The Statement was effective January 1, 2006. FAS 154 did not have an impact on our financial position or results of operations.

The FASB issued in December 2004 revised rules for accounting for stock options and other equity-based remuneration, SFAS No. 123R, *Share-Based Payment*. We adopted these revised rules in the first quarter of 2006 when they became effective. This change did not impact our results of operations and financial condition for the employee stock options we awarded through 2001 under the Plan because application of the revised rules is on a prospective basis, these awards were fully vested and we have not modified, repurchased or cancelled any of these stock options. The revised rules did not change our accounting for book value awards (BVAs), incentive awards (IAs) and the stock options we award under the American Commerce agents' option Plan.

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

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

The purpose of the following discussion and analysis is to provide you with information that will assist you in understanding our financial condition and results of operations as reported in our consolidated financial statements. Therefore, the following should be read in conjunction with our consolidated financial statements in this Form 10-Q and with our Management's Discussion and Analysis of Financial Condition and Results of Operations in our annual report on Form 10-K for the year ended December 31, 2005.

Business Overview

We provide personal and commercial property and casualty insurance primarily in Massachusetts and, to a lesser extent, in other states. Our core product lines are personal automobile, homeowners and commercial automobile. We market our products through our network of independent agents in all states except California, where we use agents and brokers. Our primary business strategy is to focus on the personal automobile insurance market in Massachusetts and to grow and diversify by increasing the proportion of our business

written in other states in which we currently have a significant presence, primarily from Commerce West and American Commerce.

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

Massachusetts personal automobile insurance rates are set annually by the Commissioner. All companies writing personal automobile policies are required to use such mandated rates, unless they have received prior approval from the Commissioner to offer a lower rate. In establishing the classifications of risks and personal automobile rates for 2007, the Commissioner must consider numerous factors that are based upon data primarily for the 2005 calendar year supplemented by trending data from previous years. In addition, the Commissioner considers rates proposed by the Automobile Insurance Bureau of Massachusetts (AIB), the State Rating Bureau of Massachusetts (SRB), and the Massachusetts Attorney General (AG). Each of these organizations has submitted its proposal for the 2007 rate. The Commissioner has not established the rate for 2007 personal automobile policies; however, we expect the Commissioner will reduce the rate from its current level, based on the industry's profitable underwriting results for calendar year 2005. The rate for 2007 will be effective for policies written from April 1, 2007 through March 31, 2008. The personal automobile policy rate changes proposed for policy years 2003 - 2007 contrasted with the state mandated average rate change for each year follows:

| | 2007 | 2006 | 2005 | 2004 | 2003 |
|---|---------|---------|----------|------------|--------|
| Proposed rate changes by: | | | | | |
| AIB | (3.7)% | (0.1)% | 5.8-9.2% | 12.4% | 7.0% |
| SRB | (8.3)% | (7.6)% | 1.0% | 3 to 4% | 2.0% |
| AG | (18.2)% | (18.0)% | (6.2)% | 0% | (5.7)% |
| Actual state mandated average rate change | Unknown | (8.7)% | (1.7)% | 2.5% | 2.7% |

The Commissioner is required by statute to announce the 2007 rate by December 15, 2006.

Our ability to capitalize on our business strengths and implement our strategies is subject to particular risks. For a complete discussion of our risk factors, see Item 1A, Risk Factors, in our annual report on Form 10-K for the year ended December 31, 2005.

During the second quarter of 2006, A.M. Best, generally considered to be a leading authority on insurance company ratings and information, affirmed our and our insurance subsidiaries' financial ratings. A.M. Best rated each entity A+, Superior, with a stable outlook. See our risk factor discussion in Item 1A of our 2005 Annual Report on Form 10-K for a complete discussion of the impact of our financial strength rating on our business.

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Commonwealth Automobile Reinsurers

A significant aspect of our automobile insurance business relates to our interaction with Commonwealth Automobile Reinsurers (CAR). CAR is a reinsurance mechanism mandated in Massachusetts that enables us

and the other participating servicing carriers to reinsure any automobile risk that the carriers perceive to be under-priced. Since its inception, CAR has annually generated significant underwriting losses, primarily in the personal automobile pool. All companies writing automobile insurance in Massachusetts share in the underwriting results of CAR business for their respective product line or lines.

Member companies of CAR have joint and several liabilities for the obligations of CAR. If one member of CAR fails to pay its assessments, the remaining members of CAR will be required to pay the pro-rata share of the member who fails to pay its obligations. As of September 30, 2006, we were not aware of any current CAR member company which failed to meet its obligations.

CAR Regulatory Reform

On January 5, 2005, we filed an action against the Insurance Commissioner in Massachusetts Superior Court appealing a December 31, 2004 order by the Commissioner adopting new rules that, among other things, would replace the current loss-pooling residual market entity, CAR, with an assigned risk plan. We contended that the Commissioner's new rules are inconsistent with existing Massachusetts insurance laws. Following a hearing on May 2, 2005, the Superior Court ruled, on June 20, 2005, that the Commissioner did not have the statutory authority to implement an assigned risk plan. The court's ruling annulled the Commissioner's order and vacated the new rules adopted pursuant to the order. The Commissioner appealed the Superior Court's decision to the Massachusetts Appeals Court. We and the Commissioner both petitioned for direct appellate review by the SJC. The SJC agreed on October 26, 2005 to hear the appeal directly. The parties submitted briefs to the SJC and the SJC heard oral arguments on May 4, 2006.

On August 23, 2006, the SJC issued its decision ruling that the Commissioner has the authority to implement these new rules, including an assigned risk plan. In a notice issued by the Commissioner on October 18, 2006, the Commissioner gave notice of a hearing which will take place on November 10, 2006. The purpose of this hearing is to afford all interested parties the opportunity to provide testimony regarding proposed changes to the transition rules and the MAIP rules. In the notice, the Commissioner indicated that even though the SJC ratified her authority to promulgate the assigned risk plan, called the MAIP, and affirmed her proposed changes in the 2004 Decision and Order to the CAR transition rules, that due to occurrences in the marketplace since December 31, 2004 some aspects of the transition rules and rules of the proposed MAIP are either no longer necessary or advisable. In addition, some of the deadlines set in the 2004 Decision and Order for implementation of the MAIP had already passed. To address these issues, the Commissioner has revised the transition rules to eliminate provisions that are no longer necessary, integrate retained provisions of the transition rules into the current CAR rules, set a new timetable for implementation of the MAIP and revise the MAIP rules to conform to the SJC's remand regarding the "clean in three" provision. An implementation schedule has been proposed wherein new business would be written through the MAIP effective April 1, 2007 and renewal business effective July 1, 2007. The proposed revised transition rules and proposed MAIP rules can be viewed on CAR's website at <http://commauto.com>. We are currently reviewing the proposed changes and, if necessary, will revise our business strategies in response to the above but are unable to quantify any impact of these changes at this time.

As more fully discussed in the 2005 Annual Report on Form 10-K, CAR implemented a redistribution plan for the personal automobile residual market. The plan was effective March 1, 2006 for new business and May 1, 2006 for renewal business. In addition, effective January 1, 2006, CAR implemented a limited servicing carrier program for the commercial automobile residual market.

Our Revenues and Expenses

Our revenues principally reflect:

- * earned premiums, consisting of:
 - premiums that we receive primarily from sales by our agents of property and casualty insurance policies, primarily personal automobile, homeowners and commercial automobile, which we refer to as direct premiums written, *plus*
 - premiums we receive from insurance policies that we assume, primarily from CAR, which we refer to as assumed premiums, *less*

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- the portion of our premiums that is ceded to CAR and other reinsurers, which we refer to as ceded premiums, *less*
- the change in the portion of premiums that will not be recognized as income for accounting purposes until a future period, which we refer to as unearned premiums;

- * investment income that we earn on our invested assets;
- * premium finance charges and service fee income that we earn in connection with the billing and deferral of premium payments; and
- * realized investment gains and losses.

Our expenses principally reflect:

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

Our Performance Measures

We evaluate our operations by monitoring key measures of growth and profitability. We measure our growth by examining our direct premiums written as well as increases in exposures and policies. We generally measure our operating results in accordance with accounting principles generally accepted in the United States of America (GAAP) by examining our net earnings, return on equity (ROE), and our loss and LAE, underwriting expense and combined ratios on a consolidated basis. Our key measures include:

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

- * Return on Equity

. Return on equity is net earnings divided by stockholders' equity at the beginning of the period.
- * Direct Premiums Written.

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

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

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

The loss and LAE ratio is the percentage of losses and loss adjustment expenses (including corporate expenses) incurred to earned premiums. We calculate this ratio net of our reinsurance recoveries. We use this ratio as a measure of the overall underwriting profitability of the insurance business we write and to assess the adequacy of our pricing.
- * Underwriting Expense Ratio.

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

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

* Combined Ratio.

The combined ratio is the sum of the loss and LAE ratio and the underwriting expense ratio and measures a company's overall underwriting profit. If the combined ratio is at or above 100%, an insurance company cannot be profitable without investment income, and may not be profitable if

investment income is insufficient. We use the combined ratio in evaluating our overall underwriting profitability and for comparing our profitability to that of our competitors. We generally seek to achieve a combined ratio of less than 100%.

Results of Operations for the Periods Ended September 30, 2006 and 2005

Consolidated Results

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

| (Dollars in Millions) | Three Months | | Nine Months | |
|----------------------------------|--------------|---------|-------------|-----------|
| | 2006 | 2005 | 2006 | 2005 |
| Diluted earnings per share (EPS) | \$0.83 | \$0.88 | \$2.68 | \$2.67 |
| Return on equity, annualized | 16.3% | 19.5% | 18.6% | 21.6% |
| Direct premiums written | \$479.2 | \$479.1 | \$1,445.0 | \$1,470.1 |
| Direct earned premiums | \$463.9 | \$468.1 | \$1,377.9 | \$1,382.1 |
| Net investment income | \$34.4 | \$30.0 | \$104.1 | \$90.4 |
| Loss and LAE ratio | 59.2% | 56.1% | 59.8% | 61.8% |
| Underwriting expense ratio | 28.4 | 32.0 | 27.5 | 27.0 |
| Combined ratio | 87.6% | 88.1% | 87.3% | 88.8% |

The increase in the year-to-date **diluted earnings per share** is primarily due to a decrease in our loss ratio and an increase in net investment income partially offset by an increase in our underwriting expense ratio and a decline in net realized investment gains. Our annualized return on equity decreased for the current year-to-date period over the same period in the prior year primarily due to a higher level of equity partially offset by increased net earnings. For the first nine months of 2006, net realized investment gains totaled \$7,665, while for the same period in 2005, \$20,800 of net gains were realized. Included in the reported diluted EPS are \$0.07 and \$0.20 for the nine months ended September 30, 2006 and 2005, respectively, related to net investment gains. Diluted EPS also benefited in 2006 from an increase in net investment income of \$13,705, or 15.2%, for the first nine months of 2006 over the comparable 2005 period.

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

- * a decrease in the current year personal automobile bodily injury and physical damage claim frequencies compared to the same period in the prior year; and,
- * continued improvement in CAR results due to fewer industry-wide cessions to CAR coupled with lower loss ratios on that business and more favorable loss reserve development.

The improved results from CAR are primarily attributable to favorable loss development on the business assumed from CAR, coupled with better current year results. Favorable loss development occurs when actual loss payments are less than the estimated payments that are built into the loss reserves. The favorable loss development from CAR was primarily the result of two factors. First was the decline in business assumed from CAR, which will be discussed in greater detail in the Premium Results section. Second, the improved results from CAR reduced our overall loss ratio by approximately one percentage point. For the nine months ended September 30, 2006, the CAR loss and LAE to earned premium ratio was 76.0%, as compared to 88.0% for the same period a year ago. Actuarial data provided by CAR indicates that this favorable development may lessen over the next several quarters.

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

| | 2006 | 2005 |
|---|-------------------|-------------------|
| | <u> </u> | <u> </u> |
| Incurring losses and LAE: | | |
| Provision for insured events of the current year | \$842,198 | \$ 853,273 |
| Decrease in provision for insured events of prior years | (63,346) | (63,099) |
| | <u> </u> | <u> </u> |
| Total incurred losses and LAE | 778,852 | 790,174 |
| | <u> </u> | <u> </u> |
| Payments: | | |
| Losses and LAE attributable to insured events of the current year | (458,317) | (471,933) |
| Losses and LAE attributable to insured events of prior years | (326,413) | (310,177) |
| | <u> </u> | <u> </u> |
| Total payments | (784,730) | (782,110) |
| | <u> </u> | <u> </u> |
| Change in loss and LAE reserves during the year | (5,878) | 8,064 |
| Loss and LAE reserves prior to the effect of ceded reinsurance recoverable, beginning of year | 834,699 | 830,126 |
| | <u> </u> | <u> </u> |
| Loss and LAE reserves prior to the effect of ceded reinsurance recoverable, end of period | 828,821 | 838,190 |
| Ceded reinsurance recoverable | 128,222 | 162,807 |
| | <u> </u> | <u> </u> |
| Loss and LAE reserves | \$957,043 | \$1,000,997 |
| | <u> </u> | <u> </u> |

As a result of changes in estimates of insured events in prior years, the provision for loss and LAE decreased \$63,346 for the nine months ended September 30, 2006. The favorable development, also called redundancies, is due primarily to lower than anticipated losses related to the personal automobile liability and the automobile physical damage lines of business. Conditions and trends that have affected development in the past may not necessarily occur in the future. Accordingly, it may not be appropriate to extrapolate future

redundancies or deficiencies based upon these developments. The amounts we will ultimately incur from loss and loss adjustment expenses could differ materially in the near term from the amounts recorded.

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

As a result of changes in estimates of insured events in prior years, the provision for loss and LAE decreased \$63,099 for the nine months ended September 30, 2005. The favorable development was due primarily to lower than anticipated losses related to the personal automobile liability and the automobile physical damage lines of business. Conditions and trends that have affected development in the past may not necessarily occur in the future.

Approximately \$52,851 in personal automobile liability redundancies developed for the nine months ended September 30, 2005, with approximately 92% of this amount coming from the 2004, 2003 and 2002 accident years. Automobile physical damage had approximately \$8,215 in redundancies chiefly related to the 2004 accident year. Redundancies relating to CAR were approximately 21% of the total redundancies relating to prior years. For the nine months ended September 30, 2005, we experienced various redundancies and deficiencies for the other lines of business and accident years that combined for the remaining \$2,033 net redundancy.

The primary reasons for the increase in our **underwriting expense ratio** are an increase in our agents' profit sharing expense and higher 2006 policy year mandated Massachusetts personal automobile commissions. The increase in agents' profit sharing expense is a result of an improved loss ratio for the first nine months of 2006 versus the same period last year. A mandated rate decrease for 2006 Massachusetts personal automobile policies enhanced the impact of the higher personal automobile commissions, therefore increasing commissions as a percentage of revenues. In addition, expense increased through lower ceded reinsurance commissions.

The decrease in the quarterly diluted EPS is primarily due to an increased loss ratio and higher underwriting expenses, partially offset by increased net investment income and net realized investment gains. For the current year third quarter, net realized investment gains totaled \$7,830, or \$0.07 per diluted share, while for the same period in 2005 net gains were \$196, with no reportable effect on diluted EPS. Net investment income increased \$4,377, or 14.6%, in the current year period over the prior year.

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The increase in our loss and LAE ratio was primarily the result of a small increase in current year physical damage claim severity, decreased earned premium per earned exposure as a result of the 2006 rate decrease, coupled with more normal CAR results compared to the same period in the prior year, which was unusually low due to higher loss redundancies.

Underwriting expenses increased \$17,121, or 12.7%, over the same quarter in the previous year. The underwriting ratio calculates low this quarter because of the significant increase in unearned premium and resulting impact on net written premium due to the termination of the quota share treaty. The increased expense resulted from higher CAR expense, higher commissions and less ceded reinsurance commission due to the termination of the quota share treaty, partially offset by lower agents' profit sharing.

Segment Results

Massachusetts Segment

Revenues for the three and nine months ended September 30, 2006 increased from their same periods a year ago. The nine month increase in revenues of \$37,642 primarily resulted from increases in earned premiums and investment income partially offset by a decline in realized investment gains. For the three months ended September 30, 2006, revenues increased by \$40,422. This increase primarily resulted from increased realized gains, coupled with an increase in earned premiums and investment income.

Earnings for the nine months ended September 30, 2006 increased over the same period a year ago. This increase was primarily the result of better loss experience and higher revenues partially offset by higher policy acquisition costs. Earnings for the three months ended September 30, 2006 increased over the same period a year ago. This increase was due to increased revenues partially offset by higher policy acquisition costs and loss experience.

Other than Massachusetts Segment

Revenues for the nine months ended September 30, 2006 decreased from the same period a year ago. This decrease in revenues primarily resulted from realized investment losses in 2006 versus realized gains for the nine months ended September 30, 2005, coupled with a decrease in earned premiums, partially offset by an increase in investment income.

Earnings for the three and nine months ended September 30, 2006 decreased over the same period a year ago. This decrease was due to lower revenues coupled with higher policy acquisition costs, partially offset by better loss experience.

Corporate and Other

Losses for corporate and other increased for the three and nine months ended September 30, 2006 versus the same periods a year ago. The primary reason for this increase was the increase in expense for options granted to our agents.

Premium Results

We evaluate our performance and allocate resources based primarily on our property and casualty insurance segments, which represent nearly all of our total revenues. Direct premiums written and earned for the three and nine months ended September 30, 2006 and 2005 can be seen in Note 9.

Massachusetts Segment

For the first nine months of 2006, direct premiums written declined \$6,911, or 0.5%, over the comparable period of 2005, while direct premiums earned increased \$17,503, or 1.5%, over the same periods. The decrease in direct premiums written resulted primarily from a decrease in premiums written for personal automobile, offset in part by an increase in premiums written for commercial automobile and homeowners.

For the third quarter of 2006, direct premiums written increased \$2,703, or 0.6%, over the comparable quarter of 2005 and direct premiums earned increased \$2,235, or 0.6%, over the same periods. Increases in homeowners direct premiums written and earned were the primary drivers of the increased direct premiums. An increase in commercial automobile direct earned premiums offset a decline in personal automobile direct earned premiums during the quarter.

The decrease of \$19,831 in year-to-date direct premiums written for personal automobiles resulted from a

decrease of 5.8% in the average written premium per exposure, partially offset by a 4.1% increase in written exposures. The increase in exposures resulted from the combination of increased volumes from continuing voluntary agents, which accounted for one

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third of the increase, and volumes from new ERPs assigned to us under the previously discussed redistribution plan, which accounted for the remaining two thirds. For 2006, the Commissioner approved an 8.7% decline in the state mandated average personal automobile rate, which resulted in the 5.8% decline for us.

Direct premiums written for commercial automobile and homeowners both increased for the first nine months of 2006 over the same period a year earlier. Commercial automobile direct premiums written increased \$6,249, or 8.7%, due to a 4.7% increase in average premium per policy coupled with a 3.8% increase in the number of policies written. The increase in the number of commercial automobile policies is the direct result of the new limited servicing carrier program enacted by the Commissioner, effective January 1, 2006. Homeowners increased \$7,574, or 7.5%. This increase is due to a 6.9% increase in average premium per policy partially offset by a 1.0% decline in the number of written policies, coupled with increased FAIR plan volumes.

Assumed premiums from CAR were \$78,377 and \$107,679 for the nine months ended September 30, 2006 and 2005, respectively. This decrease was the result of decreased cessions of private passenger automobile premiums to CAR by us and the rest of the industry for 2006, as compared to the same period in the prior year. Due to the lag in receiving data from CAR, each quarter we are required to estimate CAR results for the most recent quarter.

As a result of the termination of our 75% quota share agreement, Massachusetts net premiums increased \$60,532 in the third quarter of 2006. This increase in written premium resulted in approximately \$26,029 in earned premium for the quarter.

Other than Massachusetts Segment

For the first nine months of 2006, direct premiums written declined \$18,221, or 9.7%, over the comparable period of 2005, while direct earned premiums declined \$21,700, or 11.7%, primarily the result of the decline in direct premiums written. The decrease in direct premiums written resulted primarily from a decrease in premiums written for personal automobile. The overall decrease in personal automobile direct premiums written is primarily due to a decline in the number of policies. The decline in the number of policies is largely attributable to the loss of American Commerce's former largest agent, AAA Arizona, Inc., which resulted in a 59% decline in personal automobile policies in force in Arizona from the prior year. In addition, direct premiums written in Ohio declined 26% primarily due to the state's highly competitive market. Direct premiums written for homeowners declined due to an 8% decrease in the number of policies in force as compared to a year earlier, primarily the result of the decrease in business in Arizona, Ohio and Kentucky. In general, we are attempting to increase the business we write by lowering rates in the states in which we write business in response to competitive pressures and enhancing our technology to make it easier for agents to write business with us. Partially offsetting these declines were increases in Oregon and Washington. Direct premiums written increased 20% in Oregon and 11% in Washington, both as a result of increases in policy counts.

For the third quarter of 2006, direct premiums written declined \$2,623, or 4.2%, from the same period in the prior year, while premiums earned declined \$6,486, or 10.5%. These declines resulted from the same factors as previously discussed for the year-to-date periods. Arizona personal automobile in force policy count at September 30, 2006 has stabilized as compared to June 30, 2006.

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As a result of the termination of our 75% quota share agreement, other than Massachusetts net premiums increased \$17,176 in the third quarter of 2006. This increase in written premium resulted in approximately \$7,386 in earned premium for the quarter.

Net Investment Income

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

| | 2006 | 2005 | Change |
|--|-----------------------------|-----------------------------|-----------------------------|
| | <u> </u> | <u> </u> | <u> </u> |
| Average month-end investments (at cost) | \$2,865,215 | \$2,666,468 | \$198,747 |
| Net investment income, before federal tax | 34,417 | 30,040 | 4,377 |
| Net investment income, after federal tax | 26,017 | 23,795 | 2,222 |
| Net investment income as an annualized percentage of average net investments (at cost), before federal tax | 4.8% | 4.5% | 0.3% |
| Net investment income as an annualized percentage of average net investments (at cost), after federal tax | 3.6% | 3.6% | - |

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

| | 2006 | 2005 | Change |
|--|-----------------------------|-----------------------------|-----------------------------|
| | <u> </u> | <u> </u> | <u> </u> |
| Average month-end investments (at cost) | \$2,834,257 | \$2,627,629 | \$206,628 |
| Net investment income, before federal tax | 104,065 | 90,360 | 13,705 |
| Net investment income, after federal tax | 78,972 | 70,415 | 8,557 |
| Net investment income as an annualized percentage of average net investments (at cost), before federal tax | 4.9% | 4.6% | 0.3% |
| Net investment income as an annualized percentage of average net investments (at cost), after federal tax | 3.7% | 3.6% | 0.1% |

The increase in our net investment income for both quarter and year-to-date periods was due to the combination of increased invested assets, as noted above by the increase in average month-end investments, at cost, coupled with an increased return on those invested assets. The yield increased 30 basis points to 4.9% for the first nine months of 2006. The increase in invested assets is primarily attributable to cash generated from operating activities, including the \$48.6 million of net cash received upon termination of the quota share agreement. The primary contributor to the increase in yield was government bonds, which includes mortgage-backed securities (up 110 basis points), partially offset by a decline in dividends on common stocks and municipal bonds (down 40 basis points). The duration of our fixed maturity portfolio at September 30, 2006 was 4.9 years compared to 4.9 years at year-end 2005.

Realized Investment Gains and Losses

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

| | Three Months | | Nine Months | |
|--|-----------------|---------------|-----------------|-----------------|
| | 2006 | 2005 | 2006 | 2005 |
| Transaction net gains (losses): | | | | |
| Fixed maturity securities | \$(2,433) | \$1,882 | \$(1,317) | \$19,899 |
| Equity securities | (410) | 1,123 | (1,071) | 3,093 |
| Venture capital funds | 4,812 | 217 | 6,243 | 1,826 |
| Other investments | - | (726) | 16 | (396) |
| Total transaction net gains | 1,969 | 2,496 | 3,871 | 24,422 |
| Other-than-temporary impairment losses: | | | | |
| Fixed maturity securities | - | (146) | (1,103) | (305) |
| Equity securities | (1,839) | (743) | (1,839) | (4,547) |
| Total other-than-temporary impairment losses | (1,839) | (889) | (2,942) | (4,852) |
| Equity in earnings (losses) of closed-end preferred stock mutual funds | 7,700 | (1,411) | 6,736 | 1,230 |
| Net realized investment gains | \$ 7,830 | \$ 196 | \$ 7,665 | \$20,800 |

The higher level of net realized investment gains for the current year quarter was primarily due to the increase in gains on preferred stock mutual funds and venture capital funds. The increase in equity in earnings (losses) of closed-end preferred stock mutual funds, which hold significant amounts of long duration preferred stocks, was primarily the result of the decrease in general market interest rates during the third quarter. The lower level of gains for the current year to date period was primarily due to a higher level of general interest rates through the second quarter as compared to the previous year.

Policy Acquisition Costs

Year-to-date policy acquisition costs increased \$34,728, or 10.0%, over the same period a year ago. The increase is primarily due to increases in agents' profit sharing and commissions, a reduced amount of acquisition costs deferred and a decrease in ceded reinsurance commissions. Year-to-date 2006 commissions increased \$5,907, or 3.0%, over the same period last year. This increase was principally due to an increase in the Massachusetts 2006 policy year mandated personal automobile commission rates partially offset by a reduction in direct written premiums. Year-to-date 2006 agents' profit sharing expense increased \$5,535, or 6.2%, over the same period last year. This increase resulted from an improved loss ratio for the first nine months of 2006 versus the first nine months of 2005. Ceded reinsurance commissions decreased primarily as a result of the termination of the quota share treaty on June 30, 2006.

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Financial Condition

Our stockholders' equity per share increased 12.4% from \$19.39 per share at December 31, 2005 to \$21.79 per share at September 30, 2006, after dividends paid of \$0.725 per share. The carrying value of our total investments increased 8.0% primarily due to the investment of cash generated from operating activities and an increase in unrealized gains. Since December 31, 2005, the ratio of our total liabilities to stockholders' equity improved to 176% from 200% primarily due to net earnings for the nine months ended September 30, 2006, investment portfolio appreciation, and declines in unpaid losses and LAE, partially offset by increases in unearned premiums.

Liabilities for unpaid losses and loss adjustment expenses at September 30, 2006 and December 31, 2005 follow:

| | September 30, 2006 | December 31, 2005 |
|--|-----------------------------|-----------------------------|
| | <u> </u> | <u> </u> |
| Net voluntary unpaid losses and LAE | \$809,113 | \$806,552 |
| Voluntary salvage and subrogation recoverable | (93,816) | (102,878) |
| Assumed unpaid losses and LAE reserves from CAR | 135,005 | 152,506 |
| Assumed salvage and subrogation recoverable from CAR | (21,481) | (21,481) |
| | <u> </u> | <u> </u> |
| Total voluntary and assumed unpaid losses and LAE reserves | 828,821 | 834,699 |
| Adjustment for ceded unpaid losses and LAE reserves | 137,222 | 163,497 |
| Adjustment for ceded salvage and subrogation recoverable | (9,000) | (9,000) |
| | <u> </u> | <u> </u> |
| Total unpaid losses and LAE | <u>\$957,043</u> | <u>\$989,196</u> |

Industry and regulatory guidelines suggest that the ratio of a property and casualty insurer's annual net premiums written to statutory policyholders' surplus should not exceed 3.00 to 1.00. Our twelve-month rolling net premiums written to statutory surplus ratio was 1.16 to 1.00 for the period ended September 30, 2006 and 1.22 to 1.00 for the period ended September 30, 2005.

The decrease in unpaid loss and LAE was primarily due to better loss results, which resulted in lower reserves, coupled with a decrease in unpaid losses assumed from CAR. On July 1, 2006, we terminated our 75% quota share agreement. This termination did not have any impact on the total unpaid loss and LAE amount; however, it did impact categories within the unpaid loss and LAE total. The net voluntary unpaid losses and LAE increase, as shown in the chart above, was primarily due to the fact that other than automobile reserves established in the third quarter of 2006 were fully retained by us as opposed to being 75% ceded for periods prior to June 30, 2006. This increase is directly correlated to the corresponding decrease for ceded unpaid losses and LAE reserves.

The increase in unearned premiums was primarily the result of the seasonality of policy effective dates. The total amount of a policy's premium is recorded as written premium on the first day on which the policy is effective; however, the policy premium is earned ratably over the ensuing year. This was partially offset by a decrease in direct written premium coupled with a decrease in assumed unearned premium from CAR.

Liquidity and Capital Resources

Liquidity management allows us to meet our cash needs at a reasonable cost under various operating environments. Liquidity is actively managed and reviewed in order to maintain stable, cost-effective funding to meet our operating needs. Liquidity comes from a variety of sources such as cash flow from operating activities and borrowing capacity. Management believes its current liquidity exceeds its operational requirements as of September 30, 2006.

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

We have additional liquidity capacity through our Federal Home Loan Bank (FHLB) membership and our investment portfolio. Commerce, as a member of FHLB of Boston, is able to borrow from the FHLB on a fully secured

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basis. Our borrowing capacity is based primarily upon the composition and market value of Commerce's investment portfolio. At September 30, 2006, we estimate Commerce's borrowing capacity at approximately \$400,000. Since becoming a member in 2005, Commerce has not borrowed from FHLB of Boston.

During the second quarter of 2006, we entered into an agreement to fund a commercial loan participation of \$10,000. As of September 30, 2006, \$1,185 of this commitment has been funded and is included in other investments on the consolidated balance sheet. The remaining commitment will be funded through ordinary operating cash flows over the next two years.

On June 30, 2006, our 75% one-year quota share reinsurance program expired. This program covered all non-automobile property and liability business, except umbrella policies. Due to our entering into a catastrophe reinsurance agreement, as noted earlier, we did not continue with the quota share program effective July 1, 2006. Upon termination of the quota share program, we received the unearned premium amount at June 30, 2006, less the provisional commission rate of 37.5%. This amounted to a payment received from our reinsurers of \$48,568, which was paid in September of 2006. Also as a result of the termination of this agreement, our net premiums written has increased \$77,708 in the third quarter of 2006. This increase in written premium impacted our earned premium this quarter and will impact earned premium on a pro-rata basis as the policies expire over the course of the next nine months.

Investment Strategy and Interest Rate Risk

Our investment strategy emphasizes after-tax investment yield while maintaining overall investment quality. The primary focus of our investment objectives continues to be maximizing after-tax investment income through investing primarily in high-quality diversified fixed income investments structured to maximize after-tax investment income while minimizing risk. We generally invest in securities with maturities intended to provide adequate funds to pay claims and meet other operating needs without the forced sale of investments. When the appropriate opportunity arises, we may sell investment securities to increase after-tax total return. We held no derivatives, emerging market securities or hedge funds at September 30, 2006 and December 31, 2005.

Interest Rate Sensitivity

Our investments include positions in fixed maturity, equity, short-term and cash equivalents markets. Therefore, we are exposed to the impacts of interest rate changes in the market value of investments. We estimated our exposure to interest rate changes and equity price risk at September 30, 2006 using sensitivity

analysis. The interest rate impact is the effect of a hypothetical interest rate change of plus-or-minus 100 and 200 basis points on the market value of fixed maturities and preferred stocks.

Changes in interest rates would result in unrealized gains or losses in the market value of the fixed maturity and preferred stock portfolio. The following table summarizes our interest rate risk, based on the results of the sensitivity analysis at September 30, 2006.

| Hypothetical Change in Interest Rates | Estimated Market Value of Fixed Income and Preferred Stock Investments | Estimated Increase (Decrease) in Market Value | Hypothetical Percentage Increase (Decrease) in Stockholders' Equity ⁽¹⁾ |
|---------------------------------------|--|---|--|
| 200 basis point increase | \$2,220,098 | \$(322,492) | (14.2)% |
| 100 basis point increase | 2,375,407 | (167,183) | (7.4) |
| No change | 2,542,590 | - | - |
| 100 basis point decrease | 2,707,404 | 164,814 | 7.3 |
| 200 basis point decrease | 2,908,403 | 365,813 | 16.1 |

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

The duration of a security is the time-weighted present value of the security's expected cash flows and is used to measure a security's price sensitivity to changes in interest rates. The duration reflects industry prepayment assumptions. The analytic systems we used to calculate the above utilize optional call dates, sinking fund requirements and assume a non-static prepayment pattern in deriving market value estimates and duration averages. As of September 30, 2006, December 31, 2005 and September 30, 2005, our weighted average duration was 4.9 years, 4.9 years and 4.5 years, respectively. Our

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fixed income portfolio's weighted average duration includes all fixed maturities and preferred stocks. Our percentage of adjustable rate investments amounted to 22.1% of total fixed maturity investments at September 30, 2006 as compared to 21.4% a year earlier.

Equity Price Risk

We estimated that our exposure to equity price risk at September 30, 2006 has not changed materially from that at December 31, 2005.

Forward-Looking Statements

This quarterly report may contain statements that are not historical fact and constitute "forward-looking statements" within the meaning of Section 27A of the Securities Act and Section 21E of the Securities Exchange Act. Statements about our expectations, beliefs, plans, objectives, assumptions or future events or performance are not historical facts and may be forward-looking. These statements are often, but not always, made through the use of words or phrases such as "anticipates," "estimates," "plans," "projects," "continuing," "ongoing," "expects," "may," "will," "could," "likely," "should," "management believes," "we believe," "we intend," and similar words or phrases. These statements may address, among other things, our strategy for growth, business development, regulatory approvals, market position, expenditures, financial results and reserves. Accordingly, these statements involve estimates, assumptions and uncertainties that could cause

actual results to differ materially from those expressed in them. All forward-looking statements are qualified in their entirety by reference to the factors discussed throughout this quarterly report and in our recently filed annual report on Form 10-K and in other documents filed with the SEC. Among the key factors that could cause actual results to differ materially from forward-looking statements are:

- * the possibility of severe weather, terrorism and other adverse catastrophic experiences;
 - * adverse trends in claim severity or frequency and uncertainties in estimating property and casualty losses;
 - * adverse state and federal regulations and legislation;
 - * adverse judicial decisions;
 - * adverse changes to the laws, regulations and rules governing the residual market system in Massachusetts;
 - * fluctuations in interest rates and the performance of the financial markets in relation to the composition of our investment portfolio;
 - * premium rate making decisions for private passenger automobile policies in Massachusetts;
 - * potential rate filings;
 - * heightened competition;
 - * our concentration of business within Massachusetts and within the personal automobile line of business;
 - * market disruption in Massachusetts, if competitors exit the market or become insolvent;
 - * the cost and availability of reinsurance;
 - * our ability to collect on reinsurance and the solvency of our reinsurers;
 - * the effectiveness of our reinsurance strategies;
 - * telecommunication and information system problems, including failures to implement information technology projects timely and within budget;
 - * our ability to maintain favorable ratings from rating agencies, including A.M. Best, S&P, Moody's and Fitch;
 - * our ability to attract and retain independent agents;
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- * our ability to retain our affinity relationships with AAA clubs, especially in Massachusetts;
 - * our dependence on a key third party service vendor for our automobile business in Massachusetts;
 - * our dependence on our executive officers; and
 - *

the economic, market or regulatory conditions and risks associated with entry into new markets and diversification.

You should not place undue reliance on any forward-looking statement. The risk factors referred to above, as well as those set forth in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2005, as well as those elsewhere in this quarterly report, could cause actual results or outcomes to differ materially from those expressed in any forward-looking statement made by us or on our behalf. Further, any forward-looking statement speaks only as of the date on which it is made, and we undertake no obligation to update any forward-looking statement to reflect events or circumstances after the date on which the statement is made or to reflect the occurrence of unanticipated events. New factors emerge from time to time, and it is not possible for us to predict which factors will arise. In addition, we cannot assess the impact of each factor on our business or the extent to which any factor, or combination of factors, may cause actual results to differ materially from those contained in any forward-looking statements.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

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

Item 4. Controls and Procedures

Evaluation of disclosure controls and procedures

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

Changes in internal control

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

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Part II - Other Information

Item 1. Legal Proceedings

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

In our annual report on Form 10-K for the year ended December 31, 2005, we discussed three individual legal matters outstanding. An update, where available, is presented below. For a full discussion of these matters, refer to Item 3 of the Form 10-K.

CAR Regulatory Reform

The SJC heard oral arguments on May 4, 2006. On August 23, 2006, the SJC issued its decision, ruling that the Commissioner has the authority to implement an assigned risk plan. On October 18, 2006, the Commissioner gave notice of a hearing which will take place on November 10, 2006 to afford all interested parties the opportunity to provide testimony regarding transition rules and the MAIP rules. An implementation schedule has been proposed wherein new business would be written through the MAIP effective April 1, 2007 and renewal business effective July 1, 2007. The proposed revised transition rules and proposed MAIP rules can be viewed on CAR's website at <http://commauto.com>. We are currently reviewing the proposed changes and, if necessary, will revise our business strategies in response to the above but are unable to quantify any impact of these changes at this time.

AAA Arizona

The parties have filed dispositive motions that address some of the respective claims of the parties. We currently expect that the trial will commence during the first half of 2007.

Commerce Bancorp, Inc., et al.

On July 13, 2006, the Court held a hearing, at which a judicial stipulation was made on behalf of Commerce Bancorp, Inc., et al. that the defendants no longer intended to use the name Commerce Insurance Services, Inc. in Massachusetts. On that date, the Court referred the case to mediation. On July 14, 2006, in light of the judicial stipulation made on behalf of the defendants, we withdrew, without prejudice, our pending motion for a preliminary injunction. The parties participated in mediation on September 28, 2006 without agreement being reached. On October 26, 2006, we filed a Supplemental Complaint to supplement our claims to include the defendant's intended use of the name Commerce Banc Insurance Services in Massachusetts. The defendant's response is due on or before November 9, 2006.

Item 1A. Risk Factors

There has been no material change regarding risk factors from those set forth in our annual report on Form 10-K for the year ended December 31, 2005.

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

On July 31, 2006, we granted 400,000 stock options to eligible agents of American Commerce pursuant to a Letter Agreement dated January 29, 1999.

No cash consideration was received by us in exchange for the options. The purpose of the options is to provide an incentive for the agents to maintain their existing business volume with American Commerce. Additional options are granted based on the year-over-year increase in the volume of agency business written with American Commerce.

The options have been offered and sold pursuant to Securities Act Rule 506. Neither we nor any person acting on our behalf has offered or sold the options by any form of general solicitation or general advertising, and we have exercised reasonable care to assure that none of the recipients is an underwriter within the meaning of Section 2(11) of the Securities Act. Based upon representations from the recipients, we have reason to believe that not more than one of the recipients was not an accredited investor, as defined in Securities Act

Rule 501.

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The right of the recipient to exercise these options is contingent upon the average volume of other-than-Massachusetts private passenger automobile and homeowners direct written premiums placed and maintained with American Commerce for a five-year period specified in each option agreement. If qualified, the recipient may purchase our common stock at \$37.25 for a period of five years beginning July 31, 2011. Unexercised options will terminate not later than July 31, 2016. The options may be exercised only by withholding option shares to pay the exercise price.

In November 2001, our Board of Directors authorized a stock buy-back program to purchase up to 4,000,000 shares of our common stock, as adjusted for the June 2006 stock split. During the nine months ended September 30, 2006, we did not acquire any of our common stock. There are 1,716,600 shares that may yet be purchased under our repurchase plan.

| Period | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs |
|----------------------|----------------------------------|------------------------------|--|--|
| July 1-31, 2006 | - | - | - | 1,716,600 |
| August 1-31, 2006 | - | - | - | 1,716,600 |
| September 1-30, 2006 | - | - | - | 1,716,600 |
| Total | - | - | - | |

Item 3. Defaults upon Senior Securities

None.

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

None.

Item 5. Other Information

None.

Item 6. Exhibits

Exhibits:

- 10.42 The Commerce Group, Inc. Named Executive Officers' Salaries
- 31.1 CEO Certification Statements under Section 302 of The Sarbanes-Oxley Act of 2002
- 31.2 CFO Certification Statements under Section 302 of The Sarbanes-Oxley Act of 2002
- 32 CEO and CFO Certification Statements under Section 906 of the Sarbanes-Oxley Act of 2002

Signature

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

THE COMMERCE GROUP, INC.

/s/ Randall V. Becker

Randall V. Becker
Senior Vice President and Chief Financial Officer

Dated: November 8, 2006
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