HANOVER INSURANCE GROUP, INC.
Form 10-Q
November 01, 2012
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# UNITED STATES

# SECURITIES AND EXCHANGE COMMISSION

**WASHINGTON, D.C. 20549**

# FORM 10-Q

(Mark One)

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE SECURITIES EXCHANGE ACT OF 1934**
**For the quarterly period ended September 30, 2012**

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

**Commission File Number 1-13754**

# THE HANOVER INSURANCE GROUP, INC.

**(Exact name of registrant as specified in its charter)**

| | |
|---|---|
| **Delaware** | **04-3263626** |
| **(State or other jurisdiction of** | **(I.R.S. Employer** |

| | |
|---|---|
| **incorporation or organization)** | **Identification No.)** |

**440 Lincoln Street, Worcester, Massachusetts 01653**

**(Address of principal executive offices) (Zip Code)**

**(508) 855-1000**

**(Registrant s telephone number, including area code)**

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

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

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

The number of shares outstanding of the registrant s common stock was 44,573,485 as of October 31, 2012.

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**PART I - FINANCIAL INFORMATION**

**ITEM 1 - FINANCIAL STATEMENTS**

**THE HANOVER INSURANCE GROUP, INC. AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)**

| *(in millions, except per share data)* | **Three Months Ended September 30, 2012** | **Three Months Ended September 30, 2011** | **Nine Months Ended September 30, 2012** | **Nine Months Ended September 30, 2011** |
|---|---|---|---|---|
| **REVENUES** | | | | |
| Premiums | **$ 1,071.0** | $ 1,018.6 | **$ 3,156.6** | $ 2,550.8 |
| Net investment income | **69.2** | 67.8 | **206.5** | 189.2 |
| Net realized investment gains (losses): | | | | |
| Net realized gains from sales and other | **7.2** | 9.7 | **10.4** | 28.6 |
| Net other than temporary impairment losses on investments recognized in earnings | **(2.2)** | (1.5) | **(5.7)** | (3.7) |
| Total net realized investment gains | **5.0** | 8.2 | **4.7** | 24.9 |
| Fees and other income | **12.5** | 13.4 | **38.9** | 30.8 |
| Total revenues | **1,157.7** | 1,108.0 | **3,406.7** | 2,795.7 |
| **LOSSES AND EXPENSES** | | | | |
| Losses and loss adjustment expenses | **708.4** | 734.9 | **2,101.9** | 1,863.4 |
| Policy acquisition expenses | **235.8** | 222.3 | **697.0** | 547.5 |
| Interest expense | **14.6** | 17.4 | **46.7** | 38.6 |
| Other operating expenses | **145.7** | 152.7 | **426.0** | 388.2 |
| Total losses and expenses | **1,104.5** | 1,127.3 | **3,271.6** | 2,837.7 |
| Income (loss) before income taxes | **53.2** | (19.3) | **135.1** | (42.0) |
| Income tax expense (benefit): | | | | |
| Current | **(16.9)** | (18.4) | **11.2** | (40.7) |
| Deferred | **29.2** | 9.1 | **22.5** | 13.6 |
| Total income tax expense (benefit) | **12.3** | (9.3) | **33.7** | (27.1) |
| Income (loss) from continuing operations | **40.9** | (10.0) | **101.4** | (14.9) |
| Net gain from discontinued operations (net of income tax benefit of $0.3 and $0.1 for the three months ended September 30, 2012 and September 30, 2011 and $0.7 for the nine months ended September 30, 2012) | **(0.5)** | - | **9.5** | 2.0 |
| Net income (loss) | **$ 40.4** | $ (10.0) | **$ 110.9** | $ (12.9) |

PER SHARE DATA

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Basic | | | | | | | | |
| Income (loss) from continuing operations | **$** | **0.92** | $ | (0.22) | **$** | **2.26** | $ | (0.33) |
| Net gain from discontinued operations | | **(0.01)** | | - | | **0.21** | | 0.05 |
| Net income (loss) per share | **$** | **0.91** | $ | (0.22) | **$** | **2.47** | $ | (0.28) |
| Weighted average shares outstanding | | **44.6** | | 45.3 | | **44.8** | | 45.4 |
| Diluted | | | | | | | | |
| Income (loss) from continuing operations | **$** | **0.90** | $ | (0.22) | **$** | **2.23** | $ | (0.33) |
| Net gain from discontinued operations | | **(0.01)** | | - | | **0.21** | | 0.05 |
| Net income (loss) per share | **$** | **0.89** | $ | (0.22) | **$** | **2.44** | $ | (0.28) |
| Weighted average shares outstanding | | **45.2** | | 45.3 | | **45.4** | | 45.4 |

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

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**THE HANOVER INSURANCE GROUP, INC. AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (UNAUDITED)**

| | Three Months Ended | | Nine Months Ended | |
|---|---|---|---|---|
| | September 30, | | September 30, | |
| *(in millions)* | **2012** | **2011** | **2012** | **2011** |
| Net income (loss) | **$ 40.4** | $ (10.0) | **$ 110.9** | $ (12.9) |
| Other comprehensive income: | | | | |
| Available-for-sale securities and derivative instruments: | | | | |
| Net appreciation during the period | **82.9** | 6.3 | **173.1** | 41.9 |
| Portion of other-than-temporary impairment losses transferred from other comprehensive income | **3.7** | 0.8 | **11.0** | 6.2 |
| Benefit (provision) for deferred income taxes | **(34.8)** | 9.6 | **(43.5)** | 11.1 |
| Total available-for-sale securities and derivative instruments | **51.8** | 16.7 | **140.6** | 59.2 |
| Pension and postretirement benefits: | | | | |
| Amortization recognized as net periodic benefit costs: | | | | |
| Net actuarial loss | **3.3** | 3.9 | **9.8** | 11.6 |
| Prior service cost | **(0.9)** | (1.3) | **(2.8)** | (3.9) |
| Total amortization recognized as net periodic benefit costs | **2.4** | 2.6 | **7.0** | 7.7 |
| Provision for deferred income taxes | **(0.8)** | (0.9) | **(2.4)** | (2.7) |
| Total pension and postretirement benefits | **1.6** | 1.7 | **4.6** | 5.0 |
| Cumulative foreign currency translation adjustment: | | | | |
| Amount recognized as cumulative foreign currency translation during the period | **11.6** | (14.5) | **13.0** | (14.5) |
| Benefit (provision) for deferred income taxes | **(4.1)** | 5.1 | **(4.6)** | 5.1 |
| Total cumulative foreign currency translation adjustment | **7.5** | (9.4) | **8.4** | (9.4) |
| Other comprehensive income | **60.9** | 9.0 | **153.6** | 54.8 |
| Comprehensive income (loss) | **$ 101.3** | $ (1.0) | **$ 264.5** | $ 41.9 |

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

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**THE HANOVER INSURANCE GROUP, INC. AND SUBSIDIARIES**

**CONSOLIDATED BALANCE SHEETS (UNAUDITED)**

| *(in millions, except per share data)* | **September 30, 2012** | **December 31, 2011** |
|---|---|---|
| ASSETS | | |
| Investments: | | |
| Fixed maturities, at fair value (amortized cost of $6,363.6 and $6,008.7) | **$ 6,794.9** | $ 6,284.7 |
| Equity securities, at fair value (cost of $363.0 and $239.9) | **392.8** | 246.4 |
| Other investments | **257.1** | 190.2 |
| Total investments | **7,444.8** | 6,721.3 |
| Cash and cash equivalents | **462.0** | 820.4 |
| Accrued investment income | **74.8** | 71.8 |
| Premiums and accounts receivable, net | **1,350.5** | 1,168.1 |
| Reinsurance recoverable on paid and unpaid losses and unearned premiums | **2,444.6** | 2,262.2 |
| Deferred policy acquisition costs | **501.3** | 458.6 |
| Deferred income taxes | **206.5** | 274.0 |
| Goodwill | **184.8** | 185.5 |
| Other assets | **531.0** | 515.5 |
| Assets of discontinued operations | **129.8** | 121.2 |
| Total assets | **$ 13,330.1** | $ 12,598.6 |
| LIABILITIES | | |
| Loss and loss adjustment expense reserves | **$ 5,938.9** | $ 5,760.3 |
| Unearned premiums | **2,555.7** | 2,292.1 |
| Expenses and taxes payable | **618.5** | 642.9 |
| Reinsurance premiums payable | **473.9** | 378.9 |
| Debt | **917.5** | 911.1 |
| Liabilities of discontinued operations | **126.2** | 129.3 |
| Total liabilities | **10,630.7** | 10,114.6 |
| Commitments and contingencies | | |
| SHAREHOLDERS EQUITY | | |
| Preferred stock, $0.01 par value, 20.0 million shares authorized, none issued | **-** | - |
| Common stock, $0.01 par value, 300.0 million shares authorized, $60.5 million shares issued | **0.6** | 0.6 |
| Additional paid-in capital | **1,785.0** | 1,784.8 |
| Accumulated other comprehensive income | **364.0** | 210.4 |
| Retained earnings | **1,282.1** | 1,211.3 |
| Treasury stock, at cost (16.2 and 15.9 million shares) | **(732.3)** | (723.1) |
| Total shareholders equity | **2,699.4** | 2,484.0 |
| Total liabilities and shareholders equity | **$ 13,330.1** | $ 12,598.6 |

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

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**THE HANOVER INSURANCE GROUP, INC. AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY (UNAUDITED)**

| | Nine Months Ended September 30, | |
|---|---|---|
| *(in millions)* | **2012** | **2011** |
| PREFERRED STOCK | | |
| Balance at beginning and end of period | **$ -** | $ - |
| COMMON STOCK | | |
| Balance at beginning and end of period | **0.6** | 0.6 |
| ADDITIONAL PAID-IN CAPITAL | | |
| Balance at beginning of period | **1,784.8** | 1,796.5 |
| Employee and director stock-based awards and other | **0.2** | (11.3) |
| Balance at end of period | **1,785.0** | 1,785.2 |
| ACCUMULATED OTHER COMPREHENSIVE INCOME | | |
| NET UNREALIZED APPRECIATION ON INVESTMENTS AND DERIVATIVE INSTRUMENTS: | | |
| Balance at beginning of period | **308.7** | 218.3 |
| Net appreciation during the period: | | |
| Net appreciation on available-for-sale securities and derivative instruments | **184.1** | 48.1 |
| Benefit (provision) for deferred income taxes | **(43.5)** | 11.1 |
| | **140.6** | 59.2 |
| Balance at end of period | **449.3** | 277.5 |
| DEFINED BENEFIT PENSION AND POSTRETIREMENT PLANS: | | |
| Balance at beginning of period | **(86.8)** | (81.6) |
| Amount recognized as net periodic benefit cost during the period | **7.0** | 7.7 |
| Provision for deferred income taxes | **(2.4)** | (2.7) |
| | **4.6** | 5.0 |
| Balance at end of period | **(82.2)** | (76.6) |
| CUMULATIVE FOREIGN CURRENCY TRANSLATION ADJUSTMENT: | | |
| Balance at beginning of period | **(11.5)** | - |
| Amount recognized as cumulative foreign currency translation during the period | **13.0** | (14.5) |
| Benefit (Provision) for deferred income taxes | **(4.6)** | 5.1 |
| | **8.4** | (9.4) |
| Balance at end of period | **(3.1)** | (9.4) |

| | | |
|---|---|---|
| Total accumulated other comprehensive income | **364.0** | 191.5 |
| | | |
| RETAINED EARNINGS | | |
| Balance at beginning of period | **1,211.3** | 1,246.8 |
| Cumulative effect of accounting change, net of taxes | **-** | (25.4) |
| | | |
| Balance at beginning of period, as adjusted | **1,211.3** | 1,221.4 |
| Net income (loss) | **110.9** | (12.9) |
| Dividends to shareholders | **(40.3)** | (37.5) |
| Treasury stock issued for less than cost | **(4.6)** | (6.1) |
| Recognition of employee stock-based compensation | **4.8** | 9.7 |
| | | |
| Balance at end of period | **1,282.1** | 1,174.6 |
| | | |
| TREASURY STOCK | | |
| Balance at beginning of period | **(723.1)** | (720.1) |
| Shares purchased at cost | **(20.0)** | (20.0) |
| Net shares reissued at cost under employee stock-based compensation plans | **10.8** | 17.0 |
| | | |
| Balance at end of period | **(732.3)** | (723.1) |
| | | |
| Total shareholders equity | **$ 2,699.4** | $ 2,428.8 |

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

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**THE HANOVER INSURANCE GROUP, INC. AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)**

| *(in millions)* | **Nine Months Ended September 30, 2012** | **2011** |
|---|---|---|
| CASH FLOWS FROM OPERATING ACTIVITIES | | |
| Net income (loss) | **$ 110.9** | $ (12.9) |
| Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities: | | |
| Net realized investment gains | **(3.8)** | (13.4) |
| Net amortization and depreciation | **26.0** | 12.3 |
| Net gain on sale of Citizens Management, Inc. | **(10.8)** | - |
| Stock-based compensation expense | **9.8** | 9.7 |
| Amortization of deferred benefit plan costs | **7.0** | 7.7 |
| Deferred income taxes | **21.9** | 13.8 |
| Change in deferred acquisition costs | **(42.6)** | 17.6 |
| Change in accrued interest income | **(2.9)** | (30.7) |
| Change in premiums receivable, net of reinsurance premiums payable | **(87.5)** | 41.1 |
| Change in loss, loss adjustment expense and unearned premium reserves | **442.1** | 254.6 |
| Change in reinsurance recoverable | **(181.3)** | (53.7) |
| Change in expenses and taxes payable | **(23.8)** | 62.7 |
| Other, net | **(60.4)** | (22.5) |
| Net cash provided by operating activities | **204.6** | 286.3 |
| CASH FLOWS FROM INVESTING ACTIVITIES | | |
| Proceeds from disposals and maturities of fixed maturities | **1,267.4** | 1,138.2 |
| Proceeds from disposals of equity securities and other investments | **21.7** | 17.7 |
| Purchases of fixed maturities | **(1,601.1)** | (1,122.5) |
| Purchases of equity securities and other investments | **(206.1)** | (58.6) |
| Proceeds from disposal of Citizens Management, Inc., net of cash transferred | **5.2** | - |
| Cash used for business acquisitions, net of cash acquired | **-** | 268.4 |
| Capital expenditures | **(11.2)** | (9.8) |
| Net payments related to derivative agreements | **(4.4)** | (2.2) |
| Net cash provided by (used in) investing activities | **(528.5)** | 231.2 |
| CASH FLOWS FROM FINANCING ACTIVITIES | | |
| Proceeds from exercise of employee stock options | **1.9** | 3.9 |
| Proceeds from debt borrowings | **7.4** | 314.4 |
| Decrease in cash collateral related to securities lending program | **(6.6)** | (32.6) |
| Dividends paid to shareholders | **(40.3)** | (37.5) |
| Repurchases of debt | **(0.8)** | (86.8) |
| Repurchases of common stock | **(20.0)** | (20.0) |
| Other financing activities | **(0.2)** | (0.6) |
| Net cash provided by (used in) financing activities | **(58.6)** | 140.8 |
| Effect of exchange rate changes on cash | **24.0** | (28.4) |
| Net change in cash and cash equivalents | **(358.5)** | 629.9 |
| Net change in cash related to discontinued operations | **0.1** | 2.4 |

| | | | | |
|---|---|---|---|---|
| Cash and cash equivalents, beginning of period | | **820.4** | | 290.4 |
| Cash and cash equivalents, end of period | **$** | **462.0** | $ | 922.7 |

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

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THE HANOVER INSURANCE GROUP, INC. AND SUBSIDIARIES

NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

**1. Basis of Presentation and Principles of Consolidation**

The accompanying unaudited consolidated financial statements of The Hanover Insurance Group, Inc. and subsidiaries ( THG or the Company ) have been prepared in accordance with generally accepted accounting principles in the United States of America ( U.S. GAAP ) for interim financial information and with the requirements of Form 10-Q. Certain financial information that is provided in annual financial statements, but is not required in interim reports, has been omitted.

The interim consolidated financial statements of THG include the accounts of The Hanover Insurance Company ( Hanover Insurance ) and Citizens Insurance Company of America, THG s principal U.S. domiciled property and casualty companies; Chaucer Holdings plc ( Chaucer ), a specialist underwriting group which operates through the Society and Corporation of Lloyd s ( Lloyd s ) and certain other insurance and non-insurance subsidiaries. These legal entities conduct their operations through several business segments discussed in Note 9 Segment Information . The acquisition of Chaucer on July 1, 2011, which has added meaningful business volumes to THG results, has affected the comparability of the interim consolidated financial statements and related footnotes for the nine months ended September 30, 2012 and 2011. Results of operations for the nine months ended September 30, 2011 include Chaucer s results for only the period from July 1, 2011 through September 30, 2011, while results of operations for the nine months ended September 30, 2012 includes Chaucer s results for all nine months in 2012. Results of operations for the three months ended September 30, 2012 and 2011 include results from all of the Company s business segments. Additionally, the interim consolidated financial statements include the Company s discontinued operations, consisting primarily of the Company s former life insurance businesses, its accident and health business and its third party administrator. All intercompany accounts and transactions have been eliminated.

The preparation of financial statements in conformity with U.S. GAAP requires the Company to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amount of revenues and expenses during the reporting period. Actual results could differ from those estimates.

In the opinion of the Company s management, the accompanying interim consolidated financial statements reflect all adjustments, consisting of normal recurring items, necessary for a fair presentation of the financial position and results of operations. The results of operations for the three and nine months ended September 30, 2012 are not necessarily indicative of the results to be expected for the full year. These financial statements should be read in conjunction with the Company s 2011 Annual Report on Form 10-K filed with the Securities and Exchange Commission ( SEC ) on February 29, 2012.

**2. New Accounting Pronouncements**

***Recently Implemented Standards***

In September 2011, the Financial Accounting Standards Board ( FASB ) issued ASC Update No. 2011-08 (Topic 350) *Testing Goodwill for Impairment.* This ASC update allows an entity to first assess qualitative factors to determine whether it is necessary to perform the two-step quantitative goodwill impairment test. The update provides that an entity would not be required to calculate the fair value of a reporting unit unless the entity determines, based on its qualitative assessment, that it is more likely than not that its fair value is less than its carrying amount. The update further improves previous guidance by expanding upon the examples of events and circumstances that an entity should consider in determining whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount. Also, the update improves the examples of events and circumstances that should be considered by an entity that has a reporting unit with a zero or negative carrying amount in determining whether to measure an impairment loss, if any, under the second step of the goodwill impairment test. This ASC update is effective for annual and interim periods beginning after December 15, 2011, with early adoption permitted. The Company implemented this guidance effective January 1, 2012. The effect of implementing this guidance was not material to the Company s financial position or results of operations.

In June 2011, the FASB issued ASC Update No. 2011-05 (Topic 220) *Presentation of Comprehensive Income* ( ASC Update No. 2011-05 ). This ASC update requires companies to present net income and other comprehensive income in either a single continuous statement or in two separate, but consecutive, statements of income and other comprehensive income. The option to present items of other comprehensive income in the statement of changes in equity is eliminated. In addition, an entity is required to present on the face of the financial statements reclassification adjustments from other comprehensive income to net income. This ASC update should be applied retrospectively and except for the provisions related to reclassification adjustment, is effective for interim and annual periods beginning after December 15, 2011. In December

2011, the FASB issued ASC Update 2011-12 (Topic 220) *Comprehensive Income* which deferred the implementation date of the reclassification adjustment guidance in ASC Update No. 2011-05. The Company implemented the guidance related to financial statements presentation effective January 1, 2012. The effect of implementing the guidance related to financial statements presentation did not have a significant impact to the Company s financial statement presentation.

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In May 2011, the FASB issued ASC Update No. 2011-04 (Topic 820) *Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*. This ASC update results in a consistent definition of fair value and common requirements for measurement of and disclosure about fair value for both U.S. GAAP and International Financial Reporting Standards ( IFRS ). The new guidance includes changes to how and when the valuation premise of highest and best use applies, clarification on the application of blockage factors and other premiums and discounts, as well as new and revised disclosure requirements. This ASC update is effective for interim and annual periods beginning after December 15, 2011. The Company implemented this guidance as of January 1, 2012. The effect of implementing this guidance was not material to the Company s financial position or results of operations.

In October 2010, the FASB issued ASC Update No. 2010-26 (Topic 944), *Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts* (*a consensus of the FASB Emerging Issues Task Force*). This ASC update provides clarity in defining which costs relating to the acquisition of new or renewal insurance contracts qualify for deferral, commonly known as deferred acquisition costs. Additionally, this update specifies that only costs associated with the successful acquisition of a policy or contract may be deferred, whereas industry practice historically included costs relating to unsuccessful contract acquisition. This ASC is effective for fiscal years beginning after December 15, 2011. Retrospective application to all prior periods upon the date of adoption is permitted. The Company implemented this guidance effective January 1, 2012 and has elected to apply this guidance retrospectively. Retrospective application requires the new accounting principle to be reflected in the earliest period presented as if the accounting principle had always been used. The Company has reflected the impact of the retrospective application as a cumulative effect of a change in accounting principle through equity at the beginning of the earliest reporting period presented within this Form 10-Q and will reflect this application in all future filings with the SEC. The implementation of this ASC resulted in an after-tax reduction to our stockholders equity as of January 1, 2012 of $25.8 million, or 1%. The effect of implementing this guidance was not material to our results of operations on either a historical or prospective basis.

***Recently Issued Standards***

In July 2012, the FASB issued ASC Update No. 2012-02 (Topic 350) *Testing Indefinite Lived Intangible Assets for Impairment.* This ASC update allows an entity to first assess qualitative factors to determine whether the existence of events and circumstances indicates that it is more likely than not that the indefinite lived intangible asset is impaired. This assessment should be used as a basis for determining whether it is necessary to perform the quantitative impairment test. An entity would not be required to calculate the fair value of the intangible asset and perform the quantitative test unless the entity determines, based upon its qualitative assessment, that it is more likely than not that its fair value is less than its carrying value. The update further improves previous guidance by expanding upon the examples of events and circumstances that an entity should consider in determining whether it is more likely than not that the fair value of an indefinite lived intangible asset is less than its carrying amount. The update also allows an entity the option to bypass the qualitative assessment for any indefinite-lived intangible asset in any period and proceed directly to performing the quantitative impairment test. An entity will be able to resume performing the qualitative assessment in any subsequent period. This ASC update is effective for annual and interim periods beginning after September 15, 2012, with early adoption permitted. The Company does not expect the adoption of ASC Update 2012-02 to have a material impact on its financial position or results of operations.

**3. Acquisitions and Discontinued Operations**

**ACQUISITIONS**

***Chaucer Acquisition***

On July 1, 2011, the Company acquired Chaucer, a United Kingdom ( U.K. ) insurance business. Chaucer is a leading specialist managing agency at Lloyd s. Chaucer underwrites business in several lines of business, including property, marine and aviation, energy, U.K. motor and casualty and other coverages (which include international liability, specialist coverages, and syndicate participations). Chaucer is headquartered in London, with a regional presence in Whitstable, England and locations in Houston, Singapore, Buenos Aires, and Copenhagen.

This transaction is expected to advance the Company s specialty lines strategy and result in broader product and underwriting capabilities, as well as greater geographic and product diversification. The acquisition adds a presence in the Lloyd s market, which includes access to international licenses, an excess and surplus insurance business and the ability to syndicate certain risks.

***Pro Forma Results***

The following unaudited pro forma information presents the combined revenues, net income (loss) and net income (loss) per share of THG and Chaucer for the nine months ended September 30, 2011, with pro forma purchase accounting adjustments as if the acquisition had been consummated as of January 1, 2011. This pro forma information is not necessarily indicative of what would have occurred had the acquisition and related transactions been made on January 1, 2011, or of future results of the Company. The Company s income statement accounts denominated in foreign currencies are translated to U.S. dollars at the average rates of exchange for the period indicated.

| *(in millions, except per share data)* | **Nine Months Ended September 30, 2011** |
|---|---|
| Revenue | **$ 3,224.8** |
| Net income (loss) | **$ (66.3)** |
| Net income (loss) per share basic | **$ (1.46)** |
| Net income (loss) per share diluted | **$ (1.46)** |
| Weighted average shares outstanding basic | **45.4** |
| Weighted average shares outstanding diluted | **45.4** |

***Other***

The Company recognized $1.9 million in net foreign currency transaction losses in the Statement of Income during the three months ended September 30, 2011 and $1.0 million in net foreign currency transaction losses and $3.0 million in net foreign currency transaction gains during the three and nine months ended September 30, 2012, respectively.

**DISCONTINUED OPERATIONS**

***Discontinued Third Party Administration Business***

On April 30, 2012, the Company completed the sale of its third party administration subsidiary, Citizens Management, Inc. The Company recognized net gains of $10.8 million after taxes related to this transaction in the first nine months of 2012. Included in this amount and recognized during the third quarter of 2012 was a contingent gain with a fair value of $1.7 million that was entirely contributed to the Company s charitable foundation.

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**4. Income Taxes**

Income tax expense for the nine months ended September 30, 2012 and 2011 has been computed using estimated effective tax rates. These rates are revised, if necessary, at the end of each successive interim period to reflect current estimates of the annual effective tax rates.

For the nine months ended September 30, 2012, the tax provision is comprised of a $3.4 million U.S. federal income tax expense and $30.3 million foreign income tax expense. For the nine months ended September 30, 2011, the tax provision was comprised of a $34.4 million U.S. federal income tax benefit and $7.3 million in foreign income tax expense.

Although most of the Company s non U.S. income is subject to U.S. federal income tax, certain of its non U.S. income is not subject to U.S. federal income tax until repatriated. Foreign taxes on this non U.S. income are accrued at the lower U.K. tax rate, as opposed to the higher U.S. statutory rate, since these earnings are intended to be permanently reinvested overseas. This assumption could change, as a result of a sale of the subsidiaries, the receipt of dividends from the subsidiaries, a change in management s intentions, or as a result of various other events. For the nine months ended September 30, 2012, all of the Company s non US income was generated entirely from that portion of the business that is subject to the higher U.S. statutory federal income tax rate.

The Company or its subsidiaries files income tax returns in the U.S. federal jurisdiction and various state jurisdictions, as well as foreign jurisdictions. With few exceptions, the Company and its subsidiaries are no longer subject to U.S. federal income tax examinations by tax authorities for years before 2007. The IRS audits of the years 2009 and 2010 commenced in June 2012. The Company and its subsidiaries are still subject to U.S. state income tax examinations by tax authorities for years after 2001 and foreign examinations for years after 2008.

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**5. Pension and Other Postretirement Benefit Plans**

The components of net periodic pension cost for defined benefit pension and other postretirement benefit plans included in the Company s results of operations are as follows:

| *(in millions)* | Three Months Ended September 30, 2012 | 2011 | 2012 | 2011 |
|---|---|---|---|---|
| | Pension Plans | | Postretirement Plans | |
| Service cost benefits earned during the period | **$ 0.4** | $ 0.4 | **$ -** | $ 0.1 |
| Interest cost | **8.8** | 9.2 | **0.6** | 0.6 |
| Expected return on plan assets | **(9.6)** | (9.9) | **-** | - |
| Recognized net actuarial loss | **3.2** | 3.8 | **0.1** | 0.1 |
| Amortization of prior service cost | **0.1** | - | **(1.0)** | (1.3) |
| Net periodic cost (benefit) | **$ 2.9** | $ 3.5 | **$ (0.3)** | $ (0.5) |

| *(in millions)* | Nine Months Ended September 30, 2012 | 2011 | 2012 | 2011 |
|---|---|---|---|---|
| | Pension Plans | | Postretirement Plans | |
| Service cost benefits earned during the period | $ **1.2** | $ 0.4 | **$ 0.1** | $ 0.1 |
| Interest cost | **26.4** | 25.0 | **1.6** | 1.8 |
| Expected return on plan assets | **(29.0)** | (27.0) | **-** | - |
| Recognized net actuarial loss | **9.6** | 11.3 | **0.2** | 0.3 |
| Amortization of prior service cost | **0.1** | - | **(2.9)** | (3.9) |
| Net periodic cost (benefit) | **$ 8.3** | $ 9.7 | **$ (1.0)** | $ (1.7) |

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**6. Investments**

***A. Fixed maturities and equity securities***

The amortized cost and fair value of available-for-sale fixed maturities and the cost and fair value of equity securities were as follows:

| | September 30, 2012 | | | | |
|---|---|---|---|---|---|
| *(in millions)* | Amortized Cost or Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value | OTTI Unrealized Losses |
| Fixed maturities: | | | | | |
| U.S. Treasury and government agencies | **$ 214.3** | **$ 9.4** | **$ 0.2** | **$ 223.5** | **$ -** |
| Foreign government | **360.3** | **4.8** | **0.3** | **364.8** | **-** |
| Municipal | **951.0** | **89.3** | **1.7** | **1,038.6** | **-** |
| Corporate | **3,510.1** | **279.3** | **16.2** | **3,773.2** | **9.3** |
| Residential mortgage-backed | **792.5** | **44.5** | **4.6** | **832.4** | **2.9** |
| Commercial mortgage-backed | **342.7** | **23.3** | **0.5** | **365.5** | **-** |
| Asset-backed | **192.7** | **4.2** | - | **196.9** | **-** |
| Total fixed maturities | **$ 6,363.6** | **$ 454.8** | **$ 23.5** | **$ 6,794.9** | **$ 12.2** |
| Equity securities | **$ 363.0** | **$ 34.8** | **$ 5.0** | **$ 392.8** | **$ -** |

| | December 31, 2011 | | | | |
|---|---|---|---|---|---|
| | Amortized Cost or Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value | OTTI Unrealized Losses |
| Fixed maturities: | | | | | |
| U.S. Treasury and government agencies | $ 261.7 | $ 7.8 | $ 0.2 | $ 269.3 | $ - |
| Foreign government | 239.1 | 0.4 | 0.5 | 239.0 | - |
| Municipal | 964.5 | 67.4 | 3.9 | 1,028.0 | - |
| Corporate | 3,218.2 | 197.7 | 40.3 | 3,375.6 | 13.8 |
| Residential mortgage-backed | 816.1 | 40.9 | 8.4 | 848.6 | 6.1 |
| Commercial mortgage-backed | 384.1 | 15.0 | 1.0 | 398.1 | - |
| Asset-backed | 125.0 | 1.8 | 0.7 | 126.1 | |
| Total fixed maturities | $ 6,008.7 | $ 331.0 | $ 55.0 | $ 6,284.7 | $ 19.9 |
| Equity securities | $ 239.9 | $ 15.3 | $ 8.8 | $ 246.4 | $ - |

Other-than-temporary impairments ( OTTI ) unrealized losses in the tables above represent OTTI recognized in accumulated other comprehensive income. This amount excludes net unrealized gains on impaired securities relating to changes in the value of such securities subsequent to the impairment measurement date of $22.6 million and $25.1 million as of September 30, 2012 and December 31, 2011, respectively.

The amortized cost and fair value by maturity periods for fixed maturities are shown below. Actual maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties, or the Company may have the right to put or sell the obligations back to the issuers.

| *(in millions)* | September 30, 2012 | |
|---|---|---|
| | Amortized Cost | Fair Value |
| Due in one year or less | $ 461.6 | $ 466.9 |
| Due after one year through five years | 2,230.2 | 2,352.1 |
| Due after five years through ten years | 1,705.0 | 1,881.6 |
| Due after ten years | 638.9 | 699.5 |
| | 5,035.7 | 5,400.1 |
| Mortgage-backed and asset-backed securities | 1,327.9 | 1,394.8 |
| Total fixed maturities | $ 6,363.6 | $ 6,794.9 |

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***B. Securities in an unrealized loss position***

The following tables provide information about the Company s fixed maturities and equity securities that were in an unrealized loss position at September 30, 2012 and December 31, 2011.

| | September 30, 2012 | | | | | |
|---|---|---|---|---|---|---|
| | 12 months or less | | Greater than 12 months | | Total | |
| *(in millions)* | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses | Fair Value |
| Fixed maturities: | | | | | | |
| Investment grade: | | | | | | |
| U.S. Treasury and government agencies | $ - | $ 12.4 | $ 0.2 | $ 8.7 | $ 0.2 | $ 21.1 |
| Foreign governments | 0.2 | 44.6 | 0.1 | 0.4 | 0.3 | 45.0 |
| Municipal | 0.1 | 19.1 | 1.6 | 32.7 | 1.7 | 51.8 |
| Corporate | 2.6 | 120.3 | 6.5 | 49.7 | 9.1 | 170.0 |
| Residential mortgage-backed | 0.4 | 30.2 | 3.3 | 13.4 | 3.7 | 43.6 |
| Commercial mortgage-backed | 0.4 | 13.7 | 0.1 | 4.9 | 0.5 | 18.6 |
| Asset-backed | - | 3.1 | - | 0.5 | - | 3.6 |
| Total investment grade | 3.7 | 243.4 | 11.8 | 110.3 | 15.5 | 353.7 |
| Below investment grade: | | | | | | |
| Municipal | - | - | - | 2.0 | - | 2.0 |
| Corporate | 2.0 | 34.0 | 5.1 | 51.5 | 7.1 | 85.5 |
| Residential mortgage-backed | - | 1.4 | 0.9 | 3.6 | 0.9 | 5.0 |
| Total below investment grade | 2.0 | 35.4 | 6.0 | 57.1 | 8.0 | 92.5 |
| Total fixed maturities | 5.7 | 278.8 | 17.8 | 167.4 | 23.5 | 446.2 |
| Equity securities | 3.9 | 98.3 | 1.1 | 15.3 | 5.0 | 113.6 |
| Total | $ 9.6 | $ 377.1 | $ 18.9 | $ 182.7 | $ 28.5 | $ 559.8 |

| | December 31, 2011 | | | | | |
|---|---|---|---|---|---|---|
| | 12 months or less | | Greater than 12 months | | Total | |
| *(in millions)* | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses | Fair Value |
| Fixed maturities: | | | | | | |
| Investment grade: | | | | | | |
| U.S. Treasury and government agencies | $ 0.2 | $ 57.7 | $ - | $ - | $ 0.2 | $ 57.7 |
| Foreign governments | 0.5 | 148.8 | - | - | 0.5 | 148.8 |
| Municipal | 0.5 | 28.0 | 3.4 | 58.8 | 3.9 | 86.8 |
| Corporate | 19.9 | 699.6 | 8.2 | 35.6 | 28.1 | 735.2 |
| Residential mortgage-backed | 5.1 | 115.8 | 2.4 | 9.9 | 7.5 | 125.7 |
| Commercial mortgage-backed | 0.7 | 58.0 | 0.3 | 4.6 | 1.0 | 62.6 |
| Asset-backed | 0.2 | 67.6 | - | - | 0.2 | 67.6 |
| Total investment grade | 27.1 | 1,175.5 | 14.3 | 108.9 | 41.4 | 1,284.4 |
| Below investment grade: | | | | | | |

| | | | | | | |
|---|---|---|---|---|---|---|
| Corporate | 8.5 | 118.0 | 3.7 | 14.7 | 12.2 | 132.7 |
| Residential mortgage-backed | 0.9 | 8.0 | - | - | 0.9 | 8.0 |
| Asset-backed | 0.5 | 0.9 | - | - | 0.5 | 0.9 |
| Total below investment grade | 9.9 | 126.9 | 3.7 | 14.7 | 13.6 | 141.6 |
| Total fixed maturities | 37.0 | 1,302.4 | 18.0 | 123.6 | 55.0 | 1,426.0 |
| Equity securities | 8.8 | 87.2 | - | - | 8.8 | 87.2 |
| Total | $ 45.8 | $ 1,389.6 | $ 18.0 | $ 123.6 | $ 63.8 | $ 1,513.2 |

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The Company views the gross unrealized losses on fixed maturities and equity securities as being temporary since it is its assessment that these securities will recover in the near term, allowing the Company to realize the anticipated long-term economic value. The Company employs a systematic methodology to evaluate declines in fair value below amortized cost for fixed maturity securities or cost for equity securities. In determining OTTI of fixed maturity and equity securities, the Company evaluates several factors and circumstances, including the issuer s overall financial condition; the issuer s credit and financial strength ratings; the issuer s financial performance, including earnings trends, dividend payments and asset quality; any specific events which may influence the operations of the issuer; the general outlook for market conditions in the industry or geographic region in which the issuer operates; and the length of time and the degree to which the fair value of an issuer s securities remains below the Company s cost. With respect to fixed maturity investments, the Company considers any factors that might raise doubt about the issuer s ability to pay all amounts due according to the contractual terms and whether the Company expects to recover the entire amortized cost basis of the security. With respect to equity securities, the Company considers its ability and intent to hold the investment for a period of time to allow for a recovery in value. The Company applies these factors to all securities.

***C. Proceeds from sales***

Proceeds from sales of available-for-sale securities and the gross realized gains and losses on those sales were as follows:

| | Three Months Ended September 30, | | | | | |
|---|---|---|---|---|---|---|
| | 2012 | | | 2011 | | |
| *(in millions)* | Proceeds from Sales | Gross Gains | Gross Losses | Proceeds from Sales | Gross Gains | Gross Losses |
| Fixed maturities | **$ 78.8** | **$ 2.3** | **$ 0.3** | $ 188.5 | $ 2.2 | $ 0.1 |
| Equity securities | **13.6** | **2.4** | **-** | 14.1 | 1.1 | 0.1 |

| | Nine Months Ended September 30, | | | | | |
|---|---|---|---|---|---|---|
| | 2012 | | | 2011 | | |
| *(in millions)* | Proceeds from Sales | Gross Gains | Gross Losses | Proceeds from Sales | Gross Gains | Gross Losses |
| Fixed maturities | **$ 486.8** | **$ 8.9** | **$ 1.9** | $ 592.3 | $ 18.1 | $ 1.1 |
| Equity securities | **17.1** | **2.9** | **0.2** | 15.9 | 1.5 | 0.1 |

***D. Other Investments***

The Company held overseas deposits of $163.5 million and $135.1 million at September 30, 2012 and December 31, 2011, respectively, which are investments held in overseas funds and managed exclusively by Lloyd s. These investments are reflected in other investments in the Consolidated Balance Sheets.

***E. Other-than-temporary impairments***

For the three months ended September 30, 2012, total OTTI of fixed maturities and equity securities were $1.4 million. Of this amount, $2.2 million was recognized in earnings, including $0.8 million that was transferred from accumulated other comprehensive income. For the first nine months of 2012, total OTTI of fixed maturities and equity securities were $5.2 million. Of this amount, $5.7 million was recognized in earnings, including $0.5 million that was transferred from accumulated other comprehensive income.

For the three months ended September 30, 2011, total OTTI of fixed maturities were $1.1 million. Of this amount, $1.5 million was recognized in earnings, including $0.4 million that was transferred from unrealized losses in accumulated other comprehensive income. For the first nine months of 2011, total OTTI of fixed maturities and equity securities were $2.8 million. Of this amount, $3.7 million was recognized in earnings, including $0.9 million that was transferred from unrealized losses in accumulated other comprehensive income.

The methodology and significant inputs used to measure the amount of credit losses on fixed maturities in 2012 and 2011 were as follows:

Asset-backed securities, including commercial and residential mortgage-backed securities the Company utilized cash flow estimates based on bond specific facts and circumstances that include collateral characteristics, expectations of delinquency and default rates, loss severity, prepayment speeds and structural support, including subordination and guarantees.

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Corporate bonds the Company utilized a financial model that derives expected cash flows based on probability-of-default factors by credit rating and asset duration and loss-given-default factors based on security type. These factors are based on historical data provided by an independent third-party rating agency.

Municipals the Company utilized cash flow estimates based on bond specific facts and circumstances that may include the political subdivision s taxing authority, the issuer s ability to adjust user fees or other sources of revenue to satisfy its debt obligations and the ability to access insurance or guarantees.

The following table provides rollforwards of the cumulative amounts related to the Company s credit loss portion of the OTTI losses on fixed maturity securities for which the non-credit portion of the loss is included in other comprehensive income.

| | **Three Months Ended September 30,** | | **Nine Months Ended September 30,** | |
|---|---|---|---|---|
| *(in millions)* | **2012** | **2011** | **2012** | **2011** |
| Credit losses as of the beginning of the period | **$ 13.8** | $ 14.8 | **$ 14.5** | $ 16.7 |
| Credit losses for which an OTTI was not previously recognized | **0.1** | - | **0.5** | - |
| Additional credit losses on securities for which an OTTI was previously recognized | **-** | 0.4 | **0.6** | 0.6 |
| Reduction for securities sold, matured or called during the period | **(2.5)** | (0.3) | **(4.2)** | (1.6) |
| Reduction for securities reclassified as intend to sell | **(0.2)** | - | **(0.2)** | (0.8) |
| Credit losses as of the end of the period | **$ 11.2** | $ 14.9 | **$ 11.2** | $ 14.9 |

***F. Restricted assets***

In accordance with Lloyd s operating guidelines, the Company deposits funds at Lloyd s to support underwriting operations. These funds are available only to fund claim obligations. These restricted assets consisted of approximately $542 million of fixed maturities and $1 million of cash and cash equivalents as of September 30, 2012. The Company also deposits funds with various state and governmental authorities in the U.S. For a discussion of the Company s deposits with state and governmental authorities, see also Note 3 Investments of the Notes to Consolidated Financial Statements in our Annual Report on Form 10-K for the year ended December 31, 2011.

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**7. Fair Value**

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability, i.e., exit price, in an orderly transaction between market participants. The Company emphasizes the use of observable market data whenever available in determining fair value. Fair values presented for certain financial instruments are estimates which, in many cases, may differ significantly from the amounts that could be realized upon immediate liquidation. A hierarchy of the three broad levels of fair value are as follows, with the highest priority given to Level 1 as these are the most reliable, and the lowest priority given to Level 3:

Level 1 Unadjusted quoted prices in active markets for identical assets.

Level 2 Quoted prices for similar assets in active markets, quoted prices for identical or similar assets in markets that are not active, or other inputs that are observable or can be corroborated by observable market data, including model-derived valuations.

Level 3 Unobservable inputs that are supported by little or no market activity.

When more than one level of input is used to determine fair value, the financial instrument is classified as Level 2 or 3 according to the lowest level input that has a significant impact on the fair value measurement.

The following methods and assumptions were used to estimate the fair value of each class of financial instruments and have not changed since last year.

**Cash and Cash Equivalents**

The carrying amount approximates fair value. Cash equivalents primarily consist of money market instruments, which are generally valued using unadjusted quoted prices in active markets that are accessible for identical assets and are classified as Level 1.

**Fixed Maturities**

Level 1 securities generally include U.S. Treasury issues and other securities that are highly liquid and for which quoted market prices are available. Level 2 securities are valued using pricing for similar securities and pricing models that incorporate observable inputs including, but not limited to yield curves and issuer spreads. Level 3 securities include issues for which little observable data can be obtained, primarily due to the illiquid nature of the securities, and for which significant inputs used to determine fair value are based on the Company s own assumptions. Non-binding broker quotes are also included in Level 3.

The Company utilizes a third party pricing service for the valuation of the majority of its fixed maturity securities and receives one quote per security. When quoted market prices in an active market are available, they are provided by the pricing service as the fair value and such values are classified as Level 1. Since fixed maturities other than U.S. Treasury securities generally do not trade on a daily basis, the pricing service prepares estimates of fair value for those securities using pricing applications based on a market approach. Inputs into the fair value pricing common to all asset classes include: benchmark U.S. Treasury security yield curves; reported trades of identical or similar fixed maturity securities; broker/dealer quotes of identical or similar fixed maturity securities and structural characteristics such as maturity date, coupon, mandatory principal payment dates, frequency of interest and principal payments, and optional redemption features. Inputs into the fair value applications that are unique by asset class include, but are not limited to:

U.S. government agencies determination of direct versus indirect government support and whether any contingencies exist with respect to the timely payment of principal and interest.

Foreign government estimates of appropriate market spread versus underlying related sovereign treasury curve(s) dependent on liquidity and direct or contingent support.

Municipals    overall credit quality, including assessments of the level and variability of: sources of payment such as income, sales or property taxes, levies or user fees; credit support such as insurance; state or local economic and political base; natural resource availability; and susceptibility to natural or man-made catastrophic events such as hurricanes, earthquakes or acts of terrorism.

Corporate fixed maturities    overall credit quality, including assessments of the level and variability of: economic sensitivity; liquidity; corporate financial policies; management quality; regulatory environment; competitive position; ownership; restrictive covenants; and security or collateral.

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Residential mortgage-backed securities estimates of prepayment speeds based upon: historical prepayment rate trends; underlying collateral interest rates; geographic concentration; vintage year; borrower credit quality characteristics; interest rate and yield curve forecasts; government or monetary authority support programs; tax policies; delinquency/default trends; and, in the case of non-agency collateralized mortgage obligations, severity of loss upon default and length of time to recover proceeds following default.

Commercial mortgage-backed securities overall credit quality, including assessments of the value and supply/demand characteristics of: collateral type such as office, retail, residential, lodging, or other; geographic concentration by region, state, metropolitan statistical area and locale; vintage year; historical collateral performance including defeasance, delinquency, default and special servicer trends; and capital structure support features.

Asset-backed securities overall credit quality, including assessments of the underlying collateral type such as credit card receivables, auto loan receivables and equipment lease receivables; geographic diversification; vintage year; historical collateral performance including delinquency, default and casualty trends; economic conditions influencing use rates and resale values; and contract structural support features.

Generally, all prices provided by the pricing service, except actively traded securities with quoted market prices, are reported as Level 2.

The Company holds privately placed fixed maturity securities and certain other fixed maturity securities that do not have an active market and for which the pricing service cannot provide fair values. The Company determines fair values for these securities using either matrix pricing utilizing the market approach or broker quotes. The Company will use observable market data as inputs into the fair value applications, as discussed in the determination of Level 2 fair values, to the extent it is available, but is also required to use a certain amount of unobservable judgment due to the illiquid nature of the securities involved. Unobservable judgment reflected in the Company s matrix model accounts for estimates of additional spread required by market participants for factors such as issue size, structural complexity, high bond coupon, long maturity term or other unique features. These matrix-priced securities are reported as Level 2 or Level 3, depending on the significance of the impact of unobservable judgment on the security s value. Additionally, the Company may obtain non-binding broker quotes which are reported as Level 3.

**Equity Securities**

Level 1 includes publicly traded securities valued at quoted market prices. Level 2 includes securities that are valued using pricing for similar securities and pricing models that incorporate observable inputs. Level 2 also includes fair values obtained from net asset values provided by mutual fund investment managers, upon which subscriptions and redemptions can be executed. Level 3 consists of common or preferred stock of private companies for which observable inputs are not available.

The Company utilizes a third party pricing service for the valuation of the majority of its equity securities and receives one quote for each equity security. When quoted market prices in an active market are available, they are provided by the pricing service as the fair value and such values are classified as Level 1. Generally, all prices provided by the pricing service, except quoted market prices, are reported as Level 2. The Company holds certain equity securities that have been issued by privately-held entities that do not have an active market and for which the pricing service cannot provide fair values. Generally, the Company estimates fair value for these securities based on the issuer s book value and market multiples. These securities are reported as Level 3 as market multiples represent significant unobservable inputs.

**Other Investments**

Other investments consist primarily of overseas trust funds, for which fair values are provided by the investment manager based on quoted prices for similar instruments in active markets and are reported as Level 2. Also included in other investments are cost basis limited partnerships and mortgage loans. Cost basis limited partnerships fair values are based on the net asset value provided by the general partner and recent financial information and are reported as Level 3. Mortgage loans fair values are estimated by discounting the future contractual cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings and are reported as Level 2.

**Debt**

The fair value of debt was estimated based on quoted market prices. If a quoted market price is not available, fair values are estimated using discounted cash flows that are based on current interest rates and yield curves for debt issuances with maturities and credit risks consistent with the debt being valued. Debt is reported as Level 2.

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The estimated fair values of the financial instruments were as follows:

| *(in millions)* | September 30, 2012 Carrying Value | September 30, 2012 Fair Value | December 31, 2011 Carrying Value | December 31, 2011 Fair Value |
|---|---|---|---|---|
| **Financial Assets** | | | | |
| Cash and cash equivalents | **$ 462.0** | **$ 462.0** | $ 820.4 | $ 820.4 |
| Fixed maturities | **6,794.9** | **6,794.9** | 6,284.7 | 6,284.7 |
| Equity securities | **392.8** | **392.8** | 246.4 | 246.4 |
| Other investments | **182.5** | **182.8** | 154.4 | 153.9 |
| Total financial assets | **$ 7,832.2** | **$ 7,832.5** | $ 7,505.9 | $ 7,505.4 |
| **Financial Liabilities** | | | | |
| Debt | **$ 917.5** | **$ 1,065.3** | $ 911.1 | $ 1,014.9 |

The Company has processes designed to ensure that the values received from its third party pricing service are accurately recorded, that the data inputs and valuation techniques utilized are appropriate and consistently applied and that the assumptions are reasonable and consistent with the objective of determining fair value. The Company performs a review of the fair value hierarchy classifications and of prices received from its pricing service on a quarterly basis. The Company reviews the pricing services policies describing its methodology, processes, practices and inputs, including various financial models used to value securities. Also, the Company reviews the portfolio pricing. Securities with changes in prices that exceed a defined threshold are verified to independent sources, if available. If upon review, the Company is not satisfied with the validity of a given price, a pricing challenge would be submitted to the pricing service along with supporting documentation for its review. The Company does not adjust quotes or prices obtained from the pricing service unless the pricing service agrees with the Company s challenge. During 2012 and 2011, the Company did not adjust any prices received from brokers or its pricing service.

Changes in the observability of valuation inputs may result in a reclassification of certain financial assets or liabilities within the fair value hierarchy. Reclassifications between levels of the fair value hierarchy are reported as of the beginning of the period in which the reclassification occurs. As previously discussed, the Company utilizes a third party pricing service for the valuation of the majority of its fixed maturities and equity securities. The pricing service has indicated that it will only produce an estimate of fair value if there is objectively verifiable information to produce a valuation. If the pricing service discontinues pricing an investment, the Company will use observable market data to the extent it is available, but may also be required to make assumptions for market based inputs that are unavailable due to market conditions.

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The following tables provide, for each hierarchy level, the Company s assets at September 30, 2012 and December 31, 2011 that are measured at fair value on a recurring basis.

| | | September 30, 2012 | | |
|---|---|---|---|---|
| *(in millions)* | **Total** | **Level 1** | **Level 2** | **Level 3** |
| Fixed maturities: | | | | |
| U.S. Treasury and government agencies | **$ 223.5** | **$ 79.9** | **$ 143.6** | **$ -** |
| Foreign governments | **364.8** | **82.2** | **282.6** | **-** |
| Municipal | **1,038.6** | **-** | **1,019.0** | **19.6** |
| Corporate | **3,773.2** | **-** | **3,745.8** | **27.4** |
| Residential mortgage-backed, U.S. agency backed | **622.5** | **-** | **622.5** | **-** |
| Residential mortgage-backed, non-agency | **209.9** | **-** | **209.2** | **0.7** |
| Commercial mortgage-backed | **365.5** | **-** | **338.1** | **27.4** |
| Asset-backed | **196.9** | **-** | **195.8** | **1.1** |
| Total fixed maturities | **6,794.9** | **162.1** | **6,556.6** | **76.2** |
| Equity securities | **383.1** | **305.7** | **53.5** | **23.9** |
| Other investments | **167.1** | **-** | **163.5** | **3.6** |
| Total investment assets at fair value | **$ 7,345.1** | **$ 467.8** | **$ 6,773.6** | **$ 103.7** |

| | | December 31, 2011 | | |
|---|---|---|---|---|
| | **Total** | **Level 1** | **Level 2** | **Level 3** |
| Fixed maturities: | | | | |
| U.S. Treasury and government agencies | $ 269.3 | $ 147.3 | $ 122.0 | $ - |
| Foreign governments | 239.0 | - | 239.0 | - |
| Municipal | 1,028.0 | - | 1,014.4 | 13.6 |
| Corporate | 3,375.6 | - | 3,351.8 | 23.8 |
| Residential mortgage-backed, U.S. agency backed | 663.3 | - | 663.3 | - |
| Residential mortgage-backed, non-agency | 185.3 | - | 180.1 | 5.2 |
| Commercial mortgage-backed | 398.1 | - | 374.4 | 23.7 |
| Asset-backed | 126.1 | - | 116.9 | 9.2 |
| Total fixed maturities | 6,284.7 | 147.3 | 6,061.9 | 75.5 |
| Equity securities | 237.0 | 177.4 | 36.2 | 23.4 |
| Other investments | 138.7 | - | 135.1 | 3.6 |
| Total investment assets at fair value | $ 6,660.4 | $ 324.7 | $ 6,233.2 | $ 102.5 |

The following table provides, for each hierarchy level, the Company s estimated fair values of financial instruments that are not carried at fair value:

| | | September 30, 2012 | | |
|---|---|---|---|---|
| *(in millions)* | **Total** | **Level 1** | **Level 2** | **Level 3** |
| Assets: | | | | |
| Cash and cash equivalents | **$ 462.0** | **$ 462.0** | **$ -** | **$ -** |
| Equity securities | **9.7** | **-** | **9.7** | **-** |
| Other investments | **15.7** | **-** | **5.1** | **10.6** |
| Liabilities: | | | | |

| | | | | |
|---|---|---|---|---|
| Debt | **$ 1,065.3** | **$ -** | **$ 1,065.3** | **$ -** |

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The table below provides a reconciliation for all assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3).

| | Fixed Maturities | | | | |
|---|---|---|---|---|---|
| *(in millions)* | **Municipal** | **Corporate** | **Residential mortgage-backed, non-agency** | **Commercial mortgage-backed** | **Asset-backed** |