

## Management's Discussion and Analysis of Financial Condition and Results of Operations

The consolidated financial statements and the related notes, together with the supplemental information, should be read in conjunction with the following discussion and analysis of the consolidated financial condition and results of operations.

### I. OVERVIEW

The Progressive Corporation is a holding company that does not have any revenue producing operations, physical property, or employees of its own. The Progressive Group of Insurance Companies, together with our non-insurance subsidiaries, comprise what we refer to as Progressive. Progressive has been in business since 1937 and is estimated to be the country's fourth largest private passenger auto insurer based on net premiums written during 2009. Our insurance companies offer personal automobile insurance and other specialty property-casualty insurance and related services throughout the United States. In December 2009, we began selling personal auto insurance in Australia. Our Personal Lines segment writes insurance for private passenger automobiles and recreational vehicles through more than 30,000 independent insurance agencies and directly to consumers online and over the phone. Our Commercial Auto segment, which writes through both the independent agency and direct channels, offers insurance for cars and trucks (e.g., pick-up or panel trucks) owned by small businesses and is estimated to be in the top four in its industry. These underwriting operations, combined with our service and investment operations, make up the consolidated group.

The Progressive Corporation receives cash through subsidiary dividends, borrowings, security sales, and other transactions, and uses these funds to contribute to its subsidiaries (e.g., to support growth), to make payments to shareholders and debt holders (e.g., dividends and interest, respectively), to repurchase its common shares, and for other business purposes that might arise. In 2009, the holding company received \$1.1 billion from its subsidiaries, net of capital contributions. In December 2009, the Board declared a dividend of \$.1613 per share, or \$108.5 million, which was paid to shareholders in February 2010. This dividend was pursuant to our annual variable dividend policy and was based on 2009 underwriting results. No dividend was paid for 2008 reflecting the comprehensive loss we reported for that year, as discussed in *Financial Condition* below. During 2009, we used \$180.6 million to repurchase 11.1 million Progressive common shares, at an average cost of \$16.34 per share. We had no debt that matured in 2009. The holding company also has access to funds held in a non-insurance subsidiary; at year-end 2009, \$2.2 billion of marketable securities were available in this company. On a consolidated basis, we generated positive operating cash flows of \$1.5 billion in 2009.

For 2009, Progressive generated net income of \$1.1 billion, or \$1.57 per share, driven by strong underwriting profitability and solid investment returns. Our insurance operations generated 3% growth in written and earned premiums and 4% growth in policies in force, and produced an 8.4% underwriting profit margin. We continued to make progress on several initiatives intended to help spur our personal auto growth. Our Commercial Auto business continues to feel the effect of the weakened economy and competitive pressures on its ability to generate both premium and policy growth, but contributed to profitability with a 14.2% underwriting margin.

During 2009, our investment portfolio generated investment income of \$507.0 million with net realized gains of \$27.1 million. This was a significant change from the \$1.4 billion of net realized losses we recognized in 2008, driven by significant other-than-temporary impairments, as a result of market declines, primarily in our preferred stock holdings. We ended 2009 with \$7.9 billion of total capital (debt and equity), \$1.5 billion more than at the start of the year. We continue to manage our investing and financing activities in order to maintain sufficient capital to support all the insurance we can profitably underwrite and service.

#### A. Operations

In 2009, our insurance subsidiaries generated underwriting profitability of 8.4%, which exceeded our targeted profitability objective of 4%. Both our Personal Lines and Commercial Auto businesses contributed to our strong profitability. In Personal Lines, only eight states did not meet or exceed their target profitability, with only three of those states actually recording an underwriting loss for the year. In Commercial Auto, only five states did not generate an underwriting profit.

We realized \$136.0 million of favorable prior accident year development, which increased our profitability for 2009 by one percentage point. This development was primarily from the cost of claims settling at amounts lower than originally

estimated. Just over half of this development was in our Personal Lines business, with almost all of the balance in Commercial Auto. For the year, our overall incurred auto accident frequency and severity remained relatively flat compared to the prior year, despite changes in the individual coverages. We saw a decrease in both frequency and severity in the property coverages, while both frequency and severity increased in our personal injury protection coverage. For bodily injury, we saw frequency increase in 2009 compared to 2008, and severity remain relatively flat year-over-year.

On a year-over-year basis, net premiums written and earned both increased 3%. Changes in net premiums written are a function of new business applications (i.e., issued policies), premium per policy, and retention.

During 2009, we saw total new auto applications increase 11%, primarily driven by a 20% increase in our Direct business. For the year, our Agency auto business generated a 3% increase in new applications, despite starting 2009 with significant declines. When evaluating new business application growth on a state-by-state basis, only 12 states did not see total auto applications increase in 2009. In Agency auto, 29 states saw new applications increase. For our Direct business, all but two states saw new auto applications increase on a year-over-year basis. Our Commercial Auto and special lines products both saw new applications decline about 9%. The weakened economy contributed to the decline in our Commercial Auto business, while the surge in new motorcycle and scooter business in 2008, when gas prices were at an all-time high in the United States, drove the 2009 decrease in special lines new applications on a year-over-year basis.

We are continuing with our efforts to spur personal auto growth through several initiatives underway aimed at providing consumers with distinctive new business options. These include the countrywide rollout of Name Your Price<sup>®</sup>, a program that provides Direct auto consumers the opportunity to select the price they would like to pay for auto insurance; the rollout of new product models, designed to improve competitiveness through further price segmentation; and the expansion of our usage-based insurance product, referred to as MyRate<sup>®</sup>. We are also continuing to increase our focus on the segment of customers who like to combine their auto and homeowners insurance policies, and we now have relationships with three homeowner carriers to pursue this sizeable market. In addition, in continuing to build options for the future that are in line with our strategic goals, we launched an Internet-only personal auto product in Australia during December 2009.

During 2009, on a year-over-year basis, our monthly average written premium per policy fluctuated from slightly negative to slightly positive in our Agency auto business, and ended the year relatively flat. The Direct auto business was a different story. We continued to see average written premium per policy lower than the prior year for a total decrease of 4% for the year, thus tempering the total written premium growth to 11%. The decrease in the Direct auto business written premium per policy primarily reflects the shifts in the mix of our business relating to the age of the drivers, the proof of prior insurance, and the driving records of our customers. Commercial Auto continued to see declines in premiums per policy, reflecting the continued impact of the economy on our commercial customers who are selecting less coverage and insuring fewer vehicles. The special lines products average written premiums were relatively flat year-over-year. Adjusting rates is a continuous process and we will continue to evaluate future rate needs and react quickly as we recognize changing trends.

Companywide policies in force have increased 4% on a year-over-year basis since December 31, 2008. This increase reflects about 476,000 additional Personal Lines policies and 27,000 fewer Commercial Auto policies. The biggest contributor to this growth was our Direct auto business where policies in force grew 13%, or 377,000 policies. Agency auto policies in force were relatively flat year-over-year, while our special lines products saw an increase of about 3%. The effects of the economy continued to negatively impact our Commercial Auto business as policies in force decreased 5%.

To continue to grow policies in force, it is critical that we retain our customers for longer periods, which is why increasing retention continues to be one of our most important priorities. In 2009, we continued to see an increase in customer retention. Total personal auto policy life expectancy increased 3% on a year-over-year basis, with our Agency and Direct auto policy life expectancies increasing 2% and 3%, respectively. Our Commercial Auto business policy life expectancy remained relatively flat, while our special lines products experienced a 3% decrease from the prior year. Realizing the importance that retention has on our ability to continue to grow profitably, we continue to emphasize competitive pricing, quality service, and other retention initiatives for our current customers.

## **B. Investments and Capital Management**

The fair value of our investment portfolio was \$14.7 billion at December 31, 2009. During 2009, our asset allocation strategy was to maintain 0-25% of our portfolio in Group I securities (i.e., common equities, redeemable and nonredeemable preferred stocks (preferred stocks), and non-investment-grade and non-rated fixed-maturity securities), with the balance (75%-100%) of our portfolio in Group II securities (i.e., all other fixed-maturity securities, including U.S. Treasury Notes, municipal bonds, asset-backed securities, and corporate debt, as well as short-term investments). At December 31, 2009, our portfolio was allocated 20% to Group I and 80% to Group II.

Our investment portfolio produced a fully taxable equivalent (FTE) total return of 12.5% for 2009. We experienced positive FTE total returns in the fixed-income portfolio (i.e., fixed maturities, redeemable and nonredeemable preferred stocks, and short-term investments) of 12.2% and common stock portfolio of 29.5% in 2009. We continue to maintain our fixed-income portfolio strategy of investing in high-quality, shorter-duration securities given the current investment environment. We decreased the duration of our fixed-income portfolio during the year to end 2009 at 2.3 years, compared to 3.2 years at the end of 2008. The weighted average credit rating of our fixed-income portfolio ranged from AA+ early in 2009 to AA at the end of the year. Our common equity investment strategy remains an index replication approach using the Russell 1000 Index as the benchmark.

The first quarter 2009 marked the depths of the current financial crisis. A government administered bank stress test, the results of which were released in May, served as an effective tool to restore investor confidence in the solvency of the financial system. Many banks used the stress test results to raise equity capital to restore their balance sheet strength and improve their ability to weather a severe economic downturn. The recapitalization of the banking system, combined with significant liquidity injections and asset purchases by the Federal Reserve and a meaningful fiscal stimulus program, sparked a virtuous cycle of asset and economic recovery during the balance of 2009. Valuations improved for nearly all risk assets. The market values of common and preferred stock improved dramatically, credit spreads returned to within sight of their pre-crisis levels for corporate bonds, and liquidity improved markedly across all markets. Access to the capital markets returned for most issuers, alleviating fears of liquidity driven defaults. Housing markets arrested their rapid declines and, by late in the year, showed signs of improving in some regions. Although these were positive developments, significant risks remain in the financial markets and U.S. economy. Employment markets weakened sharply early in the year and remained soft at year end. Inflation readings were subdued, as low levels of resource utilization and high unemployment provided no pressure for higher wages or prices. The Federal Reserve maintained their target of 0-0.25% for the overnight funds rate and stated that it was likely to remain at an exceptionally low level for an extended period. At year-end 2009, two-year and ten-year U.S. Treasury Notes were yielding 1.11% and 3.88%, respectively, compared to 0.74% and 2.21% at the end of 2008.

Approximately 75% of our preferred stock holdings are obligations of financial sector issuers. During 2009, we recorded \$213.2 million of other-than-temporary impairment losses on our redeemable and nonredeemable preferred stocks. The write-downs were due to a combination of issuer fundamentals and severe market declines where we were unable to objectively determine that the securities would substantially recover in the near term. At year-end, we had a net unrealized gain of \$555.0 million in our redeemable and nonredeemable financial sector preferred stock portfolio.

At December 31, 2009, we held approximately \$164.4 million of sub-prime mortgage bonds, classified as home-equity bonds. In addition, we held \$28.7 million of non-prime collateralized mortgage obligations (Alt-A securities). Together, these securities had net unrealized losses of \$54.8 million at year-end 2009. During 2009, we recorded other-than-temporary impairment losses of \$23.7 million on home-equity securities and \$4.0 million on our Alt-A securities.

Our investment results provided a substantial contribution to the increase in our capital position. We ended 2009 with \$7.9 billion of total capital (debt plus equity). We continue to manage our investing and financing activities in order to maintain sufficient capital to support all the insurance we can profitably underwrite and service.

## **II. FINANCIAL CONDITION**

### **A. Holding Company**

In 2009, The Progressive Corporation, the holding company, received \$1.1 billion of dividends, net of capital contributions made to subsidiaries. For the three-year period ended December 31, 2009, The Progressive Corporation received \$2.6 billion of dividends from its subsidiaries, net of capital contributions. Regulatory restrictions on subsidiary dividends are described in *Note 8 – Statutory Financial Information*.

Progressive's debt-to-total capital (debt plus equity) ratios at December 31, 2009, 2008, and 2007 were 27.5%, 34.0%, and 30.6%, respectively. During the last three years, The Progressive Corporation did not retire any debt securities. In June 2007, we took actions to restructure our capital position, which included issuing \$1 billion of 6.70% Fixed-to-Floating Rate Junior Subordinated Debentures due 2067. See *Note 4 – Debt* for further discussion of our current outstanding debt. The plan also consisted of returning capital to shareholders through share repurchases and a special dividend of \$2.00 per common share. The 2007 recapitalization plan is discussed in further detail in the *Liquidity and Capital Resources* section below.

During 2009, we repurchased 11,053,953 of our common shares. The total cost to repurchase these shares was \$180.6 million, with an average cost of \$16.34 per share. During the three-year period ended December 31, 2009, we repurchased 93,858,986 of our common shares at a total cost of \$1.9 billion (average cost of \$20.33 per share), including shares repurchased as part of our 2007 recapitalization plan.

Progressive maintains a policy of paying an annual variable dividend that, if declared, would be payable shortly after the close of the year. The annual variable dividend is based on a target percentage of after-tax underwriting income multiplied by a companywide performance factor ("Gainshare factor"), subject to the limitations discussed below. The target percentage is determined by our Board of Directors on an annual basis and announced to shareholders and the public. For 2007, 2008, and 2009, the Board determined the target percentage to be 20% of annual after-tax underwriting income. For 2010, the Board has determined the target percentage to be 25% of annual after-tax underwriting income.

The Gainshare factor can range from zero to two and is determined by comparing our operating performance for the year to certain predetermined profitability and growth objectives approved by the Board. This Gainshare factor is also used in the variable cash incentive program currently in place for our employees (referred to as our "Gainsharing program"). Although recalibrated every year, the structure of the Gainsharing program generally remains the same. For 2009, the Gainshare factor was .71, compared to .80 in 2008 and .74 in 2007.

Our annual variable dividend program is subject to certain limitations. If the Gainshare factor is zero or if our after-tax comprehensive income (net income plus the after-tax change in net unrealized gains (losses), among other factors) is less than after-tax underwriting income, no dividend will be paid.

During the last three years, we paid \$1.5 billion in shareholder dividends. The annual variable dividends are intended to be paid at the beginning of the year subsequent to the date the Board of Directors declared the dividend. The dividend calculated based on 2009 underwriting results was declared by the Board in December 2009 and paid to shareholders in February 2010; the total amount of dividends was \$108.5 million, or \$.1613 per common share. No dividend was paid in 2009, based on 2008 results, reflecting the fact that we had an after-tax comprehensive loss of \$614.7 million, despite reporting \$477.7 million of after-tax underwriting income for the same period. In January 2008, we paid shareholder dividends of \$98.3 million, or \$.145 per common share, pursuant to a December 2007 declaration by our Board of Directors. In addition, in 2007, we returned \$1.4 billion to shareholders via an extraordinary cash dividend of \$2.00 per share as part of a recapitalization plan that took place during the year.

## **B. Liquidity and Capital Resources**

Progressive's insurance operations create liquidity by collecting and investing premiums from new and renewal business in advance of paying claims. As an auto insurer, our claims liabilities are generally short in duration. At any point in time, approximately 50% of our outstanding reserves are paid within the following twelve months and less than 15% are still outstanding after three years. See *Claims Payment Patterns*, a supplemental disclosure provided in this Annual Report, for further discussion on the timing of claims payments.

As of December 31, 2009, our consolidated statutory policyholders' surplus was \$5.0 billion, compared to \$4.5 billion at December 31, 2008. Our net premiums written-to-surplus ratio was 2.8 to 1 at year-end 2009, compared to 3.0 at both year-end 2008 and 2007. We also have access to \$2.2 billion in a non-insurance subsidiary, portions of which could be contributed to the capital of our insurance subsidiaries to support growth as needed. In addition, our risk-based capital ratios, which are a series of dynamic surplus-related formulas that contain a variety of factors that are applied to financial balances based on the degree of certain risks (e.g., asset, credit, and underwriting), are well in excess of minimum requirements. See *Note 8 – Statutory Financial Information* for any regulatory restrictions on subsidiary dividends.

For the three years ended December 31, 2009, operations generated positive cash flow of \$4.8 billion, and cash flows are expected to remain positive in both the short-term and reasonably foreseeable future. As of December 31, 2009, 80% of our portfolio was invested in U.S. Treasury Notes, municipal bonds, asset-backed securities, corporate debt, and short-term investments (Group II securities). In addition, our fixed-income portfolio duration was 2.3 years, with a weighted average credit quality of AA. At year end, we held \$5.9 billion in short-term investments and U.S. Treasury securities. We believe that we have sufficient readily marketable securities to cover our claims payments without having a negative effect on our cash flows from operations.

Based upon our capital planning and forecasting efforts, we believe that we have sufficient capital resources, cash flows from operations, and borrowing capacity to support our current and anticipated business, scheduled principal and interest payments on our debt, and expected capital requirements. The covenants on our existing debt securities do not include any rating or credit triggers that would require an adjustment of the interest rate or an acceleration of principal payments in the event our securities are downgraded by a rating agency. We have no scheduled debt maturities until January 2012.

Progressive seeks to deploy capital in a prudent manner and uses multiple data sources and modeling tools to estimate the frequency, severity, and correlation of identified exposures, including, but not limited to, catastrophic losses and the business interruptions discussed below, to estimate our potential capital needs.

Management views our capital position as consisting of three layers, each with a specific size and purpose. The first layer of capital, which we refer to as “regulatory capital,” is the amount of capital we need to satisfy state insurance regulatory requirements and support our objective of writing all the business we can write and service, consistent with our underwriting discipline of achieving a 96 combined ratio. This capital is held within our various insurance entities.

The second layer of capital we call “extreme contingency.” While our regulatory capital is, by definition, a cushion for absorbing financial consequences of adverse events, such as loss reserve development, litigation, weather catastrophes, or investment market corrections, we view that as a base and hold additional capital for even more extreme conditions. The modeling used to quantify capital needs for these conditions is quite extensive, including tens of thousands of simulations, representing our best estimates of such contingencies based on historical experience. This capital is held either at the holding company or in our insurance entities, where it is potentially eligible for a dividend up to the holding company.

The third layer of capital is capital in excess of the sum of the first two layers and provides maximum flexibility to repurchase stock, consider acquisitions, and pay dividends to shareholders, among other purposes. This capital is largely held at the holding company.

At all times during the last two years, our total capital exceeded the sum of our regulatory capital layer plus our self-constructed extreme contingency load. However, in 2008, and through the first quarter 2009, the amount of capital in our third layer was diminished, principally due to decreased valuations for securities held in our investment portfolio. During this time, our capital management practices allowed us to manage our business without having to sell securities at values that we believed were below our long-term assessment of the value of the investments. At December 31, 2009, we held total capital (debt plus equity) of \$7.9 billion at book value, compared to \$6.4 billion at book value at December 31, 2008.

The speed by which the market valuations of the assets held in our portfolio can change is the basis for our ongoing review of portfolio risk. To help manage these risks and preserve our capital base, as of December 31, 2009, we held approximately \$5.9 billion in short-term investments and U.S. Treasury securities. See Item 1A, “Risk Factors,” in our Form 10-K filed with the SEC for a discussion of certain matters that may affect our portfolio and capital position.

In order to provide liquidity in the event of disruptions in our cash management operations, such as disruptions in the financial markets, that could affect our ability to transfer or receive funds, we currently have a 364-Day Secured Liquidity Credit Facility Agreement with PNC Bank, National Association (PNC), successor to National City Bank. Under this agreement, we may borrow up to \$125 million, which may be increased to \$150 million at our request but subject to PNC's discretion. Any borrowings under this agreement will be secured by a lien on certain marketable securities held in our investment portfolio. In addition, we deposited \$125 million into an account at PNC in January 2009, to provide us with additional cash availability in the event of such a disruption to our cash management operations. Our access to these funds is unrestricted. However, if we withdraw funds from this account for any reason other than in connection with such a disruption in our cash management operations, the availability of borrowings under the PNC credit facility will be reduced on a dollar-for-dollar basis until such time as we replenish the funds to the deposit account. See *Note 4 – Debt* for further



discussion of our credit facility and previous line of credit; there were no borrowings under these agreements during the last three years.

In 2007, we took efforts to restructure our capital position, which included the following components:

- The payment of an extraordinary cash dividend of \$2.00 per common share, or \$1.4 billion.
- A Board authorization for us to repurchase up to 100 million of our common shares prior to June 30, 2009. Prior to expiration, we only purchased 52.8 million shares; therefore, effective July 1, 2009, the Board of Directors authorized the repurchase of up to 50.0 million common shares. This new authorization does not have an expiration date.
- The issuance of \$1 billion of 6.70% Fixed-to-Floating Rate Junior Subordinated Debentures due 2067 (the “Debentures”) on June 18, 2007. The proceeds of the offering were \$987.3 million, before \$1.5 million of expenses related to the issuance. In addition, upon issuance of the Debentures, we closed a forecasted debt issuance hedge, which was entered into to hedge against a possible rise in interest rates, and recognized a \$34.4 million pretax gain as part of shareholders’ equity; this gain is being recognized as an adjustment to interest expense and amortized over 10 years, which represents the fixed interest rate period of the Debentures. See *Note 4 – Debt* for further discussion of the terms of the Debentures.

In connection with the issuance of the Debentures, we also entered into a Replacement Capital Covenant for the benefit of the holders of our 6.25% Senior Notes due 2032 (the “Covered Debt”). Under the Replacement Capital Covenant, we may not repay, redeem, or repurchase any of the Debentures prior to June 15, 2047 (or, if earlier, prior to the occurrence of certain events specified in the Replacement Capital Covenant), except to the extent that (subject to certain limitations) the amount to be repaid, redeemed, or purchased does not exceed a specified percentage of net cash proceeds from the sale to third parties of certain replacement capital securities (as defined in the Replacement Capital Covenant) plus the proceeds from the sale or issuance of common shares or certain qualifying warrants. The identity of the Covered Debt may be changed from time to time by the company upon the occurrence of certain events specified in, and in accordance with the requirements of, the provisions of the Replacement Capital Covenant. See our Current Report on Form 8-K, filed on June 22, 2007, for additional information and a copy of the Replacement Capital Covenant.

### C. Commitments and Contingencies

#### **Contractual Obligations**

A summary of our noncancelable contractual obligations as of December 31, 2009, follows:

(millions)	Payments due by period				
	Total	Less than 1 year	1-3 years	3-5 years	More than 5 years
Debt	\$ 2,200.0	\$ —	\$ 350.0	\$150.0	\$1,700.0
Interest payments on debt	1,562.8	144.7	278.2	234.2	905.7
Operating leases	228.2	73.5	101.3	37.2	16.2
Purchase obligations	132.3	61.2	59.1	4.9	7.1
Loss and loss adjustment expense reserves	6,653.0	3,612.0	2,256.4	556.9	227.7
<b>Total</b>	<b>\$10,776.3</b>	<b>\$3,891.4</b>	<b>\$3,045.0</b>	<b>\$983.2</b>	<b>\$2,856.7</b>

Purchase obligations represent our noncancelable commitments for goods and services. Unlike many other forms of contractual obligations, loss and loss adjustment expense (LAE) reserves do not have definitive due dates and the ultimate payment dates are subject to a number of variables and uncertainties. As a result, the total loss and LAE reserve payments to be made by period, as shown above, are estimates based on our recent payment patterns. To further understand our claims payments, see *Claims Payment Patterns*, a supplemental disclosure provided in this Annual Report. In addition, we annually publish a comprehensive *Report on Loss Reserving Practices*, which was most recently filed with the SEC on a Form 8-K on June 25, 2009, that further discusses our claims payment development patterns.

We did not enter into any significant new contractual commitments outside the ordinary course of business during 2009. In 2008, we entered into two contracts to expand our brand building efforts. In January 2008, we entered into a 16-year contract for the ballpark naming rights and a sponsorship deal with the Cleveland Indians Major League Baseball team;

portions of these contracts are cancelable. Over the contract term, Progressive will pay an average of approximately \$3.6 million per year. In addition, in March 2008, we announced our title sponsorship of the Progressive Insurance Automotive X PRIZE competition. The Automotive X PRIZE is a two and one-half year international competition designed to inspire a new generation of safe, low emissions vehicles capable of achieving the equivalent of at least 100 miles per gallon in fuel efficiency. The total cost of the sponsorship is expected to be approximately \$12.5 million, which includes both the prize for the winning teams and the funding of some operational expenses over the course of the competition. These expenditures are a reallocation of a small percentage of our annual media spend and are intended to generate greater exposure for our brand.

As discussed in the *Liquidity and Capital Resources* section above, we believe that we have sufficient borrowing capacity, cash flows, and other capital resources to satisfy these contractual obligations.

**Off-Balance-Sheet Arrangements**

Our off-balance-sheet leverage includes derivative positions and open investment funding commitments (as disclosed in *Note 2 – Investments, Note 13 – Commitments and Contingencies* and the *Derivative Instruments* section of this Management’s Discussion and Analysis). It also includes operating leases and purchase obligations (disclosed in the table above).

**Other**

We currently have no significant construction underway.

We completed construction of one new claims service center in 2009, two in 2008, and four in 2007; these projects were funded internally through operating cash flows. At December 31, 2009, we have a total of 54 centers that are available to provide concierge level claims service. The service centers are located in 41 metropolitan areas across the United States and serve as our primary approach to damage assessment and coordination of vehicle repairs at authorized auto repair facilities in these markets.

We maintain insurance on our real property and other physical assets, including coverage for losses due to business interruptions caused by covered property damage. However, the insurance will not compensate us for losses that may occur due to disruptions in service as a result of a computer, data processing, or telecommunications systems failure that is unrelated to covered property damage, nor will the insurance necessarily compensate us for all losses resulting from covered events. To help maintain functionality and reduce the risk of significant interruptions of our operations, we maintain back-up systems or facilities for certain of our principal systems and services. We still may be exposed, however, should these measures prove to be unsuccessful or inadequate against severe, multiple, or prolonged service interruptions or against interruptions of systems where no back-up currently exists. In addition, we have established emergency management teams, which are responsible for responding to business disruptions and other risk events. The teams’ ability to respond successfully may be limited depending on the nature of the event, the completeness and effectiveness of our plans to maintain business continuity upon the occurrence of such an event, and other factors beyond our control.

### III. RESULTS OF OPERATIONS — UNDERWRITING

#### A. Growth

(millions)	2009	2008	2007
<b>NET PREMIUMS WRITTEN</b>			
Personal Lines			
Agency	\$ 7,391.2	\$ 7,322.3	\$ 7,549.4
Direct	5,061.9	4,556.5	4,371.8
Total Personal Lines	12,453.1	11,878.8	11,921.2
Commercial Auto	1,533.9	1,704.8	1,828.9
Other indemnity	15.9	20.7	22.4
Total underwriting operations	\$14,002.9	\$13,604.3	\$13,772.5
Growth over prior year	3%	(1)%	(3)%
<b>NET PREMIUMS EARNED</b>			
Personal Lines			
Agency	\$ 7,414.8	\$ 7,362.0	\$ 7,636.4
Direct	4,951.1	4,485.8	4,372.6
Total Personal Lines	12,365.9	11,847.8	12,009.0
Commercial Auto	1,623.3	1,762.2	1,846.9
Other indemnity	23.6	21.4	21.5
Total underwriting operations	\$14,012.8	\$13,631.4	\$13,877.4
Growth over prior year	3%	(2)%	(2)%

Net premiums written represent the premiums generated from policies written during the period less any premiums ceded to reinsurers. Net premiums earned, which are a function of the premiums written in the current and prior periods, are earned as revenue over the life of the policy using a daily earnings convention.

Progressive experienced an increase in total written and earned premiums during 2009, as compared to declines in both 2008 and 2007. The increase in premiums, which we started to see during the latter part of 2008 and in 2009, reflects the increase in new applications and our efforts to increase retention, as well as other initiatives we have underway to help provide distinctive new auto business options (discussed below). The Commercial Auto business continues to be negatively affected by the economy, as many customers are insuring fewer vehicles and selecting less coverage, which is reflected in lower premiums in the last two years.

Policies in force, our preferred measure of growth, represents all policies under which coverage is in effect as of the end of the period specified. As of December 31, our policies in force were:

(thousands)	2009	2008	2007
<b>POLICIES IN FORCE</b>			
Personal Lines			
Agency auto	4,299.2	4,288.6	4,396.8
Direct auto	3,201.1	2,824.0	2,598.5
Total auto	7,500.3	7,112.6	6,995.3
Special lines <sup>1</sup>	3,440.3	3,352.3	3,120.3
Total Personal Lines	10,940.6	10,464.9	10,115.6
Growth over prior year	5%	3%	4%
Commercial Auto	512.8	539.4	539.2
Growth over prior year	(5)%	—%	7%

<sup>1</sup>Includes insurance for motorcycles, ATVs, RVs, mobile homes, watercraft, snowmobiles, and similar items, as well as a personal umbrella product.



To analyze growth, we review new policies, rate levels, and the retention characteristics of our books of business. During the last three years, we experienced the following growth in new and renewal applications:

	Growth Over Prior Year		
	2009	2008	2007
Personal Lines			
New applications	6%	(5)%	2%
Renewal applications	6%	4%	3%
Commercial Auto			
New applications	(9)%	(8)%	3%
Renewal applications	2%	4%	5%

The increase in new applications for our Personal Lines business during 2009, as compared to 2008, reflects significant growth in our personal auto business applications, slightly offset by declines in our special lines products. Our Direct auto business saw a double-digit increase in new applications during 2009. Our Agency auto business also experienced an increase, albeit to a lesser extent than Direct. We have seen a surge in quoting activity in both our Agency and Direct businesses, but most notably in Direct business quotes obtained through the Internet. Although we are unable to definitively identify what is driving this increase, we believe that our advertising campaign, which incents customers to shop online, and our brand-building efforts, along with customers evaluating their choices in response to the current economy, may be contributors. The decrease in our new applications in our special lines products partially resulted from the significant decline in year-over-year motorcycle and scooter sales, which reflected more sales in 2008, when gas prices were higher, as compared to 2009. The decline in new applications for our Commercial Auto business reflects the economic downturn, particularly in the housing and construction sectors.

We have several initiatives underway aimed at providing consumers with distinctive new auto insurance options. During 2009, we continued the nationwide rollout of a program, which was introduced in 2008, called Name Your Price<sup>®</sup>, that allows Direct auto consumers to design a quote based on the price they would like to pay for their auto insurance; we then will tell them the level of coverage that price provides. As of year-end 2009, Name Your Price is available in 40 jurisdictions, including 32 states and the District of Columbia that rolled-out during the year. We plan to expand this program to the rest of the country during 2010.

We also rolled out a redesigned product model in our Agency auto business, which was designed to help improve competitiveness through further price segmentation, to an additional 22 states since the end of 2008, bringing the total number of states with this product to 35. We do not plan any additional rollout of this model since we have already begun shifting our focus to newer product models, which further refine our segmentation and incorporate the best design elements of the Agency and Direct auto products. During 2009, we introduced the latest product model in 3 states and we plan to continue the rollout to about 20-30 states in 2010.

In addition, during 2009, we expanded MyRate<sup>®</sup>, our usage-based insurance product, into 10 additional states. This product is now available to Direct auto customers in a total of 19 states and Agency auto customers in 10 of the 19 states. During 2010, we plan to continue expansion of MyRate into about 15 additional states depending on regulatory approval and business results.

We are also continuing with our efforts to further penetrate customer households through cross-selling products. Progressive Home Advantage<sup>®</sup>, our program in which we “bundle” our auto product with property insurance provided by one of three unaffiliated insurance carriers, is becoming an integral part of our consumer offerings and is currently available to Agency customers in 41 states and Direct customers in 48 states and the District of Columbia; this program is not available to Direct customers in Florida and Alaska. In addition, we are focused on selling auto policies to our special lines customers and vice versa. These multi-product customers are an important part of our strategic agenda, since they tend to stay with us longer, have better loss experience, and represent a sizable segment of the market.

During 2009, total personal auto written premium per policy decreased 2%, despite a modest increase in rates for the year, primarily reflecting shifts in the mix of business. On a year-over-year basis, our Agency auto business experienced a 1% increase in premium per policy on new business and was relatively flat on renewal business. Our Direct auto premium per policy was down about 7% on new business and 3% on renewals, as compared to last year. The decrease in our Direct auto premium per policy primarily reflects mix shifts (e.g., age of drivers, existence of prior insurance, and driving records).

We believe our pricing levels are aligned with our profitability targets, but we remain ready to react quickly, and as often as necessary, should trends change. In 2008 and 2007, our total auto written premium per policy was down 2% and 5%, respectively, compared to the prior year, due to rate reductions taken in mid-2006 and into 2007. Our Commercial Auto written premium per policy decreased in each of the last three years. This business is continuing to be affected by the economic downturn as our Commercial Auto customers are selecting less coverage and insuring fewer vehicles.

Another important element affecting growth is customer retention. One measure of retention is policy life expectancy, which is our actuarial estimate of the average length of time that a policy will remain in force before cancellation or lapse in coverage. Our policy life expectancy measures for our Agency and Direct personal auto products are now higher than the same measures a year ago by approximately 2% and 3%, respectively, while the special lines products policy life expectancy was down 3%. Our policy life expectancy in our Commercial Auto business remained flat, compared to the end of 2008. Our policy life expectancy for both Agency and Direct personal auto products increased in both 2008 and 2007, while Commercial Auto was down in 2008 and was relatively flat for 2007, compared to the prior year. Realizing the importance that retention has on our ability to continue to grow profitably, we continue to emphasize competitive pricing, quality service, and other retention initiatives for our current customers.

## B. Profitability

Profitability for our underwriting operations is defined by pretax underwriting profit, which is calculated as net premiums earned less losses and loss adjustment expenses, policy acquisition costs, and other underwriting expenses. We also use underwriting profit margin, which is underwriting profit expressed as a percentage of net premiums earned, to analyze our results. For the three years ended December 31, our underwriting profitability measures were as follows:

(\$ in millions)	2009		2008		2007	
	Underwriting Profit (Loss)		Underwriting Profit (Loss)		Underwriting Profit (Loss)	
	\$	Margin	\$	Margin	\$	Margin
Personal Lines						
Agency	\$ 579.2	7.8%	\$360.7	4.9%	\$ 500.2	6.5%
Direct	357.9	7.2	274.8	6.1	339.9	7.8
Total Personal Lines	937.1	7.6	635.5	5.4	840.1	7.0
Commercial Auto	229.8	14.2	94.1	5.3	185.7	10.1
Other indemnity <sup>1</sup>	8.7	NM	5.3	NM	(.7)	NM
Total underwriting operations	\$1,175.6	8.4%	\$734.9	5.4%	\$1,025.1	7.4%

<sup>1</sup>Underwriting margins for our other indemnity businesses are not meaningful (NM) due to the low level of premiums earned by, and the variability of loss costs in, such businesses.

Our underwriting margins in 2009 reflect favorable prior accident year development, compared to unfavorable development in both 2008 and 2007. In addition, in 2009, we experienced fewer losses from catastrophes as compared to 2008 when we incurred losses from hurricanes Ike and Gustav, and hail storms and floods in the Midwest and Great Plains.

Further underwriting results for our Personal Lines business, including its channel components, the Commercial Auto business, and other indemnity businesses, as defined in *Note 10 – Segment Information*, were as follows:

<b>Underwriting Performance<sup>1</sup></b>	<b>2009</b>	<b>2008</b>	<b>2007</b>
Personal Lines — Agency			
Loss & loss adjustment expense ratio	71.1	73.7	72.1
Underwriting expense ratio	21.1	21.4	21.4
Combined ratio	92.2	95.1	93.5
Personal Lines — Direct			
Loss & loss adjustment expense ratio	72.3	73.3	71.3
Underwriting expense ratio	20.5	20.6	20.9
Combined ratio	92.8	93.9	92.2
Total Personal Lines			
Loss & loss adjustment expense ratio	71.5	73.5	71.8
Underwriting expense ratio	20.9	21.1	21.2
Combined ratio	92.4	94.6	93.0
Commercial Auto			
Loss & loss adjustment expense ratio	64.7	73.2	69.7
Underwriting expense ratio	21.1	21.5	20.2
Combined ratio	85.8	94.7	89.9
Total Underwriting Operations <sup>2</sup>			
Loss & loss adjustment expense ratio	70.7	73.5	71.5
Underwriting expense ratio	20.9	21.1	21.1
Combined ratio	91.6	94.6	92.6
Accident year-Loss & loss adjustment expense ratio <sup>3</sup>	71.7	73.3	70.9

<sup>1</sup>Ratios are expressed as a percentage of net premiums earned.

<sup>2</sup>Combined ratios for the other indemnity businesses are not presented separately due to the low level of premiums earned by, and the variability of loss costs in, such businesses. For the years ended December 31, 2009, 2008, and 2007, these businesses generated an underwriting profit (loss) of \$8.7 million, \$5.3 million, and \$(0.7) million, respectively.

<sup>3</sup>The accident year ratio includes only the losses that occurred during the period noted. As a result, accident period results will change over time as our estimates of loss costs improve or deteriorate when payments are made or reserves for that accident period are reviewed.

### **Losses and Loss Adjustment Expenses (LAE)**

<b>(millions)</b>	<b>2009</b>	<b>2008</b>	<b>2007</b>
Change in net loss and LAE reserves	\$ 190.7	\$ 277.7	\$ 291.6
Paid losses and LAE	9,714.2	9,737.3	9,634.6
Total incurred losses and LAE	\$9,904.9	\$10,015.0	\$9,926.2

Claims costs, our most significant expense, represent payments made, and estimated future payments to be made, to or on behalf of our policyholders, including expenses needed to adjust or settle claims. These costs include an estimate for costs related to assignments, based on current business, under state-mandated automobile insurance programs for risks that cannot obtain insurance in the voluntary market; these assignments represent a very small portion of our total reserves. Claims costs are a function of loss severity and frequency and are influenced by inflation and driving patterns, among other factors. Accordingly, anticipated changes in these factors are taken into account when we establish premium rates and loss reserves. Our reserves would differ if the underlying assumptions were changed. See the *Critical Accounting Policies* for a discussion of the effect of changing estimates.

In 2009, the loss and LAE ratio decreased 2.8 points over last year, which includes favorable prior year accident year development, compared to unfavorable development in 2008 (discussed below) and lower catastrophe losses. Catastrophe losses from 2009 storms contributed 0.7 points to our loss/LAE ratio, compared to 1.2 points in 2008, and 0.3 points in 2007. The large amount of catastrophe losses in 2008 primarily related to hurricanes Ike and Gustav, and hail storms and floods in the Midwest and Great Plains.

The following discussion on our severity and frequency trends excludes the impact from comprehensive coverage due to the volatility related to certain types of losses, such as catastrophe losses and glass claims.

During 2009, total personal auto incurred severity (i.e., average cost per claim, including both paid losses and the change in reserves), excluding comprehensive coverage, was relatively flat compared to 2008, but increased about 3% in 2008 and 4% in 2007, over the prior year periods. The decrease in severity we experienced in the property coverages in 2009 was offset by an increase in personal injury protection (PIP) severity; bodily injury severity remained relatively flat. The overall increase in severity in both 2008 and 2007 was primarily from increases in both bodily injury and PIP coverages, while the severity for the property coverages in total was relatively flat. It is difficult to estimate future severity, especially for bodily injury and PIP claims, but we continue to monitor changes in the underlying costs, such as medical costs, jury verdicts, and regulatory changes, which may affect severity. The severity we experience will also vary relative to the change in our mix of business by policy limits and coverages.

Our incurred auto accident frequency on a calendar-year basis decreased less than 0.5% in 2009, over the prior year, with decreases in the property coverages offset by increases in our bodily injury and PIP coverages. We experienced a decline in year-over-prior year auto accident frequency in 2008, while frequency was relatively flat in 2007, compared to the prior year. We cannot predict with any certainty the degree or direction of frequency change that we will experience in the future. We continue to analyze trends to distinguish changes in our experience from external factors, such as changes in the number of vehicles per household, miles driven, gasoline prices, greater vehicle safety, and unemployment rates, versus those resulting from shifts in the mix of our business.

The table below presents the actuarial adjustments implemented and the loss reserve development experienced in the years ended December 31:

(\$ in millions)	2009	2008	2007
<b>Actuarial Adjustments</b>			
Reserve decrease/(increase)			
Prior accident years	\$ 3.9	\$ (56.1)	\$ 37.3
Current accident year	(51.5)	3.6	(37.1)
Calendar year actuarial adjustments	<u>\$ (47.6)</u>	<u>\$ (52.5)</u>	<u>\$ .2</u>
<b>Prior Accident Years Development</b>			
Favorable/(Unfavorable)			
Actuarial adjustments	\$ 3.9	\$ (56.1)	\$ 37.3
All other development	132.1	22.9	(117.6)
Total development	<u>\$ 136.0</u>	<u>\$ (33.2)</u>	<u>\$ (80.3)</u>
(Increase) decrease to calendar year combined ratio	<u>1.0 pts.</u>	<u>(.2) pts.</u>	<u>(.6) pts.</u>

Total development consists both of actuarial adjustments and "all other development." The actuarial adjustments represent the net changes made by our actuarial department to both current and prior accident year reserves based on regularly scheduled reviews. Through these reviews, the actuaries have the ability to identify and measure variances in frequency and severity trends and adjust the reserves to reflect the current costs. We report these actuarial adjustments separately for the current and prior accident years to show the impact of these changes on the prior accident years development.

"All other development" represents claims settling for more or less than reserved, emergence of unrecorded claims at rates different than reserved, and changes in reserve estimates on specific claims. Although we believe that the development from both the actuarial adjustments and "all other development" generally results from the same factors, as discussed below, we are unable to quantify the portion of the reserve development that might be applicable to any one or more of those underlying factors.

As reflected in the table above, we experienced favorable reserve development in 2009, compared to unfavorable total development in 2008 and 2007. The favorable development in 2009 is primarily attributable to favorable development for accident year 2008 and accident years 2006 and prior. For 2008, the unfavorable development is heavily weighted towards claims from the 2006 accident year with favorable development for periods older than that. The prior year loss reserve development for 2007 primarily also reflected unfavorable development from accident years greater than one year old (i.e., accident year 2005 and prior).

In 2009, approximately 90% of the favorable reserve development was attributable to our personal auto and Commercial Auto products, with each contributing nearly equal amounts. The balance of the favorable development was primarily from our special lines products. The total prior year loss reserve development in 2008 and 2007 principally arose in our Commercial Auto business for both years, while our Personal Lines business, in the aggregate, experienced little or no development for these years.

Changes in our estimate of severity from what we originally expected when establishing the loss and LAE reserves is the principal cause of prior accident year development. These changes in estimates are the result of what we observed in the underlying data as it developed. The Personal Lines case loss reserves saw minimal development during the year, which is a change from the unfavorable development of the prior two years. The favorable development we experienced in our total Personal Lines business in 2009 was primarily related to lower than expected defense and cost containment costs, which reflects less use of outside defense attorneys, due to new procedures implemented in our claims organization, as well as increased utilization of our in-house counsel. The favorable development in our Commercial Auto business was primarily due to favorable settlements on larger losses. During 2008 and 2007, we experienced unfavorable reserve development after several years of recognizing favorable development. The majority of the development in 2008 was driven by bodily injury severity on the late reported Commercial Auto claims in both the business auto and specialty truck markets, as well as personal auto PIP losses, with primarily two states experiencing the majority of the unfavorable PIP development for the year. The development in 2007 was driven by the unfavorable settlement of several outstanding lawsuits and the emergence of more than expected large losses from prior years, along with the reviews of larger bodily injury and uninsured motorist claims.

We continue to focus on our loss reserve analysis, attempting to enhance accuracy and to further our understanding of our loss costs. A detailed discussion of our loss reserving practices can be found in our *Report on Loss Reserving Practices*, which was filed in a Form 8-K on June 25, 2009.

Because we are primarily an insurer of motor vehicles, our exposure as an insurer of environmental, asbestos, and general liability claims is limited. We have established reserves for these exposures in amounts that we believe to be adequate based on information currently known. These exposures do not have a material effect on our liquidity, financial condition, cash flows, or results of operations.

### **Underwriting Expenses**

Progressive's other underwriting expenses and policy acquisition costs as a percentage of premiums earned have been fairly consistent over the last three years. On a year-over-year basis, we saw an increase in our advertising expenditures in each of the last three years. Despite an increase in advertising expenditures, in 2009 and 2008 we saw a decrease in our average costs per policy on a year-over-year basis, reflecting improved customer retention and a solid increase in companywide policies in force per employee, as well as a focus on process improvements to help reduce expenses (e.g., moving customers to a paperless environment). In accordance with GAAP, policy acquisition costs are amortized over the policy period in which the related premiums are earned (See *Note 1 – Reporting and Accounting Policies*). We do not defer any direct-response advertising costs.

### **C. Personal Lines**

	<b>Growth Over Prior Year</b>		
	<b>2009</b>	<b>2008</b>	<b>2007</b>
Net premiums written	5%	—%	(2)%
Net premiums earned	4%	(1)%	(2)%
Policies in force	5%	3%	4%

Progressive's Personal Lines business writes insurance for personal autos and recreational vehicles, and represented 89% of our total net premiums written in 2009, compared to 87% for both 2008 and 2007. We currently write our Personal Lines products in all 50 states and our personal auto product in the District of Columbia. In December 2009, we began offering our personal auto product on an Internet-only basis in Australia. In mid-2008, we began offering our personal auto product and boat insurance to Direct Internet customers in Massachusetts. In April 2009, we expanded our offerings in Massachusetts to include motorcycle and RV insurance; these products are available online, over the phone, and through a small number of independent agents. Over time, we expect more products and buying options will be introduced in Massachusetts as we continue to grow in the market.



Personal auto represented 90% of our total Personal Lines net premiums written in each of the past three years. These auto policies are primarily written for 6-month terms. The remaining Personal Lines business is comprised of special lines products (e.g., motorcycles, watercraft, and RVs), which are written for 12-month terms. Personal auto policies in force increased 5% for 2009 and 2% for both 2008 and 2007; policies in force for the special lines products increased 3% in 2009, 7% in 2008, and 8% in 2007. Net premiums written for personal auto increased 5% in 2009 and declined 1% and 3% in 2008 and 2007, respectively; special lines net premiums written grew 4% in both 2009 and 2008 and 5% in 2007.

Our total Personal Lines business generated combined ratios of 92.4, 94.6, and 93.0 in 2009, 2008, and 2007, respectively. The strong underwriting results in 2009 were widely distributed by product and state. In 2009, 45 states, and the District of Columbia, were profitable for our personal auto business, including 9 of our 10 largest auto business states. The special lines products had a favorable effect on the total Personal Lines combined ratio of approximately one point in both 2009 and 2007, compared to about 0.5 points in 2008, which reflects the higher catastrophe losses affecting these products in 2008.

Even though our Agency and Direct businesses are managed under one Personal Lines organization, we will continue to report our Agency and Direct business results separately as components of our Personal Lines segment to provide further understanding of our products by channel.

### **The Agency Business**

	<b>Growth Over Prior Year</b>		
	<b>2009</b>	<b>2008</b>	<b>2007</b>
Net premiums written	1%	(3)%	(4)%
Net premiums earned	1%	(4)%	(3)%
Auto: policies in force	—%	(2)%	(1)%
new applications	3%	(13)%	(1)%
renewal applications	—%	—%	—%

The Agency business includes business written by the more than 30,000 independent insurance agencies that represent Progressive, as well as brokerages in New York and California. During 2009, we saw new Agency auto application growth in 29 states; however, some of our big states did not see this growth during the year. Beginning in 2007 and throughout 2008, we restricted business in New York and California. In New York, we introduced a new product design in January 2009 and were able to lift the remaining restrictions on writing some classes of new business. In California, during the third quarter 2009, we introduced a new product, which includes lower auto rate levels and enhanced segmentation; the new plan is attracting a favorable mix of customers.

On a year-over-year basis, written premium per policy on total Agency auto business was flat in 2009, compared to decreases of 2% in 2008 and 4% in 2007. The declines in 2008 and 2007 were primarily attributable to declines in written premium per policy on renewal auto business, and reflected rate reductions taken in 2006 and 2007. For both 2009 and 2008, we saw a slight increase, on a year-over-year basis, in our Agency auto written premium per policy on new business.

Within the Agency business, we are continuing to see a shift from traditional agent quoting to quotes generated through third-party comparative rating systems, where our rates are quoted more often, but the conversion rate (i.e., converting a quote to a sale) is significantly lower. Year-over-year, the rate of conversion (i.e., converting a quote to a sale) was down in each of the past three years, on an increase each year in the number of Agency auto quotes. Although the rate of conversion was down in 2009, the rate of decline was significantly less than in 2008, primarily reflecting our increased competitiveness as some competitors are raising rates and the rollout of our new product models. In addition, we believe the increase in quoting activity reflects increased consumer shopping and our efforts with agents to make our competitive alternatives more visible.

The underwriting expense ratio in our Agency business has remained relatively consistent over the last three years. Improved customer retention and cost saving efforts helped keep expenses in line.

## The Direct Business

	Growth Over Prior Year		
	2009	2008	2007
Net premiums written	11%	4%	—%
Net premiums earned	10%	3%	1%
Auto: policies in force	13%	9%	7%
new applications	20%	2%	5%
renewal applications	13%	9%	7%

The Direct business includes business written directly by Progressive online and over the phone. In 2009, as compared to 2008, 48 states, including 9 of our top 10 states, and the District of Columbia, experienced an increase in new Direct auto applications. Internet sales continue to be the most significant source of new business that is initiated in the Direct channel.

Written premium per policy for total Direct auto was down about 4% for both 2009 and 2008 and 6% in 2007, compared to the prior year, reflecting decreases in written premium per policy on new auto business and more modest decreases on renewal auto business. In 2009 and 2008, a shift in the mix of business (e.g., age of drivers, proof of prior insurance) offset the rate increases taken in both years. In 2007, the decline reflected rate decreases taken at that time.

On a year-over-year basis, the total number of quotes in the Direct business increased in both 2009 and 2008, reflecting an increase in Internet quotes due to more effective advertising, an increase in consumer shopping in 2009, and our entry into Massachusetts in 2008. In 2007, the total number of quotes decreased with less quotes from both the phone and Internet.

We are continuing to see the Internet becoming a greater portion of our Direct business mix, which historically has had a lower conversion rate than phone. Nonetheless, the conversion rate for Internet-initiated quotes has improved in each of the last three years, while the conversion rate for phone-initiated business increased in 2009 and 2007, but was down in 2008.

We saw our total advertising expenditures increase on a year-over-year basis in each of the last three years. We continue to work toward achieving our key objective of having our efforts in marketing and other brand-building activities match our competency in other technical skills, such as pricing and claims handling. In 2008, we launched a new advertising campaign, which provides a consistent identity and serves as a foundation for delivery of our many messages. Despite the higher advertising spend, we saw lower average total costs per policy in each of the last three years, due to greater efficiency.

## D. Commercial Auto

	Growth Over Prior Year		
	2009	2008	2007
Net premiums written	(10)%	(7)%	(4)%
Net premiums earned	(8)%	(5)%	—%
Policies in force	(5)%	—%	7%
New applications	(9)%	(8)%	3%
Renewal applications	2%	4%	5%

Progressive's Commercial Auto business writes primary liability and physical damage insurance for automobiles and trucks owned by small businesses, with the majority of our customers insuring three or fewer vehicles. Our Commercial Auto business represented 11% of our total net premiums written in 2009, compared to 13% for both 2008 and 2007. This business is primarily distributed through independent agents and operates in the business auto and specialty truck markets. The business auto market, which accounts for slightly more than half of our total Commercial Auto premiums and approximately 60% of the vehicles we insure, includes autos, vans, and pick-up trucks used by artisans, such as contractors, landscapers, and plumbers, and a variety of other small businesses. The remainder is in the specialty truck commercial auto market, which includes dump trucks, logging trucks, tow trucks, local cartage, and other short-haul commercial vehicles. Both of these markets have been significantly affected by the downturn in the economy, as well as increased competition in the commercial auto business.

We currently write our Commercial Auto business in 49 states; we do not write Commercial Auto in Hawaii or the District of Columbia. The majority of our policies in this business are written for 12-month terms.

As compared to the prior year, total written premium per policy decreased about 7%, 4%, and 6% in 2009, 2008, and 2007, respectively. Although we have been increasing rates in our Commercial Auto business, written premium per policy is decreasing due to customers selecting less coverage and insuring fewer vehicles. The economic downturn during the last two years has had a significant effect on our Commercial Auto business growth.

Commercial Auto's expense ratio decreased slightly during 2009, but increased in 2008 and 2007. The lower amount of premiums earned contributed to higher expense and combined ratios in 2008 and 2007. Also, in 2007, we made significant investments in agency distribution and direct marketing capabilities in this business.

Although Commercial Auto differs from Personal Lines auto in its customer base and products written, both businesses require the same fundamental skills, including disciplined underwriting and pricing, as well as excellent claims service. Since the Commercial Auto policies have higher limits (up to \$1 million) than Personal Lines auto, we analyze the large loss trends and reserving in more detail to allow us to react quickly to changes in this exposure.

#### **E. Other Indemnity**

Our other indemnity businesses, which represented less than 1% of our net premiums written in each of the last three years, primarily include writing professional liability insurance for community banks, principally directors and officers liability insurance. The program, sponsored by the American Bankers Association (ABA), insures over 1,600 banks, representing every state. In addition, our other indemnity businesses include managing our run-off businesses.

We have entered into an agreement to sell our community bank program to an ABA affiliate. The transaction is expected to close during the first half of 2010. As an interim measure, effective August 1, 2009, we began reinsuring 100% of this risk with another carrier. Prior to August 1, 2009, we reinsured the majority of the risk on the professional liability insurance coverages with a small mutual reinsurer controlled by its bank customers and various other reinsurance entities. The sale of this business will not have a material effect on our financial condition, results of operations, or cash flows.

#### **F. Service Businesses**

Our service businesses provide insurance-related services and represented less than 1% of our total revenues for each of the last three years and do not have a material effect on our overall operations.

Our principal service business is providing policy issuance and claims adjusting services for the Commercial Auto Insurance Procedures/Plans (CAIP), which are state-supervised plans serving the involuntary market in 43 states. We have previously competed with two other carriers for the majority of the CAIP market. However, both of these other carriers withdrew, leaving us as the largest CAIP provider countrywide. Although our market share increased, we did not realize an increase to revenues as the downturn in the CAIP market continues. As a service provider, we collect fee revenue that is earned on a pro rata basis over the term of the related policies. We cede 100% of the premiums and losses to the plans. Reimbursements to us from the CAIP plans are required by state laws and regulations. Material violations of contractual service standards can result in ceding restrictions for the affected business. We have maintained, and plan to continue to maintain, compliance with these standards. Any changes in our participation as a CAIP service provider would not materially affect our financial condition, results of operations, or cash flows.

Our service businesses also include our alliance with three unaffiliated homeowner insurance companies. Through Progressive Home Advantage<sup>®</sup>, we act as an agent to offer new and existing Progressive customers home, condo, and renters insurance underwritten by these homeowner's insurance companies. Commissions received from this business are used to mitigate the underwriting expenses associated with maintaining this program. This program is available to our Personal Lines customers in 48 states and the District of Columbia; it is not currently available in Alaska or Florida.

Our service businesses generated an operating loss in 2009 and 2008 and a slight profit in 2007, reflecting the continuing downturn in the involuntary commercial auto market.

#### **G. Litigation**

The Progressive Corporation and/or its insurance subsidiaries are named as defendants in various lawsuits arising out of claims made under insurance policies in the ordinary course of our business. All legal actions relating to such insurance claims are considered by us in establishing our loss and loss adjustment expense reserves.

In addition, various Progressive entities are named as defendants in a number of class action or individual lawsuits arising out of the operations of the insurance subsidiaries. These cases include those alleging damages as a result of our use of credit in underwriting and related requirements under the federal Fair Credit Reporting Act; practices in evaluating or paying medical or injury claims or benefits, including, but not limited to, personal injury protection, medical payments, uninsured motorist/underinsured motorist (UM/UIM), and bodily injury benefits; rating practices at policy renewal; the utilization, content, or appearance of UM/UIM rejection forms; the practice of taking betterment on boat repairs; labor rates paid to auto body repair shops; and cases challenging other aspects of our claims or marketing practices or other business operations. Other insurance companies face many of these same issues. During the last three years, we have settled several nationwide or statewide class action lawsuits. These settlements did not have a material effect on our financial condition, cash flows, or results of operations. See *Note 12 – Litigation* for a more detailed discussion.

#### **H. Income Taxes**

As reported in the balance sheets, income taxes are comprised of net current income taxes recoverable and net deferred tax assets and liabilities. A deferred tax asset/liability is a tax benefit/expense that is expected to be realized in a future tax return. At both December 31, 2009 and 2008, our income taxes were in a net asset position.

Our net deferred tax asset was \$420.0 million at December 31, 2009, compared to \$793.3 million at December 31, 2008. The decrease in the deferred tax asset since December 31, 2008 is primarily due to the net unrealized gains generated in our investment portfolio since that date. Management believes that it is more likely than not that the entire amount of the deferred tax asset will ultimately be realized; therefore, we have not recorded any valuation allowance against the deferred tax asset at December 31, 2009 and 2008. For a complete discussion of our deferred tax assets, see the *Critical Accounting Policies-Deferred Tax Assets* section.

There have been no material changes in our uncertain tax positions during 2009.

See *Note 5 – Income Taxes* for further information.

### **IV. RESULTS OF OPERATIONS — INVESTMENTS**

#### **A. Portfolio Allocation**

At year-end 2009, the fair value of our investment portfolio was \$14.7 billion, 13% greater than at year-end 2008, reflecting significant increases in the value of our fixed-maturity and preferred stock holdings. Our investment income (e.g., interest and dividends) decreased 20% in 2009, as compared to 2008, reflecting lower yields earned due to an extremely low interest rate environment and our decision to shorten our portfolio duration and to invest in U.S. Treasury Notes and short-term investments to reduce the potential for additional portfolio valuation declines. Our investment income (e.g., interest and dividends) decreased 6% in 2008, as compared to 2007, reflecting a decrease in average assets, as well as lower yields during the year.

In 2009, we recognized \$27.1 million in net realized gains, primarily the result of security sales and changes in valuation of our hybrid preferred stocks and derivative positions, partially offset by write-downs of securities determined to have had other-than-temporary declines in fair value. In 2008, we recognized \$1,445.1 million in net realized losses, primarily the result of write-downs of securities determined to have had other-than-temporary declines in fair value. In 2007, we recognized \$106.3 million in net realized gains, primarily the result of security sales to fund our \$1.4 billion extraordinary dividend payment in September 2007.

Progressive's asset allocation strategy is to maintain 0-25% of our portfolio in Group I securities (i.e., common equities, redeemable and nonredeemable preferred stocks (preferred stocks), and non-investment-grade and non-rated fixed-maturity securities), with the balance (75%-100%) of our portfolio in Group II securities (i.e., all other fixed-maturity securities, including U.S. Treasury Notes, municipal bonds, asset-backed securities, and corporate debt, as well as short-term investments). This strategy is based on our need to maintain capital adequate to support our insurance operations, recognizing that our outstanding claims obligations are short in duration. Investments in our portfolio have varying degrees of risk. We evaluate the risk/reward trade-offs of investment opportunities, measuring their effects on stability, diversity, overall quality and liquidity, and the potential return of the investment portfolio. We also monitor the value at risk of the

portfolio (see the *Quantitative Market Risk Disclosures*, a supplemental schedule provided in this Annual Report, for further information). The composition of the investment portfolio at December 31 was:

(\$ in millions)	Cost	Gross Unrealized Gains	Gross Unrealized Losses	Net Realized Gains (Losses) <sup>1</sup>	Fair Value	% of Total Portfolio	Duration (years)	Rating <sup>2</sup>
<b>2009</b>								
Fixed maturities	\$11,717.0	\$173.0	\$(326.6)	\$ —	\$11,563.4	78.6%	2.6	AA+
Nonredeemable preferred stocks	665.4	597.6	—	(7.2)	1,255.8	8.5	1.5	BBB
Short-term investments - other	1,078.0	—	—	—	1,078.0	7.3	<1	AAA-
Total fixed-income securities	13,460.4	770.6	(326.6)	(7.2)	13,897.2	94.4	2.3	AA
Common equities	598.4	220.1	(2.3)	—	816.2	5.6	na	na
Total portfolio <sup>3,4</sup>	\$14,058.8	\$990.7	\$(328.9)	\$ (7.2)	\$14,713.4	100.0%	2.3	AA
<b>2008</b>								
Fixed maturities	\$10,295.3	\$195.9	\$(544.5)	\$ —	\$ 9,946.7	76.6%	3.7	AA+
Nonredeemable preferred stocks	1,131.3	73.5	(17.3)	(37.5)	1,150.0	8.9	2.0	BBB+
Short-term investments - other	1,153.6	—	—	—	1,153.6	8.9	<1	AA+
Total fixed-income securities	12,580.2	269.4	(561.8)	(37.5)	12,250.3	94.4	3.2	AA+
Common equities	553.6	203.5	(29.3)	—	727.8	5.6	na	na
Total portfolio <sup>3,4</sup>	\$13,133.8	\$472.9	\$(591.1)	\$(37.5)	\$12,978.1	100.0%	3.2	AA+

na = not applicable

<sup>1</sup>Represents net holding period gains (losses) on certain hybrid securities.

<sup>2</sup>Represents ratings at December 31, 2009 and 2008. Credit quality ratings are assigned by nationally recognized securities rating organizations. To calculate the weighted average credit quality ratings, we weight individual securities based on fair value and assign a numeric score of 0-5, with non-investment-grade and non-rated securities assigned a score of 0-1. To the extent the weighted average of the ratings falls between AAA and AA+, we assign an internal rating of AAA-.

<sup>3</sup>At December 31, 2009 and 2008, we had \$7.7 million and \$254.2 million, respectively, of net unsettled security transactions offset in other liabilities.

<sup>4</sup>December 31, 2009 and 2008 totals include \$2.2 billion and \$1.0 billion, respectively, of securities in the portfolio of a consolidated, non-insurance subsidiary of the holding company, net of any unsettled security transactions.

### Unrealized Gains and Losses

As of December 31, 2009, our portfolio had pretax net unrealized gains, recorded as part of accumulated other comprehensive income, of \$661.8 million, compared to net unrealized losses of \$118.2 million at December 31, 2008. During the year, our fixed-income portfolio generated net unrealized gains of \$736.4 million as a result of price recovery throughout the portfolio, especially within our preferred stock (redeemable and nonredeemable), corporate, and mortgage-backed portfolios. The net unrealized gains in the common stock portfolio increased \$43.6 million during 2009, reflecting positive returns in the equity market. See *Note 2 – Investments* for a further break-out of our gross unrealized gains and losses.

### Fixed-Income Securities

The fixed-income portfolio is managed internally and includes fixed-maturity securities, short-term investments, and nonredeemable preferred stocks. The fixed-maturity securities, including redeemable preferred stocks, and short-term investments, as reported on the balance sheets at December 31, were comprised of the following:

(\$ in millions)	2009		2008	
Investment-grade fixed maturities: <sup>1</sup>				
Short/intermediate term	\$12,034.6	95.2%	\$10,836.0	97.6%
Long term	17.8	.1	45.7	.4
Non-investment-grade fixed maturities <sup>2</sup>	589.0	4.7	218.6	2.0
Total	\$12,641.4	100.0%	\$11,100.3	100.0%

<sup>1</sup>Long term includes securities with expected liquidation dates of 10 years or greater. Asset-backed securities are reported at their weighted average maturity based upon their projected cash flows. All other securities that do not have a single expected maturity date are reported at average maturity.

<sup>2</sup>Non-investment-grade fixed-maturity securities are non-rated or have a quality rating of an equivalent BB+ or lower, classified by the lowest rating from a nationally recognized rating agency.



The increase in fixed maturities over last year represents an increase in the fair value of those securities and management's decision to invest new cash from operations in U.S. Treasury Notes and investment-grade, short- to intermediate-term securities primarily in the AAA asset-backed and non-financial corporate sectors. The increase in dollar amount of our non-investment-grade fixed maturities is largely the result of security credit downgrades since last year, primarily in our residential mortgage-backed sector.

A primary exposure for the fixed-income portfolio is interest rate risk, which is managed by maintaining the portfolio's duration between 1.8 and 5 years. Interest rate risk includes the change in value resulting from movements in the underlying market rates of debt securities held. The fixed-income portfolio had a duration of 2.3 years at December 31, 2009, compared to 3.2 years at December 31, 2008. The reduction in duration from the prior year reflects our decision to reduce the overall portfolio valuation risk exposure to a rise in interest rates from their current low levels. The distribution of duration and convexity (i.e., a measure of the speed at which the duration of a security is expected to change based on a rise or fall in interest rates) are monitored on a regular basis.

As of December 31, the duration distribution of our fixed-income portfolio, represented by the interest rate sensitivity of the comparable benchmark U.S. Treasury Notes, was:

<b>Duration Distribution</b>	<b>2009</b>	<b>2008</b>
1 year	18.1%	19.6%
2 years	21.8	19.9
3 years	20.7	17.6
5 years	27.5	32.1
10 years	11.9	10.8
Total fixed-income portfolio	100.0%	100.0%

Another primary exposure related to the fixed-income portfolio is credit risk. This risk is managed by maintaining a minimum average portfolio credit quality rating of A+, as defined by nationally recognized rating agencies. In addition, we limit our Group I investments (i.e., common equities, redeemable and nonredeemable preferred stocks (preferred stocks), and non-investment-grade and non-rated fixed-maturity securities), to between 0% and 25% of the portfolio.

The credit quality distribution of the fixed-income portfolio at December 31 was:

<b>Rating</b>	<b>2009</b>	<b>2008</b>
AAA	60.1%	59.0%
AA	11.6	16.3
A	12.1	13.6
BBB	9.9	9.0
Non-rated/other	6.3	2.1
Total fixed-income portfolio	100.0%	100.0%

During 2009, we added to our holdings of U.S. Treasury securities. We also added investment-grade, short- to intermediate-term asset-backed securities and non-financial corporate securities. The non-rated/other category increased largely due to credit downgrades primarily in our nonredeemable preferred stocks and residential mortgage-backed securities.

Our portfolio is also exposed to concentration risk. During 2009, the Board of Directors approved investment guidelines that further define our concentration exposure. Under the revised guidelines, investment in a single issuer, other than U.S. Treasury Notes or a state's general obligation bonds, is limited to 2.5% of shareholders' equity, while the single issuer limitation on preferred stocks and/or non-investment-grade debt is 1.25% of shareholders' equity. Additionally, the limitation applicable to any state's general obligation bond was reduced to 6% of shareholders' equity. As of December 31, 2009, the investment portfolio exceeded the 1.25% limitation on preferred stocks and/or non-investment-grade debt, and the portfolio may continue to be outside this guideline for a period of time as management works to bring the portfolio into compliance effectively and efficiently. Our credit risk guidelines limit single issuer exposure; however, industry sector allocation is a key concentration risk. We also consider concentration risk in the context of asset classes, including but not limited to common equities, residential and commercial mortgage securities, municipal bonds, and high-yield bonds. During 2009, our exposure carryover from 2008, primarily representing investments in financial sector preferred stocks, had a positive impact

on the overall fixed-income portfolio's valuation; however, we continue to look for opportunities to reduce our overall concentration exposure.

We also monitor prepayment and extension risk, especially in our structured product and preferred stock portfolios. Prepayment risk includes the risk of early redemption of security principal that may need to be reinvested at less attractive rates. Extension risk includes the risk that a security will not be redeemed when anticipated, and that a security we hold has a lower yield than a security we might be able to obtain by reinvesting the expected redemption principal. The different types of structured debt and preferred securities that we hold help minimize this risk. During 2009, we did not experience significant prepayment or extension of principal relative to our cash flow expectations in the portfolio.

The pricing on the majority of our preferred stocks continues to reflect expectations that many issuers will not call such securities on the first call date, and hence reflects an assumption that the securities will remain outstanding for a period of time beyond such initial call date (extension risk).

We also face the risk that our preferred stock dividend payments could be deferred for one or more periods. As of December 31, 2009, all of our preferred securities continue to pay fully and timely dividends, with the exception of one issue, which is not expected to pay after the first quarter 2010; however, the amount is immaterial to our investment income.

Liquidity risk is another risk factor we monitor. Based on the volatility of the markets in general and the widening of credit spreads, we elected to reduce portfolio valuation risk in the first quarter 2009 by allocating new investments primarily to U.S. Treasury and short-term securities in order to preserve capital and maintain our desired liquidity position. Beginning in the second quarter 2009 and to a greater extent during the third and fourth quarter, as our capital position and the economic outlook improved, we added investment-grade, short- to intermediate-term securities primarily in the AAA asset-backed and non-financial corporate sectors. As of December 31, 2009, we had \$5.9 billion in U.S. Treasury and short-term securities, approximately 25% more than we had at the same time last year. Our overall portfolio remains very liquid and sufficient to meet liquidity requirements; however, despite a significant improvement for most asset classes relative to the first half of 2009, liquidity has not returned to the levels of several years ago. The short-to-intermediate duration of our portfolio provides an additional source of liquidity, as we expect approximately \$1.8 billion, or 23%, of our non-U.S. Treasury and short-term, fixed-income portfolio to repay principal over the course of 2010. In addition, cash from interest and dividend payments provides an additional source of recurring liquidity.

Included in the fixed-income portfolio are U.S. government obligations, which include U.S. Treasury Notes and interest rate swaps. Although the interest rate swaps are not obligations of the U.S. government, they are recorded in this portfolio as the change in fair value is correlated to movements in the U.S. Treasury market. The duration of these securities was comprised of the following at December 31, 2009:

(\$ in millions)	Fair Value	Duration (years)
<u>U.S. Treasury Notes</u>		
Less than two years	\$ 117.8	1.2
Two to five years	2,787.2	3.2
Five to nine years	1,912.4	6.7
Total U.S. Treasury Notes	4,817.4	4.5
<u>Interest Rate Swaps</u>		
Five to nine years (\$713 notional value)	.1	(7.8)
Total U.S. government obligations	\$4,817.5	3.4

The negative duration of the interest rate swap is due to the position being short interest-rate exposure (i.e., receiving a variable-rate coupon). In determining duration, we add the interest rate sensitivity of our interest rate swap positions to that of our Treasury holdings, but do not add the notional value of the swaps to our Treasury holdings in order to calculate an unlevered duration for the portfolio.

## ASSET-BACKED SECURITIES

Included in the fixed-income portfolio are asset-backed securities, which were comprised of the following at December 31:

(\$ in millions)	Fair Value	Net Unrealized Gains (Losses)	% of Asset-Backed Securities	Duration (years)	Rating (at period end)
<b>2009</b>					
Collateralized mortgage obligations <sup>1</sup>	\$ 352.0	\$ (23.7)	12.4%	.6	A
Commercial mortgage-backed obligations	1,130.5	13.2	39.9	1.8	AA
Commercial mortgage-backed obligations: interest only	459.6	4.9	16.2	1.4	AAA-
Subtotal commercial mortgage-backed obligations	1,590.1	18.1	56.1	1.7	AA+
Other asset-backed securities:					
Automobile	549.9	5.7	19.4	1.5	AAA-
Credit card	81.8	(.1)	2.9	1.3	AA
Home equity (sub-prime bonds)	164.4	(51.9)	5.8	.1	A-
Other <sup>2</sup>	94.5	(1.3)	3.4	1.1	AA+
Subtotal other asset-backed securities	890.6	(47.6)	31.5	1.2	AA+
Total asset-backed securities	\$2,832.7	\$ (53.2)	100.0%	1.4	AA
<b>2008</b>					
Collateralized mortgage obligations <sup>1</sup>	\$ 409.6	\$ (89.0)	18.6%	1.5	AAA-
Commercial mortgage-backed obligations	956.8	(203.2)	43.4	2.2	AA+
Commercial mortgage-backed obligations: interest only	493.2	(39.5)	22.4	1.5	AAA-
Subtotal commercial mortgage-backed obligations	1,450.0	(242.7)	65.8	2.0	AA+
Other asset-backed securities:					
Automobile	70.0	(6.2)	3.2	2.0	AAA
Home equity (sub-prime bonds)	213.4	(46.7)	9.7	.1	AA
Other <sup>2</sup>	59.1	(3.9)	2.7	.7	AA
Subtotal other asset-backed securities	342.5	(56.8)	15.6	.6	AA+
Total asset-backed securities	\$2,202.1	\$(388.5)	100.0%	1.7	AA+

<sup>1</sup>At December 31, 2009, amounts include \$28.7 million of Alt-A, non-prime bonds (low document/no document or non-conforming prime loans) with a net unrealized loss of \$2.9 million and a credit quality of BBB; at December 31, 2008, amounts include \$30.7 million of Alt-A bonds that had a net unrealized loss of \$15.3 million and a credit quality of AA. The remainder for both periods represents seasoned prime loans.

<sup>2</sup>Includes equipment leases, manufactured housing, and other types of structured debt.

At December 31, 2009, our asset-backed securities had a net unrealized loss of \$53.2 million, compared to a net unrealized loss of \$388.5 million at December 31, 2008. Substantially all of the asset-backed securities have widely available market quotes, with narrowing spreads between the bid and offer prices and greater liquidity since the end of the first quarter 2009. As of December 31, 2009, approximately 7% of our asset-backed securities are exposed to non-prime mortgage loans (home equity and Alt-A). Consistent with our plan to add high-quality, short-maturity fixed-income securities, during 2009 we purchased AAA securities backed by auto loans with an average life of one to three years. The underlying loans in these trusts are made to prime borrowers and the securities have substantial structural credit support. We reviewed all of our asset-backed securities for other-than-temporary impairment and yield or asset valuation adjustments under current accounting guidance, and we realized \$33.6 million, \$38.8 million, and \$1.9 million in write-downs on these securities during the years ended December 31, 2009, 2008, and 2007, respectively. These write-downs occurred primarily in the residential mortgage sectors of our asset-backed portfolio as detailed below.

**Collateralized Mortgage Obligations** At December 31, 2009, 12.4% of our asset-backed securities were collateralized mortgage obligations (CMO), which are a component of our residential mortgage-backed securities. During the year ended December 31, 2009, we recorded \$8.3 million in credit loss write-downs on our CMO portfolio, including \$4.0 million of Alt-A securities, due to estimated principal losses in the security's most recent cash flow projections. During the year ended December 31, 2008, we recorded \$7.1 million in write-downs on our CMO portfolio; we had no write-downs on Alt-A

securities. During the year ended December 31, 2007, we did not record any write-downs. The following table shows the collateralized mortgage obligations by deal origination year, along with the loan classification. In addition, the table shows a comparison of the fair value at December 31, 2009 to our original investment value (adjusted for returns of principal, amortization, and write-downs).

#### Collateralized Mortgage Obligations

(\$ in millions) Category	Deal Origination Year						Total	% of Collateralized Mortgage Obligations
	2009	2008	2007	2006	2005	Pre-2005		
Non-agency prime:								
With mandatory redemption	\$ —	\$ —	\$ 14.2	\$ 50.5	\$ —	\$ —	\$ 64.7	18.4%
Increase (decrease) in value	—%	—%	1.8%	1.8%	—%	—%	1.8%	
No mandatory redemption <sup>1</sup>	\$45.8	\$ —	\$ 26.5	\$ 22.8	\$ 89.2	\$41.5	\$225.8	64.1%
Increase (decrease) in value	.5%	—%	(20.4)%	(11.5)%	(10.4)%	(6.3)%	(9.1)%	
Alt-A	\$ —	\$ —	\$ —	\$ —	\$ 18.6	\$10.1	\$ 28.7	8.2%
Increase (decrease) in value	—%	—%	—%	—%	(9.5)%	(9.0)%	(9.3)%	
Government/GSE <sup>2</sup>	\$ —	\$ —	\$ 14.0	\$ —	\$ —	\$18.8	\$ 32.8	9.3%
Increase (decrease) in value	—%	—%	5.6%	—%	—%	(.2)%	2.2%	
<b>Total</b>	<b>\$45.8</b>	<b>\$ —</b>	<b>\$ 54.7</b>	<b>\$ 73.3</b>	<b>\$107.8</b>	<b>\$70.4</b>	<b>\$352.0</b>	<b>100.0%</b>
Increase (decrease) in value	.5%	—%	(9.6)%	(2.7)%	(10.3)%	(5.1)%	(6.3)%	

<sup>1</sup>These securities do not have mandatory redemption dates; hence, the securities will retire at the earlier of contractual maturity or projected cash flow expiration. All 2006 and 2007 securities in this category are collateralized primarily (greater than 90%) by mortgages originated in or prior to 2005. In addition, our 2009 value reflects \$45.8 million of 2009 re-securitizations of 2005 and 2006 underlying deals.

<sup>2</sup>The securities in this category are insured by a Government Sponsored Entity (GSE) and/or collateralized by mortgage loans insured by the Federal Housing Administration (FHA) or the U.S. Department of Veteran Affairs (VA).

**Commercial Mortgage-Backed Securities** At December 31, 2009, 39.9% of our asset-backed securities were commercial mortgage-backed securities (CMBS). The following table details the credit quality rating and fair value of our CMBS portfolio by year of deal origination:

#### Commercial Mortgage-Backed Securities

(\$ in millions) Deal Origination Year	Rating at December 31, 2009					Non-Investment Grade	Fair Value	% of Total Exposure
	AAA	AA	A	BBB				
Pre-2000	\$ —	\$ 1.4	\$ —	\$28.3		\$21.6	\$ 51.3	4.5%
2000	36.3	22.6	—	—		—	58.9	5.2
2001	130.7	47.7	—	12.6		—	191.0	16.9
2002	72.1	—	18.7	—		—	90.8	8.0
2003	218.5	15.3	4.0	—		—	237.8	21.0
2004	96.2	20.4	3.9	10.0		—	130.5	11.6
2005	101.9	6.8	—	7.0		—	115.7	10.2
2006	136.5	—	—	—		51.7	188.2	16.7
2007	—	—	11.8	35.9		18.6	66.3	5.9
<b>Total fair value</b>	<b>\$792.2</b>	<b>\$114.2</b>	<b>\$38.4</b>	<b>\$93.8</b>		<b>\$91.9</b>	<b>\$1,130.5</b>	<b>100.0%</b>
% of Total fair value	70.1%	10.1%	3.4%	8.3%		8.1%	100.0%	

The CMBS portfolio contained 16.4% of securities that are rated BBB or lower, with a net unrealized loss of \$10.4 million at December 31, 2009, and an average duration of 1.8 years, compared to 1.8 years for the entire CMBS portfolio.

During the years ended December 31, 2009, 2008, and 2007, we did not record any write-downs on our CMBS portfolio.

Our 2005 and 2006 deal origination (vintage) year AAA exposure is heavily weighted to securities with the most senior levels (over 20%) of credit support. As with many other asset-backed classes, CMBS underwriting grew increasingly aggressive over time, peaking from 2005-2007. These more aggressive underwriting guidelines have led to a higher level of investor concern for deals originated in this timeframe. While we expect CMBS delinquencies to continue to rise in 2010, we feel that we have an adequate level of credit support to protect the expected cash flows from loss for our investments in the 2005 to 2007 vintage securities. The following table displays the amount of senior and junior AAA and AA bonds that we have in each vintage. The average credit support and delinquencies are shown in order to indicate the cushion that is available in these tranches to sustain losses.

Deal Origination Year	Junior (AJ) <sup>2</sup>		Average Life (years)	Average Credit Support <sup>3</sup>	Average Delinquencies <sup>4</sup>	Yield to Maturity <sup>5</sup>
	Senior AAA <sup>1</sup>	AAA AA				
2005	\$ 90.8	\$11.1 \$6.8	2.5	27.5%	4.2%	5.0%
2006	\$136.5	\$ — \$ —	1.2	29.6%	5.8%	3.6%

<sup>1</sup>Above 20% credit support.

<sup>2</sup>Above 13% credit support.

<sup>3</sup>Credit support reflects the percentage of the underlying principal balance that needs to become realized losses before our position begins to be eroded by further defaults. The average credit support is a current measure, which changes over time due to defaults and principal paydowns.

<sup>4</sup>This represents the percentage of loans that are 60 days or more past due.

<sup>5</sup>The yield to maturity equals the return, inclusive of interest and principal payments that we would expect to receive assuming the bond matures at its expected maturity date.

The entire 2005-2006 non-AAA segment is composed of cell phone tower securitizations. All of these bonds have a single borrower and are backed by a cross collateralized pool of cellular phone towers throughout the United States. Per the table below, these bonds have short average lives and have significant net cash flow relative to their interest payments.

Deal Origination Year	Average Life	Yield to Maturity	Debt Service Coverage Ratio
2005	.4 years	4.6%	3.8x
2006	1.9 years	5.9%	3.2x

Our entire 2007 exposure is made up of two different types of investments. The first is a group of cell tower transactions similar to the exposure in 2005 and 2006 non-AAA rated vintages discussed above. The group has a combined exposure of \$48.6 million, and the ratings range from BBB/Baa2 to B/B2. The weighted average life on these bonds is 3.5 years and the weighted average yield to maturity is 7.0%. The second 2007 exposure is a \$17.7 million position that consists of two different bonds with a single borrower, rated A+ and BBB-, and is secured by a cross collateralized portfolio of office properties. The average life on this position is just over 2.0 years, assuming the borrower exercises its option to extend the final maturity.



Commercial Mortgage-Backed Securities: Interest Only We also held CMBS interest only (IO) securities at December 31, 2009. The IO portfolio had an average credit quality of AAA- and a duration of 1.4 years. During the year ended December 31, 2009, we recorded write-downs on our IO portfolio of \$0.9 million, compared to \$0.6 million and \$0.2 million of write-downs recorded during 2008 and 2007, respectively. The following table shows the fair value of the IO securities by deal origination year:

<b>Commercial Mortgage-Backed Securities: Interest Only</b>		
(\$ in millions) Deal Origination Year	Fair Value	% of Total Exposure
Pre-2000	\$ 4.1	.9%
2000	8.6	1.9
2001	12.9	2.8
2002	—	—
2003	28.0	6.1
2004	57.5	12.5
2005	104.5	22.7
2006	244.0	53.1
Total fair value	\$459.6	100.0%

Planned amortization class IOs comprised 94.3% of our IO portfolio. This is a class that is structured to provide bondholders with greater protection against loan prepayment, default, or extension risk. The bonds are at the top of the payment order for interest distributions and benefit from increased structural support over time as they repay. Since 2004, 100% of the IO securities that we have purchased were made up of this more protected class.

We continue to monitor the announcement late in 2009 by one rating agency that they may make changes to their rating methodology for all structured finance IOs, including CMBS IOs. If these proposed changes are adopted, it could negatively impact the fair value of these securities. However, we evaluate the safety and adequacy of the expected cash flows based on the underlying loan credit quality and structural support of the deal regardless of the rating. Therefore, we do not expect these proposed rating changes to have a negative effect on our view of these securities.

Home-Equity Securities The following table shows the credit quality rating of our home-equity securities, which are a component of our residential mortgage-backed securities, by deal origination year, along with a comparison of the fair value at December 31, 2009, to our original investment value (adjusted for returns of principal, amortization, and write-downs). We recorded \$23.7 million, \$31.1 million, and \$1.7 million in write-downs for the years ended December 31, 2009, 2008, and 2007, respectively. The 2009 write-downs included \$22.8 million in credit loss write-downs due to estimated principal losses in the security's most recent cash flow projections, pursuant to the accounting guidance adopted in the second quarter 2009 (see *Note 2- Investments* for additional information).

<b>Home-Equity Securities</b>						
(\$ in millions) Rating (date acquired)	Deal Origination Year				Total	% of Home Equity Loans
	2007	2006	2005	2004		
AAA (December 2007-May 2008)	\$ —	\$ .5	\$ 35.6	\$ —	\$ 36.1	22.0%
Increase (decrease) in value	—%	(.3)%	(6.3)%	—%	(6.2)%	
AA (September 2007-April 2008)	\$ —	\$ 21.6	\$ 18.1	\$ 9.2	\$ 48.9	29.7%
Increase (decrease) in value	—%	(11.7)%	(11.4)%	(34.7)%	(17.1)%	
A (August 2007-April 2008)	\$ —	\$ —	\$ 6.3	\$ 2.7	\$ 9.0	5.5%
Increase (decrease) in value	—%	—%	(46.4)%	30.3%	(34.9)%	
BBB (February 2008-May 2008)	\$ —	\$ —	\$ 21.5	\$ —	\$ 21.5	13.1%
Increase (decrease) in value	—%	—%	(46.2)%	—%	(46.2)%	
Non-investment grade (March 2007-March 2008)	\$ .3	\$ 28.8	\$ 19.5	\$ .3	\$ 48.9	29.7%
Increase (decrease) in value	(30.0)%	(21.0)%	(29.6)%	(40.6)%	(24.9)%	
Total	\$ .3	\$ 50.9	\$101.0	\$ 12.2	\$164.4	100.0%
Increase (decrease) in value	(30.0)%	(17.1)%	(26.7)%	(26.8)%	(24.0)%	

## MUNICIPAL SECURITIES

Included in the fixed-income portfolio at December 31, 2009, were \$2,024.0 million of state and local government obligations with an overall credit quality of AA, excluding the benefit of credit support from bond insurance. These securities had a net unrealized gain of \$49.8 million at December 31, 2009, compared to a net unrealized loss of \$37.0 million at December 31, 2008. During the years ended December 31, 2009, 2008, and 2007, we did not record any write-downs on our municipal portfolio. The following table details the credit quality rating of our municipal securities at December 31, 2009, without the benefit of credit or bond insurance as discussed below:

<b>Municipal Securities Rating</b>			
(millions) Rating	General Obligations	Revenue Bonds	Total
AAA	\$206.8	\$ 330.9	\$ 537.7
AA	406.3	839.7	1,246.0
A	113.8	88.5	202.3
BBB	1.6	25.9	27.5
Other	—	10.5	10.5
<b>Total</b>	<b>\$728.5</b>	<b>\$1,295.5</b>	<b>\$2,024.0</b>

Included in revenue bonds are \$824.8 million of single family housing revenue bonds issued by state housing finance agencies, of which \$495.2 million are supported by individual mortgages held by the state housing finance agencies and \$329.6 million are supported by mortgage-backed securities. Of the programs supported by mortgage-backed securities, approximately 40% are collateralized by Fannie Mae and Freddie Mac mortgages; the remaining 60% are collateralized by Ginnie Mae loans, which are fully guaranteed by the U.S. Government. Of the programs supported by individual mortgages held by the state housing finance agencies, the overall credit quality rating is AA. Most of these mortgages are supported by FHA, VA, or private mortgage insurance providers.

Approximately 25%, or \$505.2 million (reflected in the table below), of our total municipal securities were insured general obligation or revenue bonds, which in the aggregate had a decline in credit quality from AA- at December 31, 2008, to A+ as of December 31, 2009. The credit quality decline was primarily due to our sales of higher-rated securities within this portfolio. The following table shows the composition and credit quality rating of these municipal obligations by monoline insurer at December 31, 2009. The credit quality rating represents the rating of the underlying security, excluding credit insurance, based on ratings by nationally recognized rating agencies.

<b>Insurance Enhanced Municipal Securities</b>			
(millions) Monoline Insurer/Rating	General Obligations	Revenue Bonds	Total
AMBAC			
AA	\$ 59.3	\$ 16.2	\$ 75.5
A	11.7	—	11.7
BBB	—	1.1	1.1
Non-rated	—	4.5	4.5
	<b>\$ 71.0</b>	<b>\$ 21.8</b>	<b>\$ 92.8</b>
MBIA			
AA	\$126.6	\$119.7	\$246.3
A	40.0	27.0	67.0
BBB	—	5.3	5.3
Non-rated	—	6.0	6.0
	<b>\$166.6</b>	<b>\$158.0</b>	<b>\$324.6</b>
FSA			
AA	\$ 12.6	\$ 30.9	\$ 43.5
A	8.5	16.9	25.4
BBB	—	18.9	18.9
	<b>\$ 21.1</b>	<b>\$ 66.7</b>	<b>\$ 87.8</b>
<b>TOTAL</b>			
AA	\$198.5	\$166.8	\$365.3
A	60.2	43.9	104.1
BBB	—	25.3	25.3
Non-rated	—	10.5	10.5
	<b>\$258.7</b>	<b>\$246.5</b>	<b>\$505.2</b>

As of December 31, 2009, the insurance-enhanced general obligation and revenue bonds had a net unrealized gain of \$20.5 million, compared to a net unrealized gain of \$12.9 million at December 31, 2008. We buy and hold these securities based on our evaluation of the underlying credit without reliance on the monoline insurance. Our investment policy does not require us to liquidate securities should the insurance provided by the monoline insurers cease to exist.

#### CORPORATE SECURITIES

Included in our fixed-income securities at December 31, 2009, were \$1,281.4 million of fixed-rate corporate securities, which had a duration of 3.1 years and an overall credit quality rating of BBB+. These securities had a net unrealized gain of \$36.5 million at December 31, 2009, compared to a net unrealized loss of \$52.8 million at December 31, 2008. During the second half of 2009, we added high-quality, non-financial corporate securities. During the year ended December 31, 2009, we did not record any write-downs on our corporate debt portfolio, compared to \$69.0 million of write-downs recorded during 2008 and no write-downs recorded during 2007. The table below shows the exposure break-down by sector and current rating, reflecting any changes in ratings since acquisition:

Corporate Securities (Rating at December 31, 2009)

Sector	AAA	AA	A	BBB	Non-Investment-Grade	% of Portfolio
<b>Financial Services</b>						
U.S. banks	—%	—%	2.7%	—%	—%	2.7%
Insurance	.9	1.4	5.9	—	—	8.2
Other	—	1.7	2.0	—	4.2	7.9
Total financial services	.9	3.1	10.6	—	4.2	18.8
Industrial	2.9	7.4	16.2	50.4	4.3	81.2
Total	3.8%	10.5%	26.8%	50.4%	8.5%	100.0%

#### PREFERRED STOCKS – REDEEMABLE AND NONREDEEMABLE

We hold both redeemable (i.e., mandatory redemption dates) and nonredeemable (i.e., perpetual preferred stocks with call dates) preferred stocks. Nonredeemable preferred stocks also include securities that have call features with fixed-rate coupons (i.e., hybrid securities), whereby the change in value of the call features is a component of the overall change in value of the preferred stocks. At December 31, 2009, we held \$606.7 million in redeemable preferred stocks and \$1,255.8 million in nonredeemable preferred stocks. We made no material additional investments in preferred stocks during the year ended December 31, 2009.

Our preferred stock portfolio had a net unrealized gain of \$533.0 million at December 31, 2009, compared to a net unrealized gain of \$56.9 million at December 31, 2008. During the years ended December 31, 2009, 2008, and 2007, we wrote down \$213.2 million, \$1,676.7 million, and \$17.4 million, respectively, in redeemable and nonredeemable preferred stocks due to a combination of weakened issuer fundamentals and severe market declines where we were unable to determine objectively that the securities would recover substantially in the near term, in each case in accordance with the applicable accounting guidance at the time the write-downs were taken. See the *Other-Than-Temporary Impairment* section below for further discussion.

Our preferred stocks had an overall credit quality rating of BBB at December 31, 2009. The table below shows the exposure break-down by sector and current rating, reflecting any changes in ratings since acquisition:

Preferred Stocks (Rating at December 31, 2009)

Sector	A	BBB	Non-Investment-Grade	% of Preferred Stock Portfolio
<b>Financial Services</b>				
U.S. banks	33.5%	8.2%	10.3%	52.0%
Foreign banks	1.7	—	1.4	3.1
Insurance	2.2	7.8	6.2	16.2
Other	1.6	—	1.6	3.2
Total financial services	39.0	16.0	19.5	74.5
Industrials	—	8.7	9.7	18.4
Utilities	2.2	4.9	—	7.1
Total	41.2%	29.6%	29.2%	100.0%

Approximately 50% of our preferred stock securities pay dividends that have tax preferential characteristics, while the balance pay dividends that are fully taxable. In addition, all of our non-investment-grade preferred stocks were with issuers that maintain investment-grade senior debt ratings.

Approximately 60% of our preferred stock securities are fixed-rate securities, and 40% are floating-rate securities. All of our preferred securities have call or mandatory redemption features. Most of the securities are structured to provide some protection against extension risk in the event the issuer elects not to call such securities at their initial call date, by either paying a higher dividend amount or by paying floating-rate coupons. Of our fixed-rate securities, approximately 90% will convert to floating-rate dividend payments if not called at their initial call date.

### **Common Equities**

Common equities, as reported on the balance sheets at December 31 were comprised of the following:

(\$ in millions)	2009		2008	
Common stocks	\$803.3	98.4%	\$714.3	98.1%
Other risk investments	12.9	1.6	13.5	1.9
<b>Total common equities</b>	<b>\$816.2</b>	<b>100.0%</b>	<b>\$727.8</b>	<b>100.0%</b>

At December 31, 2009 and 2008, 5.6% of the portfolio was in common equities. Beginning late in 2008 and continuing into early in 2009, as part of our risk mitigation strategy in the uncertain financial market, we reduced our common stock portfolio to approximately 2.5% of the total portfolio's fair value. During the fourth quarter 2009, with the markets showing significant recovery and a more stable and positive outlook, we decided to add to the common stock portfolio by increasing our position near the level at year-end 2008. In early February 2010, we added an additional \$300 million to our common stock portfolio. Our allocation to Group I securities remains between 0% and 25% of the total portfolio.

Common stocks are managed externally to track the Russell 1000 Index with an anticipated annual tracking error of +/- 50 basis points. Our individual holdings are selected based on their contribution to the correlation with the index. For 2009, the GAAP basis total return was within the desired tracking error when compared to the Russell 1000 Index. We held 715 out of 964, or 74%, of the common stocks comprising the Russell 1000 Index at December 31, 2009, which made up 94% of the total market capitalization of the index.

Other risk investments include private equity investments and limited partnership interests in private equity and mezzanine investment funds, which have no off-balance-sheet exposure or contingent obligations, except for \$0.2 million of open funding commitments at December 31, 2009.

The following is a summary of our common equity holdings by sector compared to the Russell 1000 Index:

Sector	Equity Portfolio Allocation at December 31, 2009	Russell 1000 Allocation at December 31, 2009	Russell 1000 Sector Return in 2009
Consumer discretionary	12.3%	12.9%	24.7%
Consumer staple	9.1	8.9	13.2
Financial service	15.0	16.4	21.7
Health care	12.3	12.0	11.7
Materials and processing	4.7	4.5	37.5
Other energy	11.3	10.9	45.4
Producer durable	9.7	10.4	21.3
Technology	17.6	17.6	47.8
Utility	6.8	6.4	4.9
Other equity <sup>1</sup>	1.2	NA	15.9
<b>Total common stocks</b>	<b>100.0%</b>	<b>100.0%</b>	<b>28.5%</b>

NA= Not Applicable

<sup>1</sup> Effective October 1, 2009, the Russell 1000 Index redefined the sector allocation; the sector return reflects activity prior to the reallocation date.

**Trading Securities** At December 31, 2009 and 2008, we did not hold any trading securities and we did not have any net realized gains (losses) on trading securities for the years ended December 31, 2009, 2008, and 2007.

### Derivative Instruments

We have invested in the following derivative exposures at various times: interest rate swaps, asset-backed credit default swaps, U.S. corporate debt credit default swaps, cash flow hedges, and equity options. See *Note 2 – Investments* for further discussion of our derivative positions.

For all derivative positions discussed below, realized holding period gains and losses are netted with any upfront cash that may be exchanged under the contract to determine if the net position should be classified either as an asset or liability. To be reported as a component of the available-for-sale portfolio, the inception-to-date realized gain on the derivative position at period end would have to exceed any upfront cash received (net derivative asset). On the other hand, a net derivative liability would include any inception-to-date realized loss plus the amount of upfront cash received (or netted, if upfront cash was paid) and would be reported as a component of other liabilities. These net derivative assets/liabilities are not separately disclosed on the balance sheet due to their immaterial effect on our financial condition, cash flows, and results of operations.

### INTEREST RATE SWAPS

We invest in interest rate swaps primarily to manage the fixed-income portfolio duration. The following table summarizes our interest rate swap activity classified by the status (open vs. closed) of the swap position as of December 31, 2009:

(millions)	Coupon	Notional Exposure			Gains (Losses)		
					Years ended		
		2009	2008	2007	2009	2008	2007
<b>Open Positions</b>							
9-year exposure	Receive variable	\$ 713	\$ —	\$ —	\$ .1	\$ —	\$ —
<b>Closed Positions</b>							
2-year exposure	Receive fixed	\$2,300	\$1,250	\$ —	\$ 3.8	\$ 44.6	\$ —
3-year exposure	Receive fixed	880	—	—	8.3	—	—
5-year exposure	Receive fixed	1,006	1,725	1,175	(1.7)	106.2	46.6
5-year exposure	Receive variable	—	225	—	—	6.9	—
10-year exposure	Receive fixed	—	150	150	—	3.7	6.5
Total closed positions		\$4,186	\$3,350	\$1,325	\$10.4	\$161.4	\$53.1
Total interest rate swaps					\$10.5	\$161.4	\$53.1

### ASSET-BACKED CREDIT DEFAULT SWAPS

The following table summarizes our holding period gains (losses) on the asset-backed credit default swaps classified by the status of the swap position as of December 31, 2009:

(millions)	Bought or Sold Protection	Notional Exposure			Gains (Losses)		
					Years ended		
		2009	2008	2007	2009	2008	2007
<b>Closed Positions</b>							
BBB- credit exposure	Sold	\$—	\$140	\$190	\$—	\$(26.1)	\$(51.3)
Treasury Note		—	140	190	—	6.4	7.9
Total asset-backed swaps					\$—	\$(19.7)	\$(43.4)

## CORPORATE CREDIT DEFAULT SWAPS

The following table summarizes our corporate credit default swap activity classified by the status of the swap position as of December 31, 2009:

(millions)	Bought or Sold Protection	Notional Exposure			Gains (Losses)		
					Years ended December 31,		
		2009	2008	2007	2009	2008	2007
<b>Open Positions</b>							
5-year exposure	Bought	\$25	\$ 25	\$ —	\$ (.6)	\$ (.7)	\$ —
<b>Closed Positions</b>							
2-year exposure	Bought	\$ 7	\$ —	\$ —	\$ (.4)	\$ —	\$ —
3-year exposure	Bought	—	260	—	—	(1.4)	—
5-year exposure	Bought	—	285	—	—	22.2	—
Non-investment-grade index	Bought	—	—	210	—	—	6.4
Investment-grade index	Bought	—	—	40	—	—	3.6
Total closed positions		\$ 7	\$545	\$250	\$ (.4)	\$20.8	\$10.0
Total corporate swaps					\$(1.0)	\$20.1	\$10.0

## EQUITY OPTIONS

The following table summarizes the activity of our equity options, classified by the status of the option position as of December 31, 2009:

(millions)		Number of Contracts <sup>1</sup>			Gains (Losses)		
					Years ended December 31,		
		2009	2008	2007	2009	2008	2007
<b>Closed Positions</b>							
Equity options		177,190	—	—	\$(9.1)	\$—	\$—

<sup>1</sup> Each contract is equivalent to 100 shares of common stock of the issuer.

## CASH FLOW HEDGES

In the fourth quarter 2009, we recognized a realized gain of \$0.9 million reflecting the previously deferred gain on our foreign currency cash flow hedge.

During the second quarter 2007, we entered into a forecasted debt issuance hedge against a possible rise in interest rates in anticipation of issuing \$1 billion of our 6.70% Fixed-to-Floating Rate Junior Subordinated Debentures due 2067 (the "Debentures"). The hedge was designated as, and qualified for, cash flow hedge accounting treatment. Upon issuance of the Debentures, the hedge was closed, and we recognized a pretax gain of \$34.4 million, which is recorded as part of accumulated other comprehensive income. The \$34.4 million gain is deferred and is being recognized as an adjustment to interest expense over the 10-year fixed interest rate term of the Debentures. During 2009, 2008, and 2007, we recognized \$2.8 million, \$2.6 million, and \$1.3 million, respectively, as an adjustment to interest expense.

## B. Investment Results

Investment income (interest and dividends, before investment and interest expenses) decreased 20% for 2009, compared to a decrease of 6% and an increase of 5% for 2008 and 2007, respectively. The reductions in 2009 and 2008 were primarily the result of investing new cash and proceeds from security sales, redemptions, and maturities into lower-yielding U.S. Treasury Notes and short-term investments as a means to protect the portfolio from additional valuation declines and the current historically low rate environment. During the second half of 2009, we began to reallocate a portion of our short-term investments to select credit-related products that had attractive risk/return profiles and modest duration risks. The increase in 2007 was primarily the result of a decision to add certain higher-yielding, though lower-rated, assets. These lower-rated assets provided additional income over our previous investments.

We report total return to reflect more accurately the management philosophy governing the portfolio and our evaluation of investment results. The fully taxable equivalent (FTE) total return includes investment income, net realized gains (losses) on securities, and changes in unrealized gains (losses) on investments.



The following summarizes investment results for the years ended December 31:

	2009	2008	2007
Pretax investment book yield	3.7%	4.7%	4.8%
Weighted average FTE book yield	4.2%	5.5%	5.6%
FTE total return:			
Fixed-income securities	12.2%	(7.1)%	4.4%
Common stocks	29.5%	(36.5)%	6.2%
Total portfolio	12.5%	(10.4)%	4.7%

A further break-down of our total returns for our fixed-income securities, including the net gains (losses) on our derivative positions, for the years ended December 31 follows:

	2009	2008	2007
Fixed-income securities:			
U.S. Treasury Notes	(1.7)%	30.5%	14.8%
Municipal bonds	10.7%	4.1%	7.1%
Corporate bonds	23.6%	(7.1)%	7.7%
Commercial mortgage-backed securities	26.0%	(9.5)%	6.2%
Collateralized mortgage obligations	26.2%	(14.0)%	6.0%
Asset-backed securities	.7%	(15.1)%	(14.7)%
Preferred stocks	60.1%	(40.5)%	(5.7)%

Investment expenses were \$11.1 million in 2009, compared to \$8.8 million in 2008 and \$12.4 million in 2007. The increase in 2009 reflects an estimated Gainsharing (cash incentive) payout to our investment managers; no bonus was accrued for 2008. For 2007, the investment expenses included the costs associated with the June 2007 issuance of our Debentures.

Interest expense in 2009 was \$139.0 million, compared to \$136.7 million in 2008 and \$108.6 million in 2007. The increases in 2009 and 2008 reflect interest following the June 2007 issuance of our Debentures.

#### **Other-Than-Temporary Impairment (OTTI)**

Realized losses may include write-downs of securities determined to have had an other-than-temporary decline in fair value. We routinely monitor our portfolio for pricing changes that might indicate potential impairments and perform detailed reviews of securities with unrealized losses based on predetermined guidelines. In such cases, changes in fair value are evaluated to determine the extent to which such changes are attributable to (i) fundamental factors specific to the issuer, such as financial conditions, business prospects, or other factors, (ii) market-related factors, such as interest rates or equity market declines (e.g., negative return at either a sector index level or at the broader market level), or (iii) credit-related losses where the present value of cash flows expected to be collected are lower than the amortized cost basis of the security.

Fixed-income securities and common equities with declines attributable to issuer-specific fundamentals are reviewed to identify all available evidence, circumstances, and influences to estimate the potential for, and timing of, recovery of the investment's impairment. An other-than-temporary impairment loss is deemed to have occurred when the potential for recovery does not satisfy the criteria set forth in the current accounting guidance.

For fixed-income investments with unrealized losses due to market- or sector-related declines, the losses are not deemed to qualify as other-than-temporary where we do not have the intent to sell an investment, and it is more likely than not that we will not be required to sell the investment, prior to the period of time that we anticipate to be necessary for the investment to recover its cost basis. In general, our policy for common equity securities with market- or sector-related declines is to recognize impairment losses on individual securities with losses we cannot reasonably conclude will recover in the near term under historical conditions by the earlier of (i) when we are able to objectively determine that the loss is other-than-temporary, or (ii) when the security has been in such a loss position for three consecutive quarters.

When a security in our fixed-maturity portfolio has an unrealized loss and we intend to sell the security, or it is more likely than not that we will be required to sell the security, then we write-down the security to its current fair value and recognize the entire unrealized loss through the income statement as a realized loss. If a fixed-maturity security has an unrealized loss and it is more likely than not that we will hold the debt security until recovery (which could be maturity), then we need to determine if any of the decline in value is due to a credit loss (i.e., where the present value of cash flows expected to be

collected is lower than the amortized cost basis of the security) and, if so, we will recognize that portion of the impairment in the income statement as a realized loss; any remaining unrealized loss on the security is considered to be due to other factors (e.g., interest rate and credit spread movements) and is reflected in shareholders' equity, along with unrealized gains or losses on securities that are not deemed to be other-than-temporarily impaired. The write-down activity recorded in the income statement for the years ended December 31 was as follows:

(millions)	Total Write-downs	Write-downs on Securities Sold	Write-downs on Securities Held at Period End
<b>2009</b>			
Preferred stocks	\$ 213.2	\$ (48.3)	\$ 164.9
Asset-backed securities	33.6	(.7)	32.9
Total fixed income	246.8	(49.0)	197.8
Common equities	17.4	(7.1)	10.3
Total portfolio	\$ 264.2	\$ (56.1)	\$ 208.1
<b>2008</b>			
Preferred stocks	\$1,676.7	\$(434.4)	\$1,242.3
Corporate debt	69.0	—	69.0
Asset-backed securities	38.8	—	38.8
Total fixed income	1,784.5	(434.4)	1,350.1
Common equities	74.3	(31.3)	43.0
Total portfolio	\$1,858.8	\$(465.7)	\$1,393.1
<b>2007</b>			
Preferred stocks	\$ 17.4	\$ —	\$ 17.4
Asset-backed securities	1.9	—	1.9
Total fixed income	19.3	—	19.3
Common equities	2.4	(2.1)	.3
Total portfolio	\$ 21.7	\$ (2.1)	\$ 19.6

See *Critical Accounting Policies, Other-Than-Temporary Impairment* for further discussion.

### C. Repurchase Transactions

From time to time we enter into repurchase commitment transactions, under which we loan U.S. Treasury or U.S. Government agency securities to accredited brokerage firms in exchange for cash equal to the fair value of the securities. These internally managed transactions are typically overnight arrangements. The cash proceeds are invested in Eurodollar deposits, reverse repurchase transactions, or unsecured commercial paper obligations issued by large, high-quality institutions with yields that exceed our interest obligation on the borrowed cash. We are able to borrow the cash at low rates since the securities loaned are in either short supply or high demand. Our interest rate exposure does not increase or decrease since the borrowing and investing periods match. However, these transactions carry the risk that the counterparty in the arrangement could default, in which event we would be unable to recover our collateral in a timely manner. To help mitigate this risk, we hold our counterparty's cash for the full value of the securities we lend and revalue the securities on a regular basis to ensure that we hold sufficient cash to cover the market value of the securities. Nevertheless, in the event of a counterparty default, we may be unable to obtain additional cash if our securities on loan appreciate in value prior to their return.

During the third quarter 2008, we suspended our repurchase activity due to increased counterparty risk and high market volatility. We have not invested in any repurchase transactions during 2009 since the overnight rates did not provide the desired return we would require. For the period in 2008 during which we invested in the transactions, our largest single outstanding balance of repurchase commitments was \$1.1 billion, which was open for one day; the average daily balance of repurchase commitments was \$0.4 billion. We earned income of \$1.7 million and \$3.7 million during 2008 and 2007, respectively, on repurchase commitments.

Additionally, we enter into reverse repurchase commitment transactions. In these transactions, we loan cash to accredited banks and receive U.S. Treasury Notes pledged as general collateral against the cash borrowed. We choose to enter into these transactions as rates on general collateral are more attractive than other short-term rates available in the market. Our

exposure to credit risk is limited, as these internally managed transactions are typically overnight arrangements. The income generated on these transactions is calculated at the then applicable general collateral rates on the value of U.S. Treasury securities received. We have counterparty exposure on reverse repurchase agreements in the event of a counterparty default to the extent the general collateral security's value is below the cash we delivered to acquire the collateral. The short-term duration of the transactions (primarily overnight investing) reduces that default exposure.

For the year ended December 31, 2009, our largest single outstanding balance of reverse repurchase commitments was \$1,845.8 million, which was open for one day; the average daily balance of reverse repurchase commitments was \$657.3 million. During 2008, our largest single outstanding balance of reverse repurchase commitments was \$600.0 million, which was open for one day; the average daily balance of reverse repurchase commitments was \$206.5 million. We earned income of \$0.9 million and \$1.6 million on reverse repurchase agreements for the years ended 2009 and 2008, respectively. No reverse repurchase commitments were entered into during 2007. We had \$775.0 million of open reverse repurchase commitments at December 31, 2009 with two counterparties, reported as part of other short-term investments. No reverse repurchase commitments were open at December 31, 2008.

## **V. CRITICAL ACCOUNTING POLICIES**

Progressive is required to make certain estimates and assumptions when preparing its financial statements and accompanying notes in conformity with GAAP. Actual results could differ from those estimates in a variety of areas. The three areas that we view as most critical with respect to the application of estimates and assumptions are the establishment of our loss reserves, the method of determining impairments in our investment portfolio, and the valuation of our deferred tax assets.

### **A. Loss and LAE Reserves**

Loss and loss adjustment expense (LAE) reserves represent our best estimate of our ultimate liability for losses and LAE relating to events that occurred prior to the end of any given accounting period but have not yet been paid. At December 31, 2009, we had \$6.1 billion of net loss and LAE reserves, which included \$4.8 billion of case reserves and \$1.3 billion of incurred but not recorded (IBNR) reserves.

Progressive's actuarial staff reviews over 400 subsets of the business data, which are at a combined state, product, and line coverage level (the "products"), to calculate the needed loss and LAE reserves. We begin our review of a set of data by producing multiple estimates of needed reserves, using both paid and incurred data, to determine if a reserve change is required. In the event of a wide variation among results generated by the different projections, our actuarial group will further analyze the data using additional techniques. Each review develops a point estimate for a relatively small subset of the business, which allows us to establish meaningful reserve levels for that subset. In addition, the actuarial staff completes separate projections of needed case and IBNR reserves.

We review a large majority of our reserves by product/state combination on a quarterly time frame, with the remaining reserves generally reviewed on a semiannual basis. A change in our scheduled reviews of a particular subset of the business depends on the size of the subset or emerging issues relating to the product or state. By reviewing the reserves at such a detailed level, we have the ability to identify and measure variances in the trends by state, product, and line coverage that otherwise would not be seen on a consolidated basis. Our intricate process of reviewing the aforementioned subsets makes compiling a companywide roll up to generate a range of needed loss reserves not meaningful. We do not review loss reserves on a macro level and, therefore, do not derive a companywide range of reserves to compare to a standard deviation.

In analyzing the ultimate accident year loss experience, our actuarial staff reviews in detail, at the subset level, frequency (number of losses per earned car year), severity (dollars of loss per each claim), and average premium (dollars of premium per earned car year). The loss ratio, a primary measure of loss experience, is equal to the product of frequency times severity divided by the average premium. The average premium for personal and commercial auto businesses is known and, therefore, is not estimated. The projection of frequency for these lines of business is usually stable in the short term, because a large majority of the parties involved in an accident report their claims within a short time period after the occurrence. The actual frequency experienced will vary depending on the change in mix of class of drivers insured by Progressive, but the accuracy of the projected level is considered to be reliable. The severity experienced by Progressive, which is much more difficult to estimate, especially for injury claims, is affected by changes in underlying costs, such as medical costs, jury verdicts, and regulatory changes. In addition, severity will vary relative to the change in our mix of business by limit.

Assumptions regarding needed reserve levels made by the actuarial staff take into consideration influences on available historical data that reduce the predictiveness of our projected future loss costs. Internal considerations that are process-related, which generally result from changes in our claims organization's activities, include claim closure rates, the number of claims that are closed without payment, and the level of the claims representatives' estimates of the needed case reserve for each claim. These changes and their effect on the historical data are studied at the state level versus on a larger, less indicative, countrywide basis.

External items considered include the litigation atmosphere, state-by-state changes in medical costs, and the availability of services to resolve claims. These also are better understood at the state level versus at a more macro countrywide level.

The manner in which we consider and analyze the multitude of influences on the historical data, as well as how loss reserves affect our financial results, is discussed in more detail in our *Report on Loss Reserving Practices*, which was filed on June 25, 2009 via Form 8-K.

At December 31, 2009, Progressive's carried net reserve balance of \$6.1 billion implicitly assumes that the loss and LAE severity for accident year 2009 over accident year 2008 will increase by 2.9% for personal auto liability and decrease 2.4% for commercial auto liability. Personal auto liability and commercial auto liability reserves represent approximately 98% of our total carried reserves. As discussed above, the severity estimates are influenced by many variables that are difficult to quantify and which influence the final amount of claims settlement. That, coupled with changes in internal claims practices, the legal environment, and state regulatory requirements, requires significant judgment in the estimate of the needed reserves to be carried.

The following table highlights what the effect would be to our carried loss and LAE reserves, on a net basis, as of December 31, 2009, if during 2010 we were to experience the indicated change in our estimate of severity for the 2009 accident year (i.e., claims that occurred in 2009):

(millions)	Estimated Changes in Severity for Accident Year 2009				
	-2%	-1%	As Reported	+1%	+2%
Personal auto liability	\$4,584.3	\$4,641.1	\$4,697.9	\$4,754.7	\$4,811.5
Commercial auto liability	1,296.1	1,304.6	1,313.1	1,321.6	1,330.1
Other <sup>1</sup>	112.6	112.6	112.6	112.6	112.6
Total	\$5,993.0	\$6,058.3	\$6,123.6	\$6,188.9	\$6,254.2

<sup>1</sup>Includes reserves for personal and commercial auto physical damage claims and our non-auto lines of business; no change in estimates is presented due to the immaterial level of these reserves.

Note: Every percentage point change in our estimate of severity for the 2009 accident year would affect our personal auto liability reserves by \$56.8 million and our commercial auto reserves by \$8.5 million.

Our 2009 year-end loss and LAE reserve balance also includes claims from prior years. Claims that occurred in 2009, 2008, and 2007, in the aggregate, accounted for approximately 91% of our reserve balance. If during 2010 we were to experience the indicated change in our estimate of severity for the total of the prior three accident years (i.e., 2009, 2008, and 2007), the effect to our year-end 2009 reserve balances would be as follows:

(millions)	Estimated Changes in Severity for Accident Year 2009, 2008, and 2007				
	-2%	-1%	As Reported	+1%	+2%
Personal auto liability	\$4,376.1	\$4,537.0	\$4,697.9	\$4,858.8	\$5,019.7
Commercial auto liability	1,259.7	1,286.4	1,313.1	1,339.8	1,366.5
Other <sup>1</sup>	112.6	112.6	112.6	112.6	112.6
Total	\$5,748.4	\$5,936.0	\$6,123.6	\$6,311.2	\$6,498.8

<sup>1</sup>Includes reserves for personal and commercial auto physical damage claims and our non-auto lines of business; no change in estimates is presented due to the immaterial level of these reserves.

Note: Every percentage point change in our estimate of severity for the 2009, 2008, and 2007 accident year would affect our personal auto liability reserves by \$160.9 million and our commercial auto reserves by \$26.7 million.

Our best estimate of the appropriate amount for our reserves as of year-end 2009 is included in our financial statements for the year. Our goal is to ensure that total reserves are adequate to cover all loss costs, while sustaining minimal variation from the time reserves are initially established until losses are fully developed. At the point in time when reserves are set, we have no way of knowing whether our reserve estimates will prove to be high or low (and, thus, whether future reserve development will be favorable or unfavorable), or whether one of the alternative scenarios discussed above is “reasonably likely” to occur. During 2009, our estimate of the needed reserves at the end of 2008 decreased 2.3%. The following table shows how we have performed against this goal over the last ten years.

(\$ in millions)											
For the years ended December 31,	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Loss and LAE Reserves <sup>1</sup>	\$2,200.2	\$2,785.3	\$3,069.7	\$3,632.1	\$4,346.4	\$4,948.5	\$5,313.1	\$5,363.6	\$5,655.2	\$5,932.9	\$6,123.6
Re-estimated reserves as of:											
One year later	2,276.0	2,686.3	3,073.2	3,576.0	4,237.3	4,592.6	5,066.2	5,443.9	5,688.4	5,796.9	
Two years later	2,285.4	2,708.3	3,024.2	3,520.7	4,103.3	4,485.2	5,130.5	5,469.8	5,593.8		
Three years later	2,277.7	2,671.2	2,988.7	3,459.2	4,048.0	4,501.6	5,093.6	5,381.9			
Four years later	2,272.3	2,666.9	2,982.7	3,457.8	4,070.0	4,471.0	5,046.7				
Five years later	2,277.5	2,678.5	2,993.7	3,475.4	4,073.7	4,475.5					
Six years later	2,284.9	2,683.7	3,002.5	3,472.5	4,072.4						
Seven years later	2,287.4	2,688.4	3,000.6	3,470.1							
Eight years later	2,291.9	2,688.6	2,995.8								
Nine years later	2,290.8	2,683.5									
Ten years later	2,286.7										
Cumulative Development:											
Favorable(Unfavorable)	\$ (86.5)	\$ 101.8	\$ 73.9	\$ 162.0	\$ 274.0	\$ 473.0	\$ 266.4	\$ (18.3)	\$ 61.4	\$ 136.0	
Percentage <sup>2</sup>	(3.9)	3.7	2.4	4.5	6.3	9.6	5.0	(.3)	1.1	2.3	

<sup>1</sup>Represents loss and LAE reserves net of reinsurance recoverables on net unpaid losses at the balance sheet date.

<sup>2</sup>Cumulative development ÷ loss and LAE reserves.

Note: The chart above represents the development of the property casualty loss and LAE reserves for 1999 through 2008. The last line in the triangle for each year represents the following:

$$\text{Re-estimated reserves} = \text{Total amount paid to-date} + \text{Total remaining case reserves on unsettled claims.}$$

Changes in the estimated severity and the actual number of late reported claims are the cause of the change in our re-estimated reserves from year to year. The cumulative development represents the aggregate change in our estimates over all years.

From 1999 through 2001, while we experienced an increase in bodily injury severity, our developed reserves were within 4% of our original estimates. The bodily injury severity change was much lower than we expected between 2002 and 2005; thus, the reserve run-off for these years was very favorable following the end of each year, or about 4% to 10% of our original carried amounts. The reserve development for each of 2006 through 2008 was less than 3% of our original carried reserves.

Because Progressive is primarily an insurer of motor vehicles, we have minimal exposure as an insurer of environmental, asbestos, and general liability claims.

## B. Other-Than-Temporary Impairment (OTTI)

Realized losses may include write-downs of securities determined to have had an other-than-temporary decline in fair value. We routinely monitor our portfolio for pricing changes that might indicate potential impairments and perform detailed reviews of securities with unrealized losses based on predetermined guidelines. In such cases, changes in fair value are evaluated to determine the extent to which such changes are attributable to (i) fundamental factors specific to the issuer, such as financial conditions, business prospects, or other factors, (ii) market-related factors, such as interest rates or equity market declines (e.g., negative return at either a sector index level or at the broader market level), or (iii) credit-related losses, where the present value of cash flows expected to be collected is lower than the amortized cost basis of the security.

Fixed-income securities and common equities with declines attributable to issuer-specific fundamentals are reviewed to identify all available evidence, circumstances, and influences to estimate the potential for, and timing of, recovery of the investment’s impairment. An other-than-temporary impairment loss is deemed to have occurred when the potential for recovery does not satisfy the criteria set forth in the current accounting guidance.



For fixed-income investments with unrealized losses due to market- or sector-related declines, the losses are not deemed to qualify as other-than-temporary where we do not have the intent to sell an investment, and it is more likely than not that we will not be required to sell the investment, prior to the period of time that we anticipate to be necessary for the investment to recover its cost basis. In general, our policy for common equity securities with market- or sector-related declines is to recognize impairment losses on individual securities with losses we cannot reasonably conclude will recover in the near term under historical conditions by the earlier of (i) when we are able to objectively determine that the loss is other-than-temporary, or (ii) when the security has been in such a loss position for three consecutive quarters.

When a security in our fixed-maturity portfolio has an unrealized loss and we intend to sell the security, or it is more likely than not that we will be required to sell the security, we write-down the security to its current fair value and recognize the entire unrealized loss through the income statement as a realized loss. If a fixed-maturity security has an unrealized loss and it is more likely than not that we will hold the debt security until recovery (which could be maturity), then we need to determine if any of the decline in value is due to a credit loss (i.e., where the present value of cash flows expected to be collected is lower than the amortized cost basis of the security) and, if so, we will recognize that portion of the impairment in the income statement as a realized loss; any remaining unrealized loss on the security is considered to be due to other factors (e.g., interest rate and credit spread movements) and is reflected in shareholders' equity, along with unrealized gains or losses on securities that are not deemed to be other-than-temporarily impaired.

The following table stratifies the gross unrealized losses in our fixed-income and common equity portfolios at December 31, 2009, by the duration in a loss position and magnitude of the loss as a percentage of the cost of the security:

(millions)	Fair Value	Total Gross Unrealized Losses	Decline of Investment Value			
			>15%	>25%	>35%	>45%
Fixed Income:						
Unrealized loss for less than 12 months	\$2,846.1	\$ 12.1	\$ 2.5	\$ 2.2	\$ .3	\$ —
Unrealized loss for 12 months or greater	3,884.6	314.5	138.4	82.8	26.6	26.6
<b>Total</b>	<b>\$6,730.7</b>	<b>\$326.6</b>	<b>\$140.9</b>	<b>\$85.0</b>	<b>\$26.9</b>	<b>\$26.6</b>
Common Equity:						
Unrealized loss for less than 12 months	\$ 20.9	\$ 1.7	\$ .9	\$ —	\$ —	\$ —
Unrealized loss for 12 months or greater	9.8	.6	—	—	—	—
<b>Total</b>	<b>\$ 30.7</b>	<b>\$ 2.3</b>	<b>\$ .9</b>	<b>\$ —</b>	<b>\$ —</b>	<b>\$ —</b>

We completed a thorough review of the existing securities in these loss categories and determined that, applying the procedures and criteria discussed above, these securities were not other-than-temporarily impaired. We do not intend to sell these securities. We also determined that it is more likely than not that we will not be required to sell these securities, for the periods of time necessary to recover the cost bases of these securities, and that there is no additional credit-related impairment on our debt securities.

Since total unrealized losses are already a component of our shareholders' equity, any recognition of these losses as additional OTTI losses would have no effect on our comprehensive income, book value, or reported investment total return.

### C. Deferred Tax Assets

The income tax provision is calculated under the balance sheet approach. Deferred tax assets and liabilities are recorded based on the difference between the financial statement and tax bases of assets and liabilities at the enacted tax rates. We regularly review our deferred tax assets for recoverability. As of December 31, 2009, we did not record a valuation allowance against the gross deferred tax asset.

Realization of the deferred tax asset ultimately depends on the existence of sufficient taxable income available of the same character, which may include future reversals of existing temporary differences, future taxable income exclusive of reversing differences, taxable income in prior carryback years, and tax planning strategies.

Our net deferred tax asset was \$420.0 million at December 31, 2009. This amount includes \$113.7 million related to net unrealized tax losses in our investment portfolio. The losses creating this deferred tax asset resulted primarily from the widening credit spreads on our fixed-income securities, especially in our preferred stock portfolio that occurred during late 2008 and early 2009. Due to the nature of these writedowns, they have not yet been recognized for tax purposes. To the extent these losses are ultimately recognized, they would generate net capital losses for tax purposes.



In evaluating the need for a valuation allowance, we have to determine if it is more likely than not that the deferred tax asset will be realized and that we will be able to fully use the deductions that are ultimately recognized for tax purposes. Part of our analysis revolves around the reversal of existing temporary differences (e.g., timing of the recognition of unrealized gains/losses) and our tax planning strategies. In reviewing our need for a valuation allowance, we separate our preferred stock portfolio into two groups. The first group includes those securities that we believe are fundamentally impaired or that we are likely to sell in the near future; we assume no recovery in value for these securities.

The second group is preferred securities that we have the intent and ability to hold to substantial recovery. We believe that the issuers of this second group of securities are financially sound companies with adequate capital. However, if an opportunity presents itself where we can diversify our preferred stock holdings, we may elect to sell a particular security rather than hold it until substantial recovery. This does not change our tax strategy, but provides us with the flexibility to manage our available-for-sale portfolio. Since we are unable to specifically identify when these situations might arise, or which security might be affected, we determined that it would be appropriate to reduce the potential recoverable value of the second group of our preferred stocks when determining our need for a valuation allowance on our deferred tax asset.

As of December 31, 2009, we have sufficient realized and unrealized gains in our investment portfolio to offset any potential losses we may recognize resulting from sales of preferred securities in either of the two groups discussed above. Although realization of the deferred tax asset is not assured, management believes it is more likely than not that the deferred tax asset will be realized based on our expectation that we will be able to fully utilize the deductions that are ultimately recognized for tax purposes.

Our ability to recognize these deferred tax assets could be affected by further market value declines as well as if our expectations change about either the ability of the securities to recover in value or our intent or ability to hold the securities until recovery. Such changes may require us to establish a valuation allowance against the deferred tax asset, which could have a material effect on our financial condition and results of operations.

**Safe Harbor Statement Under the Private Securities Litigation Reform Act of 1995:** *Statements in this report that are not historical fact are forward-looking statements that are subject to certain risks and uncertainties that could cause actual events and results to differ materially from those discussed herein. These risks and uncertainties include, without limitation, uncertainties related to estimates, assumptions, and projections generally; inflation and changes in economic conditions (including changes in interest rates and financial markets); the financial condition of, and other issues relating to the strength of and liquidity available to, issuers of securities held in our investment portfolios and other companies with which we have ongoing business relationships, including counterparties to certain financial transactions; the accuracy and adequacy of our pricing and loss reserving methodologies; the competitiveness of our pricing and the effectiveness of our initiatives to retain more customers; initiatives by competitors and the effectiveness of our response; our ability to obtain regulatory approval for requested rate changes and the timing thereof; the effectiveness of our brand strategy and advertising campaigns relative to those of competitors; legislative and regulatory developments; disputes relating to intellectual property rights; the outcome of litigation pending or that may be filed against us; weather conditions (including the severity and frequency of storms, hurricanes, snowfalls, hail, and winter conditions); changes in driving patterns and loss trends; acts of war and terrorist activities; our ability to maintain the uninterrupted operation of our facilities, systems (including information technology systems), and business functions; court decisions and trends in litigation and health care and auto repair costs; and other matters described from time to time in our releases and publications, and in our periodic reports and other documents filed with the United States Securities and Exchange Commission. In addition, investors should be aware that generally accepted accounting principles prescribe when a company may reserve for particular risks, including litigation exposures. Accordingly, results for a given reporting period could be significantly affected if and when a reserve is established for one or more contingencies. Also, our regular reserve reviews may result in adjustments of varying magnitude as additional information regarding pending loss and loss adjustment expense reserves becomes known. Reported results, therefore, may be volatile in certain accounting periods.*