

SELECTIVE INSURANCE GROUP INC  
Form 10-Q  
October 28, 2010

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended: September 30, 2010

or

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

For the transition period from

to

Commission File Number: 001-33067

SELECTIVE INSURANCE GROUP, INC.  
(Exact name of registrant as specified in its charter)

New Jersey  
(State or Other Jurisdiction of Incorporation or  
Organization)

22-2168890  
(I.R.S. Employer Identification No.)

40 Wantage Avenue  
Branchville, New Jersey  
(Address of Principal Executive Offices)

07890  
(Zip Code)

(973) 948-3000  
(Registrant's Telephone Number, Including Area Code)

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(Former Name, Former Address and Former Fiscal Year, if Changed Since Last Report)

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

Yes  No

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

Yes  No

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

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

Yes

No

As of September 30, 2010, there were 53,512,025 shares of common stock, par value \$2.00 per share, outstanding.

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SELECTIVE INSURANCE GROUP, INC.  
Table of Contents

|                 |                                                                                                                 | Page<br>No. |
|-----------------|-----------------------------------------------------------------------------------------------------------------|-------------|
| <b>PART I.</b>  | <b>FINANCIAL INFORMATION</b>                                                                                    |             |
| Item 1.         | Financial Statements                                                                                            |             |
|                 | Consolidated Balance Sheets as of September 30, 2010 (Unaudited) and December 31, 2009                          | 1           |
|                 | Unaudited Consolidated Statements of Income for the Quarter and Nine Months Ended September 30, 2010 and 2009   | 2           |
|                 | Unaudited Consolidated Statements of Stockholders' Equity for the Nine Months Ended September 30, 2010 and 2009 | 3           |
|                 | Unaudited Consolidated Statements of Cash Flow for the Nine Months Ended September 30, 2010 and 2009            | 4           |
|                 | Notes to Unaudited Interim Consolidated Financial Statements                                                    | 5           |
| Item 2.         | Management's Discussion and Analysis of Financial Condition and Results of Operations                           |             |
|                 | Forward-Looking Statements                                                                                      | 26          |
|                 | Introduction                                                                                                    | 26          |
|                 | Critical Accounting Policies and Estimates                                                                      | 26          |
|                 | Financial Highlights of Results for Third Quarter 2010 and Nine Months 2010                                     | 27          |
|                 | Results of Operations and Related Information by Segment                                                        | 29          |
|                 | Federal Income Taxes                                                                                            | 51          |
|                 | Financial Condition, Liquidity, and Capital Resources                                                           | 51          |
|                 | Ratings                                                                                                         | 53          |
|                 | Accounting Pronouncements to be Adopted                                                                         | 54          |
|                 | Off-Balance Sheet Arrangements                                                                                  | 54          |
|                 | Contractual Obligations and Contingent Liabilities and Commitments                                              | 54          |
| Item 3.         | Quantitative and Qualitative Disclosures About Market Risk                                                      | 55          |
| Item 4.         | Controls and Procedures                                                                                         | 55          |
| <b>PART II.</b> | <b>OTHER INFORMATION</b>                                                                                        |             |
| Item 1.         | Legal Proceedings                                                                                               | 55          |
| Item 1A.        | Risk Factors                                                                                                    | 56          |
| Item 2.         | Unregistered Sales of Equity Securities and Use of Proceeds                                                     | 59          |
| Item 6.         | Exhibits                                                                                                        | 60          |

## PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS  
SELECTIVE INSURANCE GROUP, INC.

## CONSOLIDATED BALANCE SHEETS

(\$ in thousands, except share amounts)

|                                                                                                                              | Unaudited<br>September 30,<br>2010 | December 31,<br>2009 |
|------------------------------------------------------------------------------------------------------------------------------|------------------------------------|----------------------|
| <b>ASSETS</b>                                                                                                                |                                    |                      |
| Investments:                                                                                                                 |                                    |                      |
| Fixed maturity securities, held-to-maturity – at carry value<br>(fair value: \$1,440,143 – 2010; \$1,740,211 – 2009)         | \$ 1,372,698                       | 1,710,403            |
| Fixed maturity securities, available-for-sale – at fair value<br>(amortized cost: \$2,006,685 – 2010; \$1,616,456 – 2009)    | 2,115,049                          | 1,635,869            |
| Equity securities, available-for-sale – at fair value<br>(cost of: \$55,051 – 2010; \$64,390 – 2009)                         | 63,116                             | 80,264               |
| Short-term investments (at cost which approximates fair value)                                                               | 265,043                            | 213,848              |
| Other investments                                                                                                            | 154,728                            | 140,667              |
| Total investments                                                                                                            | 3,970,634                          | 3,781,051            |
| Cash                                                                                                                         | 422                                | 811                  |
| Interest and dividends due or accrued                                                                                        | 36,283                             | 34,651               |
| Premiums receivable, net of allowance for uncollectible<br>accounts of: \$4,856 – 2010; \$5,880 – 2009                       | 460,394                            | 446,577              |
| Reinsurance recoverables, net                                                                                                | 307,105                            | 276,018              |
| Prepaid reinsurance premiums                                                                                                 | 115,745                            | 105,522              |
| Current federal income tax                                                                                                   | 24,760                             | 17,662               |
| Deferred federal income tax                                                                                                  | 79,799                             | 111,038              |
| Property and equipment – at cost, net of accumulated<br>depreciation and amortization of: \$149,255 – 2010; \$141,251 – 2009 | 41,832                             | 46,287               |
| Deferred policy acquisition costs                                                                                            | 218,590                            | 218,601              |
| Goodwill                                                                                                                     | 7,849                              | 7,849                |
| Other assets                                                                                                                 | 71,108                             | 68,760               |
| Total assets                                                                                                                 | \$ 5,334,521                       | 5,114,827            |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>                                                                                  |                                    |                      |
| Liabilities:                                                                                                                 |                                    |                      |
| Reserve for losses and loss expenses                                                                                         | \$ 2,809,797                       | 2,745,799            |
| Unearned premiums                                                                                                            | 880,698                            | 844,847              |
| Notes payable                                                                                                                | 262,326                            | 274,606              |
| Accrued salaries and benefits                                                                                                | 101,464                            | 103,802              |
| Other liabilities                                                                                                            | 187,920                            | 143,398              |
| Total liabilities                                                                                                            | \$ 4,242,205                       | 4,112,452            |
| Stockholders' Equity:                                                                                                        |                                    |                      |
| Preferred stock of \$0 par value per share:                                                                                  |                                    |                      |
| Authorized shares 5,000,000; no shares issued or outstanding                                                                 | \$ -                               | -                    |
| Common stock of \$2 par value per share                                                                                      |                                    |                      |
| Authorized shares 360,000,000                                                                                                |                                    |                      |
| Issued: 96,189,223 – 2010; 95,822,959 – 2009                                                                                 | 192,378                            | 191,646              |
| Additional paid-in capital                                                                                                   | 241,472                            | 231,933              |
| Retained earnings                                                                                                            | 1,159,496                          | 1,138,978            |

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|                                                                         |              |           |
|-------------------------------------------------------------------------|--------------|-----------|
| Accumulated other comprehensive income (loss)                           | 48,220       | (12,460)  |
| Treasury stock – at cost (shares: 42,677,198 – 2010; 42,578,779 – 2009) | (549,250)    | (547,722) |
| Total stockholders' equity                                              | 1,092,316    | 1,002,375 |
| Commitments and contingencies                                           |              |           |
| Total liabilities and stockholders' equity                              | \$ 5,334,521 | 5,114,827 |

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

## SELECTIVE INSURANCE GROUP, INC.

## UNAUDITED CONSOLIDATED STATEMENTS OF INCOME

| (\$ in thousands, except per share amounts)                                                                                  | Quarter ended         |                       | Nine Months ended     |                       |
|------------------------------------------------------------------------------------------------------------------------------|-----------------------|-----------------------|-----------------------|-----------------------|
|                                                                                                                              | September 30,<br>2010 | September 30,<br>2009 | September 30,<br>2010 | September 30,<br>2009 |
| <b>Revenues:</b>                                                                                                             |                       |                       |                       |                       |
| Net premiums earned                                                                                                          | \$ 354,709            | 355,906               | 1,063,101             | 1,078,090             |
| Net investment income earned                                                                                                 | 32,986                | 36,585                | 104,237               | 78,670                |
| Net realized gains (losses):                                                                                                 |                       |                       |                       |                       |
| Net realized investment gains (losses)                                                                                       | 2,864                 | (741)                 | 13,960                | 3,515                 |
| Other-than-temporary impairments                                                                                             | (4,091)               | (5,833)               | (16,326)              | (45,467)              |
| Other-than-temporary impairments on fixed maturity securities recognized in other comprehensive income                       | 1,284                 | 1,591                 | (905)                 | 1,650                 |
| Total net realized gains (losses)                                                                                            | 57                    | (4,983)               | (3,271)               | (40,302)              |
| Other income                                                                                                                 | 1,950                 | 2,667                 | 6,465                 | 7,758                 |
| <b>Total revenues</b>                                                                                                        | <b>389,702</b>        | <b>390,175</b>        | <b>1,170,532</b>      | <b>1,124,216</b>      |
| <b>Expenses:</b>                                                                                                             |                       |                       |                       |                       |
| Losses and loss expenses incurred                                                                                            | 245,019               | 242,032               | 739,142               | 733,275               |
| Policy acquisition costs                                                                                                     | 114,042               | 114,520               | 346,143               | 342,148               |
| Interest expense                                                                                                             | 4,559                 | 4,751                 | 14,056                | 14,618                |
| Other expenses                                                                                                               | 4,022                 | 7,045                 | 18,636                | 21,083                |
| <b>Total expenses</b>                                                                                                        | <b>367,642</b>        | <b>368,348</b>        | <b>1,117,977</b>      | <b>1,111,124</b>      |
| <b>Income from continuing operations, before federal income tax</b>                                                          | <b>22,060</b>         | <b>21,827</b>         | <b>52,555</b>         | <b>13,092</b>         |
| <b>Federal income tax expense (benefit):</b>                                                                                 |                       |                       |                       |                       |
| Current                                                                                                                      | (1,691)               | (426)                 | 8,475                 | 3,818                 |
| Deferred                                                                                                                     | 4,920                 | 1,647                 | (1,435)               | (13,740)              |
| <b>Total federal income tax expense (benefit)</b>                                                                            | <b>3,229</b>          | <b>1,221</b>          | <b>7,040</b>          | <b>(9,922)</b>        |
| <b>Net income from continuing operations</b>                                                                                 | <b>18,831</b>         | <b>20,606</b>         | <b>45,515</b>         | <b>23,014</b>         |
| Loss from discontinued operations, net of tax of \$(4,147) for Third Quarter 2009 and \$(4,106) for Nine Months 2009         |                       |                       |                       |                       |
|                                                                                                                              | -                     | (7,599)               | -                     | (7,196)               |
| Loss on disposal of discontinued operations, net of tax of \$(880) for Third Quarter 2010 and \$(2,019) for Nine Months 2010 |                       |                       |                       |                       |
|                                                                                                                              | (1,634)               | -                     | (3,749)               | -                     |
| <b>Total discontinued operations, net of tax</b>                                                                             | <b>(1,634)</b>        | <b>(7,599)</b>        | <b>(3,749)</b>        | <b>(7,196)</b>        |
| <b>Net income</b>                                                                                                            | <b>\$ 17,197</b>      | <b>13,007</b>         | <b>41,766</b>         | <b>15,818</b>         |
| <b>Earnings per share:</b>                                                                                                   |                       |                       |                       |                       |
| Basic net income from continuing operations                                                                                  | 0.35                  | 0.39                  | 0.85                  | 0.44                  |
| Basic net loss from disposal of discontinued operations                                                                      | (0.03)                | (0.14)                | (0.07)                | (0.14)                |
| <b>Basic net income</b>                                                                                                      | <b>\$ 0.32</b>        | <b>0.25</b>           | <b>0.78</b>           | <b>0.30</b>           |
| <b>Diluted net income from continuing operations</b>                                                                         | <b>0.35</b>           | <b>0.38</b>           | <b>0.84</b>           | <b>0.43</b>           |

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|                                                           |         |        |        |        |
|-----------------------------------------------------------|---------|--------|--------|--------|
| Diluted net loss from disposal of discontinued operations | (0.03)  | (0.14) | (0.07) | (0.13) |
| Diluted net income                                        | \$ 0.32 | 0.24   | 0.77   | 0.30   |
| Dividends to stockholders                                 | \$ 0.13 | 0.13   | 0.39   | 0.39   |

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

SELECTIVE INSURANCE GROUP, INC.  
 UNAUDITED CONSOLIDATED STATEMENTS OF  
 STOCKHOLDERS' EQUITY

| (\$ in thousands, except per share amounts)                                                                                                 | Nine Months ended September 30, |           |         |           |
|---------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------|-----------|---------|-----------|
|                                                                                                                                             | 2010                            |           | 2009    |           |
| <b>Common stock:</b>                                                                                                                        |                                 |           |         |           |
| Beginning of year                                                                                                                           | \$                              | 191,646   |         | 190,527   |
| Dividend reinvestment plan<br>(shares: 81,471 – 2010; 96,265 – 2009)                                                                        |                                 | 163       |         | 193       |
| Stock purchase and compensation plans<br>(shares: 284,793 – 2010; 274,517 – 2009)                                                           |                                 | 569       |         | 549       |
| End of period                                                                                                                               |                                 | 192,378   |         | 191,269   |
| <b>Additional paid-in capital:</b>                                                                                                          |                                 |           |         |           |
| Beginning of year                                                                                                                           |                                 | 231,933   |         | 217,195   |
| Dividend reinvestment plan                                                                                                                  |                                 | 1,098     |         | 1,136     |
| Stock purchase and compensation plans                                                                                                       |                                 | 8,441     |         | 9,873     |
| End of period                                                                                                                               |                                 | 241,472   |         | 228,204   |
| <b>Retained earnings:</b>                                                                                                                   |                                 |           |         |           |
| Beginning of year                                                                                                                           |                                 | 1,138,978 |         | 1,128,149 |
| Cumulative effect adjustment due to adoption of<br>other-than-temporary<br>impairment guidance under ASC 320, net of deferred income<br>tax |                                 | -         |         | 2,380     |
| Net income                                                                                                                                  |                                 | 41,766    | 41,766  | 15,818    |
| Cash dividends to stockholders (\$0.39 per share – 2010;<br>\$0.39 per share – 2009)                                                        |                                 | (21,248)  |         | (20,932)  |
| End of period                                                                                                                               |                                 | 1,159,496 |         | 1,125,415 |
| <b>Accumulated other comprehensive income (loss):</b>                                                                                       |                                 |           |         |           |
| Beginning of year                                                                                                                           |                                 | (12,460)  |         | (100,666) |
| Cumulative-effect adjustment due to adoption of<br>other-than-temporary<br>impairment guidance under ASC 320, net of deferred income<br>tax |                                 | -         |         | (2,380)   |
| <b>Other comprehensive income (loss), increase (decrease) in:</b>                                                                           |                                 |           |         |           |
| <b>Unrealized gains on investment securities:</b>                                                                                           |                                 |           |         |           |
| Non-credit portion of other-than-temporary impairment<br>losses<br>recognized in other comprehensive income, net of deferred<br>income tax  |                                 | 3,026     |         | (998)     |
| Other net unrealized gains on investment securities, net of<br>deferred income tax                                                          |                                 | 55,556    |         | 91,529    |
| Total unrealized gains on investment securities                                                                                             |                                 | 58,582    | 58,582  | 90,531    |
| Defined benefit pension plans, net of deferred income tax                                                                                   |                                 | 2,098     | 2,098   | 1,377     |
| End of period                                                                                                                               |                                 | 48,220    |         | (11,138)  |
| Comprehensive income                                                                                                                        |                                 |           | 102,446 | 107,726   |



## Treasury stock:

|                                                                          |              |           |
|--------------------------------------------------------------------------|--------------|-----------|
| Beginning of year                                                        | (547,722)    | (544,712) |
| Acquisition of treasury stock<br>(shares: 98,419 – 2010; 172,937 – 2009) | (1,528)      | (2,709)   |
| End of period                                                            | (549,250)    | (547,421) |
| Total stockholders' equity                                               | \$ 1,092,316 | 986,329   |

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

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

## SELECTIVE INSURANCE GROUP, INC.

## UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOW

Nine Months ended  
September 30,

(\$ in thousands)

2010 2009

## Operating Activities

|            |           |        |
|------------|-----------|--------|
| Net Income | \$ 41,766 | 15,818 |
|------------|-----------|--------|

## Adjustments to reconcile net income to net cash provided by operating activities:

|                                                            |         |          |
|------------------------------------------------------------|---------|----------|
| Depreciation and amortization                              | 23,175  | 21,045   |
| Loss on disposal of discontinued operations                | 3,749   | -        |
| Stock-based compensation expense                           | 9,774   | 9,178    |
| Undistributed (income) losses of equity method investments | (6,338) | 26,744   |
| Net realized losses                                        | 3,271   | 40,302   |
| Postretirement life curtailment benefit                    | -       | (4,217)  |
| Unrealized gain on trading securities                      | -       | (262)    |
| Goodwill impairment                                        | -       | 12,214   |
| Deferred tax benefit                                       | (1,435) | (17,666) |

## Changes in assets and liabilities:

|                                                                                    |          |          |
|------------------------------------------------------------------------------------|----------|----------|
| Increase in reserves for losses and loss expenses, net of reinsurance recoverables | 32,912   | 47,631   |
| Increase in unearned premiums, net of prepaid reinsurance and advance premiums     | 25,123   | 39,121   |
| (Increase) decrease in net federal income tax recoverable                          | (5,079)  | 13,252   |
| Increase in premiums receivable                                                    | (13,817) | (10,275) |
| Decrease (increase) in deferred policy acquisition costs                           | 11       | (11,375) |
| (Increase) decrease in interest and dividends due or accrued                       | (1,491)  | 1,038    |
| Decrease in accrued salaries and benefits                                          | (2,749)  | (10,920) |
| Decrease in accrued insurance expenses                                             | (6,872)  | (4,242)  |
| Sale of trading securities                                                         | -        | 2,831    |
| Other-net                                                                          | 1,284    | (2,905)  |
| Net adjustments                                                                    | 61,518   | 151,494  |
| Net cash provided by operating activities                                          | 103,284  | 167,312  |

## Investing Activities

|                                                                            |             |             |
|----------------------------------------------------------------------------|-------------|-------------|
| Purchase of fixed maturity securities, held-to-maturity                    | -           | (158,827)   |
| Purchase of fixed maturity securities, available-for-sale                  | (699,133)   | (757,538)   |
| Purchase of equity securities, available-for-sale                          | (47,930)    | (75,856)    |
| Purchase of other investments                                              | (14,348)    | (13,466)    |
| Purchase of short-term investments                                         | (1,409,971) | (1,600,685) |
| Sale of subsidiary                                                         | 681         | -           |
| Sale of fixed maturity securities, held-to-maturity                        | -           | 5,819       |
| Sale of fixed maturity securities, available-for-sale                      | 157,823     | 470,202     |
| Sale of short-term investments                                             | 1,358,779   | 1,561,901   |
| Redemption and maturities of fixed maturity securities, held-to-maturity   | 238,923     | 197,095     |
| Redemption and maturities of fixed maturity securities, available-for-sale | 251,875     | 88,402      |
| Sale of equity securities, available-for-sale                              | 76,277      | 125,211     |
| Proceeds from other investments                                            | 18,468      | 23,149      |
| Purchase of property and equipment                                         | (4,062)     | (4,139)     |
| Net cash used in investing activities                                      | (72,618)    | (138,732)   |

## Financing Activities

|                                                                        |          |          |
|------------------------------------------------------------------------|----------|----------|
| Dividends to stockholders                                              | (19,516) | (19,833) |
| Acquisition of treasury stock                                          | (1,528)  | (2,709)  |
| Principal payment of notes payable                                     | (12,300) | (12,300) |
| Net proceeds from stock purchase and compensation plans                | 3,084    | 2,914    |
| Excess tax benefits from share-based payment arrangements              | (795)    | (1,125)  |
| Net cash used in financing activities                                  | (31,055) | (33,053) |
| Net decrease in cash and cash equivalents                              | (389)    | (4,473)  |
| Net decrease in cash and cash equivalents from discontinued operations | -        | (1,609)  |
| Net decrease in cash from continuing operations                        | (389)    | (2,864)  |
| Cash from continuing operations, beginning of year                     | 811      | 3,606    |
| Cash from continuing operations, end of period                         | \$ 422   | 742      |

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

## NOTES TO UNAUDITED INTERIM CONSOLIDATED FINANCIAL STATEMENTS

### NOTE 1. Organization

Selective Insurance Group, Inc., through its subsidiaries, (collectively referred to as “we,” “us,” or “our”) offers property and casualty insurance products. Selective Insurance Group, Inc. (referred to as the “Parent”) was incorporated in New Jersey in 1977 and its main offices are located in Branchville, New Jersey. The Parent’s common stock is publicly traded on the NASDAQ Global Select Market under the symbol “SIGL.”

We classify our business into two operating segments:

- Insurance Operations, which sells property and casualty insurance products and services primarily in 22 states in the Eastern and Midwestern U.S.; and
- Investments.

### NOTE 2. Basis of Presentation

These interim unaudited consolidated financial statements (“Financial Statements”) include the accounts of the Parent and its subsidiaries, and have been prepared in conformity with: (i) U.S. generally accepted accounting principles (“GAAP”); and (ii) the rules and regulations of the U.S. Securities and Exchange Commission (“SEC”) regarding interim financial reporting. The preparation of Financial Statements in conformity with GAAP requires us to make estimates and assumptions that affect the reported financial statement balances, as well as the disclosure of contingent assets and liabilities. Actual results could differ from those estimates. All significant intercompany accounts and transactions between the Parent and its subsidiaries are eliminated in consolidation.

These Financial Statements reflect all adjustments that, in our opinion, are normal, recurring, and necessary for a fair presentation of our results of operations and financial condition. The Financial Statements cover the third quarters ended September 30, 2010 (“Third Quarter 2010”) and September 30, 2009 (“Third Quarter 2009”) and the nine-month periods ended September 30, 2010 (“Nine Months 2010”) and September 30, 2009 (“Nine Months 2009”). The Financial Statements do not include all of the information and disclosures required by GAAP and the SEC for audited financial statements. Results of operations for any interim period are not necessarily indicative of results for a full year. Consequently, the Financial Statements should be read in conjunction with the consolidated financial statements contained in our Annual Report on Form 10-K for the year ended December 31, 2009 (“2009 Annual Report”).

### NOTE 3. Reclassification

Certain prior year amounts in these Financial Statements and related footnotes have been reclassified to conform to the current year presentation. Such reclassifications had no effect on our net income, stockholders’ equity, or cash flows.

### NOTE 4. Adoption of Accounting Pronouncements

In December 2009, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Codification (“ASC”) Update 2009-16, Transfers and Servicing (Topic 860) – Accounting for Transfers of Financial Assets. This guidance: (i) eliminates the concept of a qualifying “special-purpose entity”; (ii) alters the requirements for transferring assets off of the reporting company’s balance sheet; (iii) requires additional disclosure about a transferor’s involvement in transferred assets; and (iv) eliminates special treatment of guaranteed mortgage securitizations. The adoption of this guidance, which was effective for fiscal years beginning after November 15, 2009, did not impact our financial condition or results of operations.

In December 2009, the FASB issued ASC Update 2009-17, Consolidations (Topic 810) – Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities. This guidance requires the reporting entity to perform a qualitative analysis that results in a variable interest entity (“VIE”) being consolidated if the reporting entity: (i) has the power to direct activities of the VIE that significantly impact the VIE’s financial performance; and

(ii) has an obligation to absorb losses or receive benefits that may be significant to the VIE. This guidance further requires enhanced disclosures, including disclosure of significant judgments and assumptions as to whether a VIE must be consolidated, and how involvement with a VIE affects the company's financial statements. The adoption of this guidance, which was effective for fiscal years beginning after November 15, 2009, did not impact our financial condition or results of operations.

In January 2010, the FASB issued ASC Update 2010-06, Fair Value Measurements and Disclosures (Topic 820 – Improving Disclosures about Fair Value Measurements). This guidance requires: (i) separate disclosure of significant transfers between Level 1 and Level 2 of the fair value hierarchy and reasons for the transfers; (ii) disclosure, on a gross basis, of purchases, sales, issuances, and net settlements within Level 3 of the fair value hierarchy; (iii) disclosures by class of assets and liabilities; and (iv) a description of the valuation techniques and inputs used to measure fair value for both recurring and nonrecurring fair value measurements. This guidance is effective for reporting periods beginning after December 15, 2009, except for the Level 3 disclosure requirements, which will be effective for fiscal years beginning after December 15, 2010 and interim periods within those fiscal years. We have included the disclosures required by this guidance in our notes to the consolidated financial statements, where appropriate.

#### Accounting Pronouncements to be Adopted

In October 2010, the FASB issued ASU Update 2010-26, Financial Services-Insurance (Topic 944) – Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts. This guidance requires that only costs that are incremental or directly related to the successful acquisition of new or renewal insurance contracts are to be capitalized as a deferred acquisition cost. This would include, among other items, sales commissions paid to agents, premium taxes, and the portion of employee salaries and benefits directly related to time spent on acquired contracts. This guidance is effective, either with a prospective or retrospective application, for interim and annual periods beginning after December 15, 2011, with early adoption permitted. Although we are currently evaluating the impact of this guidance, we anticipate that a significant portion of our deferred policy acquisition costs balance may be eliminated under the newly issued guidance, resulting in a reduction to GAAP equity. Deferred policy acquisition cost totaled \$218.6 million as of September 30, 2010.

#### NOTE 5. Statements of Cash Flow

Our cash paid (received) during the period for interest and federal income tax was as follows:

| (\$ in thousands)                           | Nine Months ended September 30, |         |
|---------------------------------------------|---------------------------------|---------|
|                                             | 2010                            | 2009    |
| Cash paid (received) during the period for: |                                 |         |
| Interest                                    | \$ 11,620                       | 11,879  |
| Federal income tax                          | 14,000                          | (8,500) |

## NOTE 6. Investments

(a) The carrying value, unrecognized holding gains and losses, and fair values of held-to-maturity (“HTM”) fixed maturity securities were as follows:

September 30, 2010

| (\$ in thousands)                                            | Amortized<br>Cost | Net<br>Unrealized<br>Gains<br>(Losses) | Carrying<br>Value | Unrecognized<br>Holding<br>Gains | Unrecognized<br>Holding<br>Losses | Fair<br>Value |
|--------------------------------------------------------------|-------------------|----------------------------------------|-------------------|----------------------------------|-----------------------------------|---------------|
| U.S. government and government agencies                      | \$ 94,677         | 4,904                                  | 99,581            | 7,530                            | -                                 | 107,111       |
| Obligations of state and political subdivisions              | 995,521           | 24,989                                 | 1,020,510         | 38,314                           | (213)                             | 1,058,611     |
| Corporate securities                                         | 87,145            | (3,974)                                | 83,171            | 10,945                           | -                                 | 94,116        |
| Asset-backed securities (“ABS”)                              | 14,165            | (2,574)                                | 11,591            | 1,591                            | (424)                             | 12,758        |
| Commercial mortgage-backed securities (“CMBS”) <sup>1</sup>  | 64,355            | (6,009)                                | 58,346            | 7,438                            | (1,375)                           | 64,409        |
| Residential mortgage-backed securities (“RMBS”) <sup>2</sup> | 98,000            | 1,499                                  | 99,499            | 3,639                            | -                                 | 103,138       |
| Total HTM fixed maturity securities                          | \$ 1,353,863      | 18,835                                 | 1,372,698         | 69,457                           | (2,012)                           | 1,440,143     |

December 31, 2009

| (\$ in thousands)                               | Amortized<br>Cost | Net<br>Unrealized<br>Gains<br>(Losses) | Carrying<br>Value | Unrecognized<br>Holding<br>Gains | Unrecognized<br>Holding<br>Losses | Fair<br>Value |
|-------------------------------------------------|-------------------|----------------------------------------|-------------------|----------------------------------|-----------------------------------|---------------|
| U.S. government and government agencies         | \$ 139,278        | 5,555                                  | 144,833           | 1,694                            | (549)                             | 145,978       |
| Obligations of state and political subdivisions | 1,167,461         | 33,951                                 | 1,201,412         | 14,833                           | (5,450)                           | 1,210,795     |
| Corporate securities                            | 104,854           | (6,028)                                | 98,826            | 9,665                            | (913)                             | 107,578       |
| ABS                                             | 32,025            | (5,707)                                | 26,318            | 3,920                            | (82)                              | 30,156        |
| CMBS <sup>1</sup>                               | 110,812           | (19,171)                               | 91,641            | 7,407                            | (3,658)                           | 95,390        |
| RMBS <sup>2</sup>                               | 146,124           | 1,249                                  | 147,373           | 3,153                            | (212)                             | 150,314       |
| Total HTM fixed maturity securities             | \$ 1,700,554      | 9,849                                  | 1,710,403         | 40,672                           | (10,864)                          | 1,740,211     |

<sup>1</sup> CMBS includes government guaranteed agency securities with a carrying value of \$9.9 million at September 30, 2010 and \$10.8 million at December 31, 2009.

<sup>2</sup> RMBS includes government guaranteed agency securities with a carrying value of \$4.0 million at September 30, 2010 and \$3.9 million at December 31, 2009.

Unrecognized holding gains/losses of HTM securities are not reflected in the consolidated financial statements, as they represent market value fluctuations from the later of: (i) the date a security is designated as HTM; or (ii) the date that an other-than-temporary impairment (“OTTI”) charge is recognized on an HTM security, through the date of the balance sheet. Our HTM securities had an average duration of 3.4 years as of September 30, 2010 and 3.5 years as of December 31, 2009.





(b) The cost/amortized cost, unrealized gains (losses), and fair value of available-for-sale (“AFS”) securities were as follows:

September 30, 2010

| (\$ in thousands)                                    | Cost/<br>Amortized<br>Cost | Unrealized<br>Gains | Unrealized<br>Losses | Fair<br>Value |
|------------------------------------------------------|----------------------------|---------------------|----------------------|---------------|
| U.S. government and government agencies <sup>1</sup> | \$ 318,805                 | 11,829              | -                    | 330,634       |
| Foreign government                                   | 7,908                      | 632                 | -                    | 8,540         |
| Obligations of states and political subdivisions     | 446,716                    | 33,610              | (5)                  | 480,321       |
| Corporate securities                                 | 820,970                    | 48,628              | (113)                | 869,485       |
| ABS                                                  | 23,334                     | 897                 | (218)                | 24,013        |
| CMBS <sup>2</sup>                                    | 98,338                     | 6,783               | (3,079)              | 102,042       |
| RMBS <sup>3</sup>                                    | 290,614                    | 11,117              | (1,717)              | 300,014       |
| AFS fixed maturity securities                        | 2,006,685                  | 113,496             | (5,132)              | 2,115,049     |
| AFS equity securities                                | 55,051                     | 8,065               | -                    | 63,116        |
| Total AFS securities                                 | \$ 2,061,736               | 121,561             | (5,132)              | 2,178,165     |

December 31, 2009

| (\$ in thousands)                                    | Cost/<br>Amortized<br>Cost | Unrealized<br>Gains | Unrealized<br>Losses | Fair<br>Value |
|------------------------------------------------------|----------------------------|---------------------|----------------------|---------------|
| U.S. government and government agencies <sup>1</sup> | \$ 473,750                 | 2,994               | (1,210)              | 475,534       |
| Obligations of states and political subdivisions     | 359,517                    | 20,419              | (137)                | 379,799       |
| Corporate securities                                 | 365,500                    | 15,330              | (1,246)              | 379,584       |
| ABS                                                  | 17,638                     | 358                 | (17)                 | 17,979        |
| CMBS <sup>2</sup>                                    | 102,514                    | 1,854               | (677)                | 103,691       |
| RMBS <sup>3</sup>                                    | 297,537                    | 2,457               | (20,712)             | 279,282       |
| AFS fixed maturity securities                        | 1,616,456                  | 43,412              | (23,999)             | 1,635,869     |
| AFS equity securities                                | 64,390                     | 16,484              | (610)                | 80,264        |
| Total AFS securities                                 | \$ 1,680,846               | 59,896              | (24,609)             | 1,716,133     |

<sup>1</sup> U.S. government includes corporate securities fully guaranteed by the Federal Depositary Insurance Corporation (“FDIC”) with a fair value of \$121.7 million at September 30, 2010 and \$136.2 million at December 31, 2009.

<sup>2</sup> CMBS includes government guaranteed agency securities with a fair value of \$74.7 million at September 30, 2010 and \$94.6 million at December 31, 2009.

<sup>3</sup> RMBS includes government guaranteed agency securities with a fair value of \$93.5 million at September 30, 2010 and \$105.2 million at December 31, 2009.

Unrealized gains/losses represent market value fluctuations from the later of: (i) the date of security is designated as AFS; or (ii) the date that an OTTI charge is recognized on an AFS security, through the date of the balance sheet. These unrealized gains and losses are recorded in accumulated other comprehensive income (“AOCI”) on the Consolidated Balance Sheets.

During Nine Months 2010, 34 securities with a carrying value of \$85.1 million in a net unrecognized gain position of \$4.6 million were reclassified from the HTM category to AFS due to recent credit rating downgrades by either Moody’s Investors Service (“Moody’s”) or Standard and Poor’s Financial Services (“S&P”). These unexpected rating

downgrades raised significant concerns about the issuers' credit worthiness, which changed our intention to hold these securities to maturity.

(c) The following tables summarize, for all securities in a net unrealized/unrecognized loss position at September 30, 2010 and December 31, 2009, the fair value and gross pre-tax net unrealized/unrecognized loss by asset class, and by length of time those securities have been in a net loss position:

| September 30, 2010<br>(\$ in thousands)          | Less than 12 months |                                | 12 months or longer <sup>1</sup> |                                |
|--------------------------------------------------|---------------------|--------------------------------|----------------------------------|--------------------------------|
|                                                  | Fair Value          | Unrealized Losses <sup>2</sup> | Fair Value                       | Unrealized Losses <sup>2</sup> |
| <b>AFS securities</b>                            |                     |                                |                                  |                                |
| Obligations of states and political subdivisions | \$ 505              | (5)                            | -                                | -                              |
| Corporate securities                             | 41,792              | (113)                          | -                                | -                              |
| ABS                                              | -                   | -                              | 933                              | (218)                          |
| CMBS                                             | -                   | -                              | 11,048                           | (3,079)                        |
| RMBS                                             | 24,297              | (109)                          | 30,116                           | (1,608)                        |
| Total fixed maturity securities                  | 66,594              | (227)                          | 42,097                           | (4,905)                        |
| Equity securities                                | -                   | -                              | -                                | -                              |
| Subtotal                                         | \$ 66,594           | (227)                          | 42,097                           | (4,905)                        |

| (\$ in thousands)                                | Less than 12 months |                                |                                          | 12 months or longer <sup>1</sup> |                                |                                          |
|--------------------------------------------------|---------------------|--------------------------------|------------------------------------------|----------------------------------|--------------------------------|------------------------------------------|
|                                                  | Fair Value          | Unrealized Losses <sup>2</sup> | Unrecognized Gains (Losses) <sup>3</sup> | Fair Value                       | Unrealized Losses <sup>2</sup> | Unrecognized Gains (Losses) <sup>3</sup> |
| <b>HTM securities</b>                            |                     |                                |                                          |                                  |                                |                                          |
| Obligations of states and political subdivisions | \$ 5,579            | (264)                          | 249                                      | 33,546                           | (2,508)                        | 1,404                                    |
| Corporate securities                             | -                   | -                              | -                                        | 5,872                            | (927)                          | 774                                      |
| ABS                                              | 534                 | (547)                          | (414)                                    | 6,723                            | (1,972)                        | 1,270                                    |
| CMBS                                             | 3,640               | 36                             | (38)                                     | 5,510                            | (1,993)                        | (1,337)                                  |
| RMBS                                             | -                   | -                              | -                                        | 94                               | (39)                           | -                                        |
| Subtotal                                         | \$ 9,753            | (775)                          | (203)                                    | 51,745                           | (7,439)                        | 2,111                                    |
| Total AFS and HTM                                | \$ 76,347           | (1,002)                        | (203)                                    | 93,842                           | (12,344)                       | 2,111                                    |

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| December 31, 2009<br>(\$ in thousands)               | Less than 12 months <sup>1</sup> |                                | 12 months or longer <sup>1</sup> |                                |
|------------------------------------------------------|----------------------------------|--------------------------------|----------------------------------|--------------------------------|
|                                                      | Fair Value                       | Unrealized Losses <sup>2</sup> | Fair Value                       | Unrealized Losses <sup>2</sup> |
| <b>AFS securities</b>                                |                                  |                                |                                  |                                |
| U.S. government and government agencies <sup>4</sup> | \$ 187,283                       | (1,210)                        | -                                | -                              |
| Obligations of states and political subdivisions     | 8,553                            | (120)                          | 3,059                            | (17)                           |
| Corporate securities                                 | 74,895                           | (829)                          | 10,550                           | (417)                          |
| ABS                                                  | 2,983                            | (17)                           | -                                | -                              |
| CMBS                                                 | 36,447                           | (637)                          | 3,960                            | (40)                           |
| RMBS                                                 | 78,328                           | (514)                          | 53,607                           | (20,198)                       |
| Total fixed maturity securities                      | 388,489                          | (3,327)                        | 71,176                           | (20,672)                       |
| Equity securities                                    | 3,828                            | (214)                          | 5,932                            | (396)                          |
| Subtotal                                             | \$ 392,317                       | (3,541)                        | 77,108                           | (21,068)                       |

| (\$ in thousands)                                    | Less than 12 months <sup>1</sup> |                                |                                          | 12 months or longer <sup>1</sup> |                                |                                          |
|------------------------------------------------------|----------------------------------|--------------------------------|------------------------------------------|----------------------------------|--------------------------------|------------------------------------------|
|                                                      | Fair Value                       | Unrealized Losses <sup>2</sup> | Unrecognized Gains (Losses) <sup>3</sup> | Fair Value                       | Unrealized Losses <sup>2</sup> | Unrecognized Gains (Losses) <sup>3</sup> |
| <b>HTM securities</b>                                |                                  |                                |                                          |                                  |                                |                                          |
| U.S. government and government agencies <sup>4</sup> | \$ 29,459                        | -                              | (317)                                    | -                                | -                              | -                                        |
| Obligations of states and political subdivisions     | 46,671                           | (598)                          | 85                                       | 74,360                           | (4,315)                        | 1,631                                    |
| Corporate securities                                 | 6,124                            | (1,170)                        | 1,068                                    | 19,233                           | (4,751)                        | 3,441                                    |
| ABS                                                  | -                                | -                              | -                                        | 10,403                           | (4,633)                        | 2,197                                    |
| CMBS                                                 | 316                              | (538)                          | (190)                                    | 24,984                           | (15,650)                       | (604)                                    |
| RMBS                                                 | 5,068                            | -                              | (146)                                    | 5,892                            | (1,062)                        | 127                                      |
| Subtotal                                             | \$ 87,638                        | (2,306)                        | 500                                      | 134,872                          | (30,411)                       | 6,792                                    |
| Total AFS and HTM                                    | \$ 479,955                       | (5,847)                        | 500                                      | 211,980                          | (51,479)                       | 6,792                                    |

1 The month count for aging of unrealized losses was reset back to historical unrealized loss month counts for securities impacted by the adoption of OTTI guidance in Second Quarter 2009 and for securities that were transferred from an AFS to HTM category.

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

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

4 U.S. government includes corporate securities fully guaranteed by the FDIC.

Unrealized/unrecognized losses decreased by \$38.6 million compared to December 31, 2009 due to: (i) the general improvement in the overall marketplace for our fixed maturity securities portfolio, which is reflected in the reduction in the number of securities in an unrealized/unrecognized loss position; and (ii) the sale of certain fixed maturity securities that resulted in a decrease to unrealized/unrecognized losses of \$14.3 million. For further discussion on realized gains and losses, see section (i) of this note below.

We have reviewed the securities in the tables above in accordance with our OTTI policy, which is discussed in Note 2. "Summary of Significant Accounting Policies" in Item 8. "Financial Statements and Supplementary Data." of our 2009 Annual Report. At September 30, 2010, securities that had an unrealized/unrecognized loss position for more than 12 months amounted to \$10.2 million, primarily driven by a \$6.4 million unrealized/unrecognized loss in our CMBS portfolio. This includes: (i) \$4.0 million of non-credit OTTI charges recognized in AOCI that were generated concurrently with credit-related charges; and (ii) \$2.4 million of securities with an average decline in fair value of 20% of their amortized cost. Evaluations were performed on the securities which indicated that the impairments were temporary. All scheduled principal and interest payments have been received to date. The remaining \$3.8 million of unrealized/unrecognized losses are comprised of 45 securities, 14 of which are RMBS. Declines in the fair value of these 45 securities averaged 5% of their amortized cost.

We do not have the intent to sell any securities in an unrealized/unrecognized loss position nor do we believe we will be required to sell these securities, and therefore we have concluded that they are temporarily impaired as of September 30, 2010. This conclusion reflects our current judgment as to the financial position and future prospects of the entity that issued the investment security and underlying collateral. If our judgment about an individual security changes in the future, we may ultimately record a credit loss after having originally concluded that one did not exist, which could have a material impact on our net income and financial position in future periods.

(d) Fixed maturity securities at September 30, 2010, by contractual maturity, are shown below. Mortgage-backed securities are included in the maturity tables using the estimated average life of each security. Expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

Listed below are HTM fixed maturity securities at September 30, 2010:

| (\$ in thousands)                     | Carrying Value | Fair Value |
|---------------------------------------|----------------|------------|
| Due in one year or less               | \$ 201,742     | 202,505    |
| Due after one year through five years | 732,566        | 767,509    |
| Due after five years through 10 years | 417,911        | 447,037    |
| Due after 10 years                    | 20,479         | 23,092     |
| Total HTM fixed maturity securities   | \$ 1,372,698   | 1,440,143  |

Listed below are AFS fixed maturity securities at September 30, 2010:

| (\$ in thousands)                     | Fair Value   |
|---------------------------------------|--------------|
| Due in one year or less               | \$ 91,156    |
| Due after one year through five years | 1,258,704    |
| Due after five years through 10 years | 719,254      |
| Due after 10 years                    | 45,935       |
| Total AFS fixed maturity securities   | \$ 2,115,049 |

(e) The following table outlines a summary of our other investment portfolio by strategy and the remaining commitment amount associated with each strategy:

| Other Investments             | Carrying Value |              | September 30,        |
|-------------------------------|----------------|--------------|----------------------|
|                               | September 30,  | December 31, | 2010                 |
| (\$ in thousands)             | 2010           | 2009         | Remaining Commitment |
| Alternative Investments       |                |              |                      |
| Energy/Power Generation       | \$ 34,212      | 32,996       | 11,139               |
| Secondary Private Equity      | 28,605         | 20,936       | 21,184               |
| Mezzanine Financing           | 23,409         | 20,323       | 26,119               |
| Private Equity                | 23,235         | 21,525       | 15,427               |
| Distressed Debt               | 20,380         | 19,201       | 4,611                |
| Real Estate                   | 15,709         | 16,856       | 12,192               |
| Venture Capital               | 6,341          | 5,752        | 1,400                |
| Total Alternative Investments | 151,891        | 137,589      | 92,072               |
| Other Securities              | 2,837          | 3,078        | -                    |
| Total Other Investments       | \$ 154,728     | 140,667      | 92,072               |

The increase in other investments of \$14.1 million at September 30, 2010 compared to December 31, 2009 was primarily due to the \$14.3 million increase in the value of our alternative investments, which included fundings under

our existing commitments of \$3.2 million, net of distributions received. Alternative investments are reported to us on a quarter lag, and therefore the increase was driven primarily by improved equity and credit markets as well as increased stability in the financial markets during the first half of 2010.

For a description of our seven alternative investment strategies outlined above, refer to Note 5. “Investments” in Item 8. “Financial Statements and Supplementary Data.” of our 2009 Annual Report. Our seven alternative investment strategies employ low or moderate levels of leverage and generally use hedging only to reduce foreign exchange or interest rate volatility. At this time, our alternative investment strategies do not include hedge funds. We cannot redeem our investments with the general partners of these investments; however, occasionally these partnerships do trade on the secondary market. Once liquidation is triggered by clauses within the limited partnership agreements or at the funds’ stated end date, we will receive our final allocation of capital and any earned appreciation of the underlying investments, assuming we have not divested ourselves of our partnership interests prior to that time. We currently receive distributions from these alternative investments through the realization of the underlying investments in the limited partnerships. We anticipate that the general partners of these alternative investments will liquidate their underlying investment portfolios through 2023.

(f) At September 30, 2010, we had one fixed maturity security, with a carrying value of \$15.8 million that was pledged as collateral for our outstanding borrowing with the Federal Home Loan Bank of Indianapolis (“FHLBI”). This borrowing, which has an outstanding principal balance of \$13.0 million, is included in “Notes payable” on our Consolidated Balance Sheets. In accordance with the terms of our agreement with the FHLBI, we retain all rights regarding this security, which is included in the “U.S. government and government agencies” classification of our AFS fixed maturity securities portfolio.

(g) The components of net investment income earned were as follows:

| (\$ in thousands)            | Quarter ended<br>September 30, |         | Nine Months ended<br>September 30, |          |
|------------------------------|--------------------------------|---------|------------------------------------|----------|
|                              | 2010                           | 2009    | 2010                               | 2009     |
| Fixed maturity securities    | \$ 31,741                      | 34,747  | 97,914                             | 106,980  |
| Equity securities            | 347                            | 551     | 1,279                              | 1,562    |
| Trading securities           | -                              | -       | -                                  | 262      |
| Short-term investments       | 134                            | 237     | 367                                | 1,161    |
| Other investments            | 2,400                          | 2,713   | 11,216                             | (26,451) |
| Investment expenses          | (1,636)                        | (1,663) | (6,539)                            | (4,844)  |
| Net investment income earned | \$ 32,986                      | 36,585  | 104,237                            | 78,670   |

Net investment income, before tax, decreased by \$3.6 million for Third Quarter 2010 compared to Third Quarter 2009, and increased by \$25.6 million for Nine Months 2010 compared to Nine Months 2009. For Third Quarter, the decrease was primarily driven by a \$3.0 million decrease in income on our fixed maturity securities due to lower yields as compared to the prior year. The improvement in Nine Months 2010 was primarily attributable to an increase in income on the alternative investment portion of our other investment portfolio compared to a loss on these investments in the comparable period during 2009, partially offset by: (i) lower fixed maturity reinvestment yields; and (ii) increased investment expense related to severance payments and contract termination costs as a result of our decision to outsource the management of our investment portfolio.

Our alternative investments, which are included in “Other investments” in the table above, are accounted for under the equity method and primarily consist of investments in limited partnerships. The improvement in the returns on these investments is reflective of improved equity and credit markets, as well as increased stability in the financial markets.



(h) The following tables summarize OTTI by asset type for the periods indicated:

| Third Quarter 2010<br>(\$ in thousands) | Gross    | Included in Other<br>Comprehensive<br>Income ("OCI") | Recognized in<br>Earnings |
|-----------------------------------------|----------|------------------------------------------------------|---------------------------|
| <b>Fixed maturity securities</b>        |          |                                                      |                           |
| CMBS                                    | \$ 2,116 | 1,245                                                | 871                       |
| RMBS                                    | 150      | 39                                                   | 111                       |
| Total fixed maturity securities         | 2,266    | 1,284                                                | 982                       |
| Equity securities                       | 1,825    | -                                                    | 1,825                     |
| OTTI losses                             | \$ 4,091 | 1,284                                                | 2,807                     |

| Third Quarter 2009<br>(\$ in thousands) | Gross    | Included in OCI | Recognized in<br>Earnings |
|-----------------------------------------|----------|-----------------|---------------------------|
| <b>Fixed maturity securities</b>        |          |                 |                           |
| Corporate securities                    | \$ -     | -               | -                         |
| ABS                                     | 68       | -               | 68                        |
| CMBS                                    | -        | -               | -                         |
| RMBS                                    | 5,473    | 1,591           | 3,882                     |
| Total fixed maturity securities         | 5,541    | 1,591           | 3,950                     |
| Equity securities                       | 292      | -               | 292                       |
| OTTI losses                             | \$ 5,833 | 1,591           | 4,242                     |

| Nine Months 2010<br>(\$ in thousands) | Gross     | Included in OCI | Recognized in<br>Earnings |
|---------------------------------------|-----------|-----------------|---------------------------|
| <b>Fixed maturity securities</b>      |           |                 |                           |
| ABS                                   | \$ 158    | 127             | 31                        |
| CMBS                                  | 5,561     | (807)           | 6,368                     |
| RMBS                                  | 8,110     | (225)           | 8,335                     |
| Total fixed maturity securities       | 13,829    | (905)           | 14,734                    |
| Equity securities                     | 2,497     | -               | 2,497                     |
| OTTI losses                           | \$ 16,326 | (905)           | 17,231                    |

| Nine Months 2009<br>(\$ in thousands) | Gross     | Included in OCI | Recognized in<br>Earnings |
|---------------------------------------|-----------|-----------------|---------------------------|
| <b>Fixed maturity securities</b>      |           |                 |                           |
| Corporate securities                  | \$ 1,270  | -               | 1,270                     |
| ABS                                   | 1,595     | (826)           | 2,421                     |
| CMBS                                  | 1,417     | 706             | 711                       |
| RMBS                                  | 39,447    | 1,770           | 37,677                    |
| Total fixed maturity securities       | 43,729    | 1,650           | 42,079                    |
| Equity securities                     | 1,738     | -               | 1,738                     |
| OTTI losses                           | \$ 45,467 | 1,650           | 43,817                    |

The following tables set forth, for the periods indicated, credit loss impairments on fixed maturity securities for which a portion of the OTTI charge was recognized in OCI, and the corresponding changes in such amounts:

## Third Quarter 2010

| (\$ in thousands)                                                                                                                                                                              | Gross     |
|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------|
| Balance, June 30, 2010                                                                                                                                                                         | \$ 20,343 |
| Addition for the amount related to credit loss for which an OTTI was not previously recognized                                                                                                 | 192       |
| Reductions for securities sold during the period                                                                                                                                               | -         |
| Reductions for securities for which the amount previously recognized in OCI was recognized in earnings because of intention or potential requirement to sell before recovery of amortized cost | -         |
| Reductions for securities for which the entire amount previously recognized in OCI was recognized in earnings due to a decrease in cash flows expected                                         | (3,254)   |
| Additional increases to the amount related to credit loss for which an OTTI was previously recognized                                                                                          | 530       |
| Accretion of credit loss impairments previously recognized due to an increase in cash flows expected to be collected                                                                           | -         |
| Balance, September 30, 2010                                                                                                                                                                    | \$ 17,811 |

## Third Quarter 2009

| (\$ in thousands)                                                                                                                                                                              | Gross     |
|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------|
| Balance, June, 30, 2009                                                                                                                                                                        | \$ 11,643 |
| Addition for the amount related to credit loss for which an OTTI was not previously recognized                                                                                                 | 72        |
| Reductions for securities sold during the period                                                                                                                                               | -         |
| Reductions for securities for which the amount previously recognized in OCI was recognized in earnings because of intention or potential requirement to sell before recovery of amortized cost | -         |
| Reductions for securities for which the entire amount previously recognized in OCI was recognized in earnings due to a decrease in cash flows expected                                         | -         |
| Additional increases to the amount related to credit loss for which an OTTI was previously recognized                                                                                          | -         |
| Accretion of credit loss impairments previously recognized due to an increase in cash flows expected to be collected                                                                           | -         |
| Balance, September 30, 2009                                                                                                                                                                    | \$ 11,715 |

## Nine Months 2010

| (\$ in thousands)                                                                                                                                                                              | Gross     |
|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------|
| Balance, December 31, 2009                                                                                                                                                                     | \$ 22,189 |
| Addition for the amount related to credit loss for which an OTTI was not previously recognized                                                                                                 | 2,326     |
| Reductions for securities sold during the period                                                                                                                                               | (2,990)   |
| Reductions for securities for which the amount previously recognized in OCI was recognized in earnings because of intention or potential requirement to sell before recovery of amortized cost | -         |
| Reductions for securities for which the entire amount previously recognized in OCI was recognized in earnings due to a decrease in cash flows expected                                         | (7,906)   |
|                                                                                                                                                                                                | 4,192     |

Additional increases to the amount related to credit loss for which an OTTI was previously recognized

|                                                                                                                      |           |
|----------------------------------------------------------------------------------------------------------------------|-----------|
| Accretion of credit loss impairments previously recognized due to an increase in cash flows expected to be collected | -         |
| Balance, September 30, 2010                                                                                          | \$ 17,811 |

Nine Months 2009

(\$ in thousands)

|                                                                                                                                                                                                | Gross     |
|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------|
| Balance, March 31, 2009                                                                                                                                                                        | \$ -      |
| Credit losses remaining in retained earnings after adoption of OTTI accounting guidance                                                                                                        | 9,719     |
| Addition for the amount related to credit loss for which an OTTI was not previously recognized                                                                                                 | -         |
| Reductions for securities sold during the period                                                                                                                                               | -         |
| Reductions for securities for which the amount previously recognized in OCI was recognized in earnings because of intention or potential requirement to sell before recovery of amortized cost | -         |
| Reductions for securities for which the entire amount previously recognized in OCI was recognized in earnings due to a decrease in cash flows expected                                         | -         |
| Additional increases to the amount related to credit loss for which an OTTI was previously recognized                                                                                          | 1,996     |
| Accretion of credit loss impairments previously recognized due to an increase in cash flows expected to be collected                                                                           | -         |
| Balance, September 30, 2009                                                                                                                                                                    | \$ 11,715 |

The following is a discussion surrounding the OTTI charges that were recognized in earnings in Third Quarter and Nine Months 2010 as outlined in the table above:

- \$0.1 million and \$8.3 million of RMBS credit OTTI charges in Third Quarter and Nine Months 2010, respectively. The Third Quarter 2010 charges related to declines in the related cash flows of the underlying collateral. Based on our analysis, we do not believe it is probable that we will receive all contractual cash flows for these securities. In addition to the Third Quarter 2010 charges, losses in Nine Months 2010 were largely driven by impairments on two securities in the first quarter of 2010 that we intended to sell. We sold these securities in Second Quarter 2010.
- \$0.9 million and \$6.4 million of CMBS credit OTTI charges in Third Quarter and Nine Months 2010, respectively. These charges were related to reductions in the related cash flows of the underlying collateral of these securities. These charges were primarily associated with securities that had been previously impaired but, over time, have shown little, if any, improvement in valuations, poor net operating income performance of the underlying properties, and, in some cases, an increase in over 60-day delinquency rates. For Third Quarter 2010, these securities had, on average, unrealized/unrecognized loss positions of more than 60% of their amortized cost. Based on our analysis, we do not believe it is probable that we will receive all contractual cash flows for these securities.
- \$1.8 million and \$2.5 million of equity OTTI charges in Third Quarter and Nine Months 2010, respectively. These charges were driven primarily by a change in our intent to hold these securities to recovery in the near term as we lower our exposure to equities and pursue a more index-neutral position for this asset class in the near term, providing greater sector and sponsor diversification.

The following is a discussion surrounding the credit-related OTTI charges taken in Third Quarter and Nine Months 2009 as outlined in the table above:

- \$3.9 million and \$37.7 million of RMBS credit OTTI charges in Third Quarter and Nine Months 2009, respectively. As of September 30, 2009, we had the intention to sell one security in a loss position and, as a result, recorded an OTTI charge in Third Quarter 2009 for the related \$3.8 million unrealized loss position on this security. Additional charges taken during the year related to securities that experienced declines in the cash flows of their underlying collateral. Based on our assumptions of the expected default rates and loss severities, we did not believe it was probable that we would receive all contractual cash flows for these securities.
- There were no CMBS credit OTTI charges in Third Quarter 2009 and \$0.7 million for Nine Months 2009. These charges related to declines in the related cash flows of the underlying collateral. For these securities, based on our assumptions of the expected default rates and loss severities, we did not believe it was probable that we would receive all contractual cash flows for these securities.
- \$0.1 million and \$2.4 million of ABS credit OTTI charges in Third Quarter and Nine Months 2009, respectively. These charges related primarily to two bonds from the same issuer that were previously written down, which experienced a technical default in the first quarter of 2009 by violating indenture covenants. There was no payment default on these securities, but we believed a payment default was imminent and had recorded impairment charges for these securities. These charges also include additional credit impairment losses on another security that was previously written down in 2008 which, based on our assumptions of the conditional default rates and loss severities, indicated that it was probable that we would not receive all contractual cash flows for this security.
- \$1.3 million for Nine Months 2009 of corporate debt credit OTTI charges. In assessing corporate debt securities for OTTI, we evaluate, among other things, the issuer's ability to meet its debt obligations, the value of the company, and, if applicable, the value of specific collateral securing the position. These charges were primarily related to a financial institution issuer that we believed to be on the verge of bankruptcy. This security was sold in Third Quarter 2009 at an additional loss of \$1.1 million.
- \$0.3 million and \$1.7 million of equity charges in Third Quarter and Nine Months 2009, respectively, related to securities issued by two banks, one energy company, a membership warehouse chain of stores, and one bank exchange traded fund. We believed the share price weakness of these securities was more reflective of general overall financial market conditions, as we were not aware of any significant deterioration in the fundamentals of these four companies. However, the length of time these securities had been in an unrealized loss position, and the

overall distressed trading levels of many banking stocks in the financial services sector, coal stocks in the energy sector, and retail/wholesale store stocks made a recovery to our cost basis unlikely in the near term.

(i) The components of net realized losses, excluding OTTI charges, were as follows:

| (\$ in thousands)                                         | Quarter ended<br>September 30, |                | Nine Months ended<br>September 30, |                 |
|-----------------------------------------------------------|--------------------------------|----------------|------------------------------------|-----------------|
|                                                           | 2010                           | 2009           | 2010                               | 2009            |
| <b>HTM fixed maturity securities</b>                      |                                |                |                                    |                 |
| Gains                                                     | \$ 123                         | 81             | 535                                | 219             |
| Losses                                                    | (296)                          | (236)          | (746)                              | (530)           |
| <b>AFS fixed maturity securities</b>                      |                                |                |                                    |                 |
| Gains                                                     | 2,961                          | 4,154          | 7,743                              | 17,752          |
| Losses                                                    | (15)                           | (4,441)        | (7,604)                            | (13,400)        |
| <b>AFS equity securities</b>                              |                                |                |                                    |                 |
| Gains                                                     | 912                            | 551            | 15,086                             | 29,257          |
| Losses                                                    | (821)                          | -              | (1,054)                            | (27,744)        |
| <b>Other Investments</b>                                  |                                |                |                                    |                 |
| Gains                                                     | -                              | -              | -                                  | -               |
| Losses                                                    | -                              | (850)          | -                                  | (2,039)         |
| <b>Total other net realized investment gains (losses)</b> | <b>2,864</b>                   | <b>(741)</b>   | <b>13,960</b>                      | <b>3,515</b>    |
| <b>Total OTTI charges recognized in earnings</b>          | <b>(2,807)</b>                 | <b>(4,242)</b> | <b>(17,231)</b>                    | <b>(43,817)</b> |
| <b>Total net realized gains (losses)</b>                  | <b>\$ 57</b>                   | <b>(4,983)</b> | <b>(3,271)</b>                     | <b>(40,302)</b> |

Realized gains and losses on the sale of investments are determined on the basis of the cost of the specific investments sold. Proceeds from the sale of AFS securities were \$49.7 million in Third Quarter 2010 and \$234.1 million in Nine Months 2010. In addition to calls and maturities, the net realized gain, excluding OTTI charges, in Third Quarter 2010 was driven by the sale of AFS fixed maturity securities, primarily corporate holdings. In addition, as part of our transition to the newly hired external investment managers, in Third Quarter 2010, we changed our intent regarding certain equity holdings that we sold to lower our equity exposure and pursue a more index-neutral position for this asset class in the near term, providing greater sector and sponsor diversification. The sale of these equity holdings resulted in gross realized gains of \$0.9 million and gross realized losses of \$0.8 million.

In addition to the Third Quarter 2010 realized gains discussed above, Nine Months 2010 realized gains were driven by: (i) the sale of energy-focused AFS equity securities in the second quarter of 2010 to mitigate portfolio risk and sector exposure; and (ii) sales in the first quarter of 2010 that were predominantly associated with tax planning strategies. These gains were largely offset by realized losses on certain AFS fixed maturity securities in the second quarter of 2010 that our new investment managers, during their initial review of the portfolio, had recommended that we sell. This recommendation was due to ongoing credit concerns of the underlying investments coupled with strategically positioning the portfolio to generate maximum yield while balancing risk objectives.

During the second quarter of 2009, A.M. Best Company (“A.M. Best”) changed our ratings outlook from “Stable” to “Negative” due, in part, to concerns over the risk in our investment portfolio. To reduce this risk, we sold \$31.1 million of equity securities in the second quarter of 2009 for a net loss of \$0.6 million, which included gross gains of \$7.7 million and gross losses of \$8.3 million. In addition, certain equity securities were sold in the first quarter of 2009, resulting in a net realized gain of approximately \$0.6 million, comprised of \$19.7 million in realized gains and \$19.1 million in realized losses. These securities were sold in an effort to reduce overall portfolio risk and was in response to an overall year-to-date market decline of approximately 24% by the end of the first week of March. In addition, the Parent’s market capitalization at that time had decreased more than 50% since the latter part of January, which we believed to be due partially to investment community views of our equity and equity-like investments. Our equity-like investments include alternative investments, many of which report results to us on a one quarter

lag. Consequently, we believed that the investment community would wait to evaluate our results based on the knowledge they had of the previous quarter's general market conditions. As a result, we determined it was prudent to mitigate a portion of our overall equity exposure. In determining which securities were to be sold, we contemplated, among other things, security-specific considerations with respect to downward earnings trends corroborated by recent analyst reports, primarily in the energy, commodity, and pharmaceutical sectors.

## NOTE 7. Fair Values Measurements

The following table presents the carrying amounts and estimated fair values of our financial instruments as of September 30, 2010 and December 31, 2009:

| (\$ in thousands)                                    | September 30, 2010 |            | December 31, 2009 |            |
|------------------------------------------------------|--------------------|------------|-------------------|------------|
|                                                      | Carrying Amount    | Fair Value | Carrying Amount   | Fair Value |
| <b>Financial Assets</b>                              |                    |            |                   |            |
| Fixed maturity securities:                           |                    |            |                   |            |
| HTM                                                  | \$ 1,372,698       | 1,440,143  | 1,710,403         | 1,740,211  |
| AFS                                                  | 2,115,049          | 2,115,049  | 1,635,869         | 1,635,869  |
| Equity securities, AFS                               | 63,116             | 63,116     | 80,264            | 80,264     |
| Short-term investments                               | 265,043            | 265,043    | 213,848           | 213,848    |
| Receivable for proceeds related to sale of Selective |                    |            |                   |            |
| HR Solutions Inc. ("Selective HR")                   | 5,239              | 5,239      | -                 | -          |
| <b>Financial Liabilities</b>                         |                    |            |                   |            |
| Notes payable:1                                      |                    |            |                   |            |
| 7.25% Senior Notes                                   | 49,903             | 50,221     | 49,900            | 49,505     |
| 6.70% Senior Notes                                   | 99,423             | 93,600     | 99,406            | 90,525     |
| 7.50% Junior Notes                                   | 100,000            | 99,920     | 100,000           | 83,680     |
| 2.90% borrowings from FHLBI                          | 13,000             | 13,684     | 13,000            | 13,000     |
| 8.87% Senior Notes Series B                          | -                  | -          | 12,300            | 12,300     |
| Total notes payable                                  | \$ 262,326         | 257,425    | 274,606           | 249,010    |

1 Our notes payable are subject to certain debt covenants that were met in their entirety in 2009 and Nine Months 2010. For further discussion regarding the debt covenants, refer to Note 10, "Indebtedness" in Item 8. "Financial Statements and Supplementary Data." in our 2009 Annual Report.

## Assets

The fair value of our investment portfolio is generated using various valuation techniques and is placed into the fair value hierarchy considering the following: (i) the highest priority is given to quoted prices in active markets for identical assets (Level 1); (ii) the next highest priority is given to quoted prices in markets that are not active or inputs that are observable either directly or indirectly, including quoted prices for similar assets in markets that are not active and other inputs that can be derived principally from, or corroborated by, observable market data for substantially the full term of the assets (Level 2); and (iii) the lowest priority is given to unobservable inputs supported by little or no market activity and that reflect our assumptions about the exit price, including assumptions that market participants would use in pricing the asset (Level 3). An asset's classification within the fair value hierarchy is based on the lowest level of significant input to its valuation.

For discussion regarding the techniques used to value our investment portfolio, refer to Note 2. "Summary of Significant Accounting Policies" in Item 8. "Financial Statements and Supplementary Data." in our 2009 Annual Report. The fair values of the fixed maturity securities classified as Level 3 are estimated using non-binding broker quotes. The fair value of the receivable for proceeds related to the sale of Selective HR is estimated using a discounted cash flow analysis with updated worksite lives and retention assumptions. For discussion of the sale of Selective HR, refer to Note 15. "Discontinued Operations."

## Liabilities

The techniques used to value our notes payable are as follows:



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- The fair values of the 7.25% Senior Notes due November 15, 2034, the 6.70% Senior Notes due November 1, 2035, and the 7.5% Junior Subordinated Notes due September 27, 2066, are based on quoted market prices.
- The fair value of the 2.90% borrowings from FHLBI is estimated using a discounted cash flow analysis based on a current borrowing rate provided by the FHLBI consistent with the remaining term of the borrowing.
- The fair value of the 8.87% Senior Notes as of December 31, 2009 that matured on May 4, 2010 was estimated to be its carrying value due to the close proximity of this note's maturity date to the balance sheet date.

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The following tables provide quantitative disclosures of our financial assets that were measured at fair value at September 30, 2010 and December 31, 2009:

September 30, 2010

| (\$ in thousands)<br>Description                        | Fair Value Measurements Using            |                                                           |                                                      |                                                 |
|---------------------------------------------------------|------------------------------------------|-----------------------------------------------------------|------------------------------------------------------|-------------------------------------------------|
|                                                         | Assets Measured at Fair Value at 9/30/10 | Active Markets for Identical Assets/Liabilities (Level 1) | Quoted Prices in Significant Assets/Inputs (Level 2) | Other Significant Unobservable Inputs (Level 3) |
| Measured on a recurring basis:                          |                                          |                                                           |                                                      |                                                 |
| U.S. government and government agencies <sup>1</sup>    | \$ 330,634                               | 106,541                                                   | 224,093                                              | -                                               |
| Foreign government                                      | 8,540                                    | -                                                         | 8,540                                                | -                                               |
| Obligations of states and political subdivisions        | 480,321                                  | -                                                         | 480,321                                              | -                                               |
| Corporate securities                                    | 869,485                                  | -                                                         | 869,485                                              | -                                               |
| ABS                                                     | 24,013                                   | -                                                         | 21,276                                               | 2,737                                           |
| CMBS                                                    | 102,042                                  | -                                                         | 101,712                                              | 330                                             |
| RMBS                                                    | 300,014                                  | -                                                         | 300,014                                              | -                                               |
| Total AFS fixed maturity securities                     | 2,115,049                                | 106,541                                                   | 2,005,441                                            | 3,067                                           |
| Equity securities                                       | 63,116                                   | 63,116                                                    | -                                                    | -                                               |
| Short-term investments                                  | 265,043                                  | 265,043                                                   | -                                                    | -                                               |
| Measured on a non-recurring basis:                      |                                          |                                                           |                                                      |                                                 |
| CMBS, HTM                                               | 1,847                                    | -                                                         | -                                                    | 1,847                                           |
| RMBS, HTM                                               | 94                                       | -                                                         | 94                                                   | -                                               |
| Receivable for proceeds related to sale of Selective HR | 5,239                                    | -                                                         | -                                                    | 5,239                                           |
| Total assets                                            | \$ 2,450,388                             | 434,700                                                   | 2,005,535                                            | 10,153                                          |

<sup>1</sup> U.S. government includes corporate securities fully guaranteed by the FDIC.

December 31, 2009

| (\$ in thousands)<br>Description                     | Fair Value Measurements Using             |                                                           |                                                      |                                                 |
|------------------------------------------------------|-------------------------------------------|-----------------------------------------------------------|------------------------------------------------------|-------------------------------------------------|
|                                                      | Assets Measured at Fair Value at 12/31/09 | Active Markets for Identical Assets/Liabilities (Level 1) | Quoted Prices in Significant Assets/Inputs (Level 2) | Other Significant Unobservable Inputs (Level 3) |
| Measured on a recurring basis:                       |                                           |                                                           |                                                      |                                                 |
| U.S. government and government agencies <sup>1</sup> | \$ 475,534                                | 52,361                                                    | 423,173                                              | -                                               |
| Obligations of states and political subdivisions     | 379,799                                   | -                                                         | 379,799                                              | -                                               |
| Corporate securities                                 | 379,584                                   | -                                                         | 379,584                                              | -                                               |
| ABS                                                  | 17,979                                    | -                                                         | 17,979                                               | -                                               |
| CMBS                                                 | 103,691                                   | -                                                         | 103,691                                              | -                                               |
| RMBS                                                 | 279,282                                   | -                                                         | 279,282                                              | -                                               |
| Total AFS fixed maturity securities                  | 1,635,869                                 | 52,361                                                    | 1,583,508                                            | -                                               |
| Equity securities                                    | 80,264                                    | 80,264                                                    | -                                                    | -                                               |
| Short-term investments                               | 213,848                                   | 213,848                                                   | -                                                    | -                                               |
| Measured on a non-recurring basis:                   |                                           |                                                           |                                                      |                                                 |

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|              |              |         |           |   |
|--------------|--------------|---------|-----------|---|
| ABS, HTM     | 2,412        | -       | 2,412     | - |
| CMBS, HTM    | 5,400        | -       | 5,400     | - |
| Total assets | \$ 1,937,793 | 346,473 | 1,591,320 | - |

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

The following assets were written down to fair value on a non-recurring basis as of September 30, 2010:

- As the result of our OTTI analysis, we impaired approximately \$1.9 million of HTM securities down to fair value, which are typically not carried at fair value.
- Due to changes in assumptions regarding worksite life generation and retention, we reduced the value of our receivable for the expected proceeds from the sale of Selective HR, which we are scheduled to receive over the course of a 10-year period. This fair value was determined using Level 3 pricing. The reduction in this receivable is included in “Loss on disposal of discontinued operations” on the Consolidated Statement of Income.

The following table provides a summary of the changes in fair value of securities using Level 3 inputs for Third Quarter and Nine Months 2010. The transfers of the CMBS, AFS securities between levels in the fair value hierarchy in Third Quarter and Nine Months 2010 were driven primarily by the availability and nature of the broker quotes used at the valuation dates:

Third Quarter 2010

| (\$ in thousands)                                    | ABS, AFS | CMBS, AFS | TOTAL   |
|------------------------------------------------------|----------|-----------|---------|
| Fair value, June 30, 2010                            | \$ -     | 3,253     | 3,253   |
| Total net gains (losses) for the period included in: |          |           |         |
| Other comprehensive income <sup>1</sup>              | -        | 1,799     | 1,799   |
| Net income <sup>2</sup>                              | -        | 55        | 55      |
| Purchases, sales, issuances, and settlements (net)   | 2,737    | (137)     | 2,600   |
| Net transfers in and/or out of Level 3 <sup>3</sup>  | -        | (4,640)   | (4,640) |
| Fair value, September 30, 2010                       | \$ 2,737 | 330       | 3,067   |

Nine Months 2010

| (\$ in thousands)                                    | ABS, AFS | CMBS, AFS | TOTAL   |
|------------------------------------------------------|----------|-----------|---------|
| Fair value, December 31, 2009                        | \$ -     | -         | -       |
| Total net gains (losses) for the period included in: |          |           |         |
| Other comprehensive income <sup>1</sup>              | -        | 1,799     | 1,799   |
| Net income <sup>2</sup>                              | -        | 55        | 55      |
| Purchases, sales, issuances, and settlements (net)   | 2,737    | (137)     | 2,600   |
| Net transfers in and/or out of Level 3 <sup>3</sup>  | -        | (1,387)   | (1,387) |
| Fair value, September 30, 2010                       | \$ 2,737 | 330       | 3,067   |

1 Amounts are reported in "Other net unrealized gains on investment securities, net of deferred income tax" on the Consolidated Statements of Stockholders' Equity.

2 Amounts are reported in "Net realized investment gains (losses)" on the Consolidated Statements of Income.

3 Transfers between levels in the fair value hierarchy are recognized at the end of the reporting period.

NOTE 8. Reinsurance

The following table contains a listing of direct, assumed, and ceded reinsurance amounts by income statement caption. For more information concerning reinsurance, refer to Note 8. "Reinsurance" in Item 8. "Financial Statements and Supplementary Data." in our 2009 Annual Report.

| (\$ in thousands)        | Quarter ended<br>September 30, |          | Nine Months ended<br>September 30, |           |
|--------------------------|--------------------------------|----------|------------------------------------|-----------|
|                          | 2010                           | 2009     | 2010                               | 2009      |
| <b>Premiums written:</b> |                                |          |                                    |           |
| Direct                   | \$ 431,312                     | 435,169  | 1,274,061                          | 1,294,019 |
| Assumed                  | 15,372                         | 11,250   | 21,561                             | 18,611    |
| Ceded                    | (79,570)                       | (69,701) | (206,893)                          | (194,866) |
| Net                      | \$ 367,114                     | 376,718  | 1,088,729                          | 1,117,764 |
| <b>Premiums earned:</b>  |                                |          |                                    |           |
| Direct                   | \$ 413,759                     | 413,007  | 1,238,912                          | 1,244,840 |
| Assumed                  | 9,158                          | 5,944    | 20,858                             | 16,677    |

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|       |            |          |           |           |
|-------|------------|----------|-----------|-----------|
| Ceded | (68,208)   | (63,045) | (196,669) | (183,427) |
| Net   | \$ 354,709 | 355,906  | 1,063,101 | 1,078,090 |

Losses and loss expenses incurred:

|         |            |          |           |          |
|---------|------------|----------|-----------|----------|
| Direct  | \$ 277,111 | 264,650  | 834,431   | 793,995  |
| Assumed | 6,612      | 4,134    | 11,535    | 11,207   |
| Ceded   | (38,704)   | (26,752) | (106,824) | (71,927) |
| Net     | \$ 245,019 | 242,032  | 739,142   | 733,275  |

The ceded premiums and losses related to our involvement with the National Flood Insurance Program (“NFIP”), in which all of our Flood premiums, losses, and loss expenses are ceded to the NFIP, are as follows:

| National Flood Insurance Program<br>(\$ in thousands) | Quarter ended<br>September 30, |          | Nine Months ended<br>September 30, |           |
|-------------------------------------------------------|--------------------------------|----------|------------------------------------|-----------|
|                                                       | 2010                           | 2009     | 2010                               | 2009      |
| Ceded premiums written                                | \$ (57,838)                    | (48,375) | (148,296)                          | (137,205) |
| Ceded premiums earned                                 | (47,240)                       | (43,432) | (137,220)                          | (127,858) |
| Ceded losses and loss expenses incurred               | \$ (11,227)                    | (8,729)  | (54,303)                           | (19,829)  |

**NOTE 9. Segment Information**

We have classified our operations into two segments, the disaggregated results of which are reported to and used by senior management to manage our operations:

- Insurance Operations, which is evaluated based on statutory underwriting results (net premiums earned, incurred losses and loss expenses, policyholders dividends, policy acquisition costs, and other underwriting expenses), and statutory combined ratios; and
  - Investments, which is evaluated based on net investment income and net realized gains and losses.

Our segments may, from time-to-time, provide services to each other in the normal course of business. These service transactions included transactions with our discontinued operations, Selective HR prior to its sale, and totaled \$2.3 million in Third Quarter 2009 and \$6.9 million in Nine Months 2009. These transactions were eliminated in all consolidated statements. For discussion of the 2009 sale of Selective HR, refer to Note 15. “Discontinued Operations.” In computing the results of each segment, we do not make adjustments for interest expense, net general corporate expenses, or federal income taxes. We do not maintain separate investment portfolios for the segments and therefore, do not allocate assets to the segments. In addition, we do not aggregate any of our operating segments.

The following summaries present revenues from continuing operations (net investment income and net realized losses on investments in the case of the Investments segment) and pre-tax income from continuing operations for the individual segments:

| Revenue from continuing operations by segment<br>(\$ in thousands) | Quarter ended<br>September 30, |         | Nine Months ended<br>September 30, |           |
|--------------------------------------------------------------------|--------------------------------|---------|------------------------------------|-----------|
|                                                                    | 2010                           | 2009    | 2010                               | 2009      |
| <b>Insurance Operations:</b>                                       |                                |         |                                    |           |
| Net premiums earned:                                               |                                |         |                                    |           |
| Commercial automobile                                              | \$ 73,440                      | 75,513  | 220,932                            | 226,698   |
| Workers compensation                                               | 63,165                         | 64,742  | 189,875                            | 201,709   |
| General liability                                                  | 83,250                         | 88,280  | 252,438                            | 274,357   |
| Commercial property                                                | 49,558                         | 49,880  | 150,188                            | 147,735   |
| Business owners’ policy                                            | 16,400                         | 15,804  | 48,838                             | 46,565    |
| Bonds                                                              | 4,884                          | 4,634   | 14,315                             | 13,817    |
| Other                                                              | 2,528                          | 2,426   | 7,548                              | 7,188     |
| Total commercial lines                                             | 293,225                        | 301,279 | 884,134                            | 918,069   |
| Personal automobile                                                | 35,927                         | 33,319  | 105,490                            | 99,205    |
| Homeowners                                                         | 22,544                         | 18,613  | 64,163                             | 53,337    |
| Other                                                              | 3,013                          | 2,695   | 9,314                              | 7,479     |
| Total personal lines                                               | 61,484                         | 54,627  | 178,967                            | 160,021   |
| Total net premiums earned                                          | 354,709                        | 355,906 | 1,063,101                          | 1,078,090 |
| Miscellaneous income                                               | 1,916                          | 2,657   | 6,413                              | 7,720     |

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|                                           |            |         |           |           |
|-------------------------------------------|------------|---------|-----------|-----------|
| Total Insurance Operations revenues       | 356,625    | 358,563 | 1,069,514 | 1,085,810 |
| Investments:                              |            |         |           |           |
| Net investment income                     | 32,986     | 36,585  | 104,237   | 78,670    |
| Net realized gain (loss) on investments   | 57         | (4,983) | (3,271)   | (40,302)  |
| Total investment revenues                 | 33,043     | 31,602  | 100,966   | 38,368    |
| Total all segments                        | 389,668    | 390,165 | 1,170,480 | 1,124,178 |
| Other income                              | 34         | 10      | 52        | 38        |
| Total revenues from continuing operations | \$ 389,702 | 390,175 | 1,170,532 | 1,124,216 |

20

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| Income from continuing operations, before federal income tax<br>(\$ in thousands) | Quarter ended         |               | Nine Months ended     |               |
|-----------------------------------------------------------------------------------|-----------------------|---------------|-----------------------|---------------|
|                                                                                   | September 30,<br>2010 | 2009          | September 30,<br>2010 | 2009          |
| <b>Insurance Operations:</b>                                                      |                       |               |                       |               |
| Commercial lines underwriting                                                     | \$ (26)               | 2,171         | (7,693)               | 10,185        |
| Personal lines underwriting                                                       | (3,907)               | (2,313)       | (14,006)              | (7,258)       |
| Underwriting (loss) income, before federal income tax                             | (3,933)               | (142)         | (21,699)              | 2,927         |
| GAAP combined ratio                                                               | 101.1%                | 100.0         | 102.0%                | 99.7          |
| Statutory combined ratio                                                          | 100.3%                | 99.8          | 101.4%                | 99.6          |
| <b>Investments:</b>                                                               |                       |               |                       |               |
| Net investment income                                                             | 32,986                | 36,585        | 104,237               | 78,670        |
| Net realized gain (loss) on investments                                           | 57                    | (4,983)       | (3,271)               | (40,302)      |
| Total investment income, before federal income tax                                | 33,043                | 31,602        | 100,966               | 38,368        |
| Total all segments                                                                | 29,110                | 31,460        | 79,267                | 41,295        |
| Interest expense                                                                  | (4,559)               | (4,751)       | (14,056)              | (14,618)      |
| General corporate and other expenses                                              | (2,491)               | (4,882)       | (12,656)              | (13,585)      |
| <b>Income from continuing operations, before federal income tax</b>               | <b>\$ 22,060</b>      | <b>21,827</b> | <b>52,555</b>         | <b>13,092</b> |

**NOTE 10. Federal Income Taxes**

Federal income taxes from continuing operations increased by: (i) \$2.0 million for Third Quarter 2010, to an expense of \$3.2 million, compared to an expense of \$1.2 million for Third Quarter 2009; and (ii) \$17.0 million for Nine Months 2010, to an expense of \$7.0 million compared to a benefit of \$9.9 million for Nine Months 2009. These increases, which are attributable to an increase in net investment income earned coupled with a reduction in net realized losses, resulted in an effective tax rate of approximately 15% for Third Quarter 2010 compared to an effective tax rate of 6% for Third Quarter 2009. The effective tax rate was 13% for Nine Months 2010, and the tax benefit in Nine Months 2009 of \$9.9 million resulted in an effective tax rate of (76)%. The Nine Months 2009 tax benefit resulted from lower pre-tax income associated with the decline in investment income and an increase in net realized losses. Our effective tax rate for continuing operations differs from the federal corporate rate of 35% primarily as a result of tax-advantaged investment income.



## NOTE 11. Retirement Plans

The following tables show the costs of the Retirement Income Plan for Selective Insurance Company of America (“Retirement Income Plan”) and the retirement life insurance component (“Retirement Life Plan”) of the Selective Insurance Company of America Welfare Benefits Plan. For more information concerning these plans, refer to Note 16. “Retirement Plans” in Item 8. “Financial Statements and Supplementary Data.” of our 2009 Annual Report.

| (\$ in thousands)                               | Retirement Income Plan      |         | Retirement Life Plan        |      |
|-------------------------------------------------|-----------------------------|---------|-----------------------------|------|
|                                                 | Quarter ended September 30, |         | Quarter ended September 30, |      |
|                                                 | 2010                        | 2009    | 2010                        | 2009 |
| <b>Components of Net Periodic Benefit Cost:</b> |                             |         |                             |      |
| Service cost                                    | \$ 1,842                    | 1,531   | -                           | -    |
| Interest cost                                   | 2,950                       | 2,695   | 80                          | 79   |
| Expected return on plan assets                  | (2,811)                     | (2,243) | -                           | -    |
| Amortization of unrecognized prior service cost | 38                          | 38      | -                           | -    |
| Amortization of unrecognized net loss           | 1,016                       | 1,202   | 1                           | -    |
| Net periodic cost                               | \$ 3,035                    | 3,223   | 81                          | 79   |

| (\$ in thousands)                                        | Retirement Income Plan |         | Retirement Life Plan |         |
|----------------------------------------------------------|------------------------|---------|----------------------|---------|
|                                                          | Nine Months ended      |         | Nine Months ended    |         |
|                                                          | September 30,          |         | September 30,        |         |
|                                                          | 2010                   | 2009    | 2010                 | 2009    |
| <b>Components of Net Periodic Benefit Cost:</b>          |                        |         |                      |         |
| Service cost                                             | \$ 5,784               | 5,538   | -                    | 32      |
| Interest cost                                            | 8,965                  | 8,237   | 238                  | 270     |
| Expected return on plan assets                           | (8,437)                | (6,977) | -                    | -       |
| Amortization of unrecognized prior service cost (credit) | 113                    | 113     | -                    | (44)    |
| Amortization of unrecognized net loss                    | 3,111                  | 3,437   | 4                    | -       |
| Curtailment benefit                                      | -                      | -       | -                    | (4,217) |
| Net periodic cost (benefit)                              | \$ 9,536               | 10,348  | 242                  | (3,959) |

**Weighted-Average Expense Assumptions for the years ended December 31:**

|                                | 2010  | 2009 | 2010  | 2009 |
|--------------------------------|-------|------|-------|------|
| Discount rate                  | 5.93% | 6.24 | 5.93% | 6.24 |
| Expected return on plan assets | 8.00% | 8.00 | -%    | -    |
| Rate of compensation increase  | 4.00% | 4.00 | 4.00% | 4.00 |

In the first quarter of 2009, Selective Insurance Company of America eliminated the benefits under the Retirement Life Plan to active employees. This elimination resulted in a curtailment to the plan, the benefit of which was \$4.2 million in Nine Months 2009 and was comprised of: (i) a \$2.8 million reversal of the Retirement Life Plan liability; and (ii) a \$1.4 million reversal of prior service credits and net actuarial losses included in Accumulated Other Comprehensive Loss.

We presently anticipate contributing \$8.0 million to the Retirement Income Plan in 2010, \$6.8 million of which has been funded as of September 30, 2010.



## NOTE 12. Comprehensive Income

The components of comprehensive income, both gross and net of tax, for Third Quarter 2010 and Third Quarter 2009 are as follows:

## Third Quarter 2010

| (\$ in thousands)                                             | Gross     | Tax    | Net    |
|---------------------------------------------------------------|-----------|--------|--------|
| Net income                                                    | \$ 19,546 | 2,349  | 17,197 |
| Components of other comprehensive income:                     |           |        |        |
| Unrealized gains on securities:                               |           |        |        |
| Unrealized holding gains during the period                    | 45,871    | 16,055 | 29,816 |
| Portion of OTTI recognized in OCI                             | (1,237)   | (433)  | (804)  |
| Amortization of net unrealized gains on HTM securities        | (1,383)   | (484)  | (899)  |
| Reclassification adjustment for losses included in net income | 2,454     | 859    | 1,595  |
| Net unrealized gains                                          | 45,705    | 15,997 | 29,708 |
| Defined benefit pension plans:                                |           |        |        |
| Reversal of amortization items:                               |           |        |        |
| Net actuarial loss                                            | 1,017     | 355    | 662    |
| Prior service credit                                          | 38        | 14     | 24     |
| Defined benefit pension plans                                 | 1,055     | 369    | 686    |
| Comprehensive income                                          | \$ 66,306 | 18,715 | 47,591 |

## Third Quarter 2009

| (\$ in thousands)                                             | Gross     | Tax     | Net     |
|---------------------------------------------------------------|-----------|---------|---------|
| Net income                                                    | \$ 10,081 | (2,926) | 13,007  |
| Components of other comprehensive income:                     |           |         |         |
| Unrealized gains on securities:                               |           |         |         |
| Unrealized holding gains during the period                    | 44,637    | 15,624  | 29,013  |
| Portion of OTTI recognized in OCI                             | (1,508)   | (528)   | (980)   |
| Amortization of net unrealized gains on HTM securities        | (3,976)   | (1,392) | (2,584) |
| Reclassification adjustment for losses included in net income | 7,375     | 2,581   | 4,794   |
| Net unrealized gains                                          | 46,528    | 16,285  | 30,243  |
| Defined benefit pension plans:                                |           |         |         |
| Reversal of amortization items:                               |           |         |         |
| Net actuarial loss                                            | 1,202     | 421     | 781     |
| Prior service credit                                          | 38        | 13      | 25      |
| Defined benefit pension plans                                 | 1,240     | 434     | 806     |
| Comprehensive income                                          | \$ 57,849 | 13,793  | 44,056  |

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The components of comprehensive income, both gross and net of tax, for Nine Months 2010 and Nine Months 2009 are as follows:

Nine Months 2010

| (\$ in thousands)                                             | Gross      | Tax     | Net     |
|---------------------------------------------------------------|------------|---------|---------|
| Net income                                                    | \$ 46,787  | 5,021   | 41,766  |
| Components of other comprehensive income:                     |            |         |         |
| Unrealized gains on securities:                               |            |         |         |
| Unrealized holding gains during the period                    | 92,569     | 32,399  | 60,170  |
| Portion of OTTI recognized in OCI                             | 4,655      | 1,629   | 3,026   |
| Amortization of net unrealized gains on HTM securities        | (7,938)    | (2,778) | (5,160) |
| Reclassification adjustment for losses included in net income | 840        | 294     | 546     |
| Net unrealized gains                                          | 90,126     | 31,544  | 58,582  |
| Defined benefit pension plans:                                |            |         |         |
| Reversal of amortization items:                               |            |         |         |
| Net actuarial loss                                            | 3,115      | 1,090   | 2,025   |
| Prior service credit                                          | 113        | 40      | 73      |
| Defined benefit pension plans                                 | 3,228      | 1,130   | 2,098   |
| Comprehensive income                                          | \$ 140,141 | 37,695  | 102,446 |

Nine Months 2009

| (\$ in thousands)                                             | Gross      | Tax      | Net     |
|---------------------------------------------------------------|------------|----------|---------|
| Net income                                                    | \$ 1,790   | (14,028) | 15,818  |
| Components of other comprehensive income:                     |            |          |         |
| Unrealized gains on securities:                               |            |          |         |
| Unrealized holding gains during the period                    | 100,912    | 35,320   | 65,592  |
| Portion of OTTI recognized in OCI                             | (1,535)    | (537)    | (998)   |
| Amortization of net unrealized gains on HTM securities        | 427        | 149      | 278     |
| Reclassification adjustment for losses included in net income | 39,475     | 13,816   | 25,659  |
| Net unrealized gains                                          | 139,279    | 48,748   | 90,531  |
| Defined benefit pension plans:                                |            |          |         |
| Reversal of amortization items:                               |            |          |         |
| Net actuarial loss                                            | 3,437      | 1,203    | 2,234   |
| Curtailment benefit                                           | (1,387)    | (485)    | (902)   |
| Prior service credit                                          | 69         | 24       | 45      |
| Defined benefit pension plans                                 | 2,119      | 742      | 1,377   |
| Comprehensive income                                          | \$ 143,188 | 35,462   | 107,726 |

The balances of, and changes in, each component of AOCI (net of taxes) as of September 30, 2010 are as follows:

September 30, 2010

| (\$ in thousands)          | Net Unrealized Gain (Loss) |             |           | Defined Benefit Pension Plans | Total Accumulated OCI |
|----------------------------|----------------------------|-------------|-----------|-------------------------------|-----------------------|
|                            | OTTI Related               | HTM Related | All Other |                               |                       |
| Balance, December 31, 2009 | \$ (8,009)                 | 11,937      | 25,410    | (41,798)                      | (12,460)              |

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|                                    |            |        |        |          |        |
|------------------------------------|------------|--------|--------|----------|--------|
| Changes in component during period | 3,026      | 2,057  | 53,499 | 2,098    | 60,680 |
| Balance, September 30, 2010        | \$ (4,983) | 13,994 | 78,909 | (39,700) | 48,220 |

NOTE 13. Commitments and Contingencies

At September 30, 2010, we had contractual obligations to invest up to an additional \$92.1 million in other investments that expire at various dates through 2023. There is no certainty that any such additional investment will be required.

## NOTE 14. Litigation

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

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

## NOTE 15. Discontinued Operations

In December 2009, we sold 100% of our interest in Selective HR, which had historically comprised the human resource administration outsourcing segment of our operations. We sold our interest in Selective HR for proceeds scheduled to be received over a 10-year period based on the ability of the purchaser to retain and generate new worksite lives through our independent agency distribution channel. In Third Quarter 2010 and Nine Months 2010, we recorded an after-tax charge of \$1.6 million and \$3.7 million, respectively, primarily due to our revaluation of the contingent proceeds, including assumptions regarding worksite life generation and retention, bringing our estimated sales price to approximately \$6.9 million of which \$1.7 million has been received as of September 30, 2010 as compared to \$12.3 million at December 31, 2009.

The following tables reflect the reclassification of the operating results of Selective HR as a discontinued operation as of September 30, 2009:

|                   | Third<br>Quarter<br>2009 | Nine<br>Months<br>2009 |
|-------------------|--------------------------|------------------------|
| (\$ in thousands) |                          |                        |
| Net revenue       | \$ 10,641                | 34,414                 |
| Pre-tax loss      | (11,746)                 | (11,302)               |
| After-tax loss    | (7,599)                  | (7,196)                |

Intercompany transactions related to the discontinued operations are as follows as of September 30, 2009:

|                   | Third<br>Quarter<br>2009 | Nine<br>Months<br>2009 |
|-------------------|--------------------------|------------------------|
| (\$ in thousands) |                          |                        |
| Net revenue       | \$ 2,318                 | 6,857                  |



## ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

### Forward-Looking Statements

In this Quarterly Report on Form 10-Q, we discuss and make statements regarding our intentions, beliefs, current expectations, and projections regarding our company's future operations and performance. Such statements are "forward-looking" statements within the meaning of the Private Securities Litigation Reform Act of 1995. These forward-looking statements are often identified by words such as "anticipates," "believes," "expects," "will," "should," and "intends" and their negatives. We caution prospective investors that such forward-looking statements are not guarantees of future performance. Risks and uncertainties are inherent in our future performance. Factors that could cause actual results to differ materially from those indicated by such forward-looking statements include, but are not limited to, those discussed under Item 1A. "Risk Factors" below. These risk factors may not be exhaustive. We operate in a continually changing business environment and new risk factors may emerge from time to time. We can neither predict such new risk factors nor can we assess the impact, if any, of such new risk factors on our businesses or the extent to which any factor or combination of factors may cause actual results to differ materially from those expressed or implied in any forward-looking statements in this report. In light of these risks, uncertainties, and assumptions, the forward-looking events discussed in this report might not occur. We make forward-looking statements based on currently available information and assume no obligation to update these statements due to changes in underlying factors, new information, future developments, or otherwise.

### Introduction

We offer property and casualty insurance products through our various subsidiaries. We classify our businesses into two operating segments: (i) Insurance Operations, which consists of commercial lines ("Commercial Lines") and personal lines ("Personal Lines"); and (ii) Investments.

The purpose of the Management's Discussion and Analysis ("MD&A") is to provide an understanding of the consolidated results of operations and financial condition and known trends and uncertainties that may have a material impact in future periods. Consequently, investors should read the MD&A in conjunction with the consolidated financial statements in our annual report on Form 10-K for the year ended December 31, 2009 ("2009 Annual Report").

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

- Critical Accounting Policies and Estimates;
- Financial Highlights of Results for Third Quarter 2010 and Nine Months 2010;
- Results of Operations and Related Information by Segment;
- Federal Income Taxes;
- Financial Condition, Liquidity, and Capital Resources;
- Ratings;
- Off-Balance Sheet Arrangements; and
- Contractual Obligations and Contingent Liabilities and Commitments.

### Critical Accounting Policies and Estimates

These unaudited interim consolidated financial statements include amounts based on our informed estimates and judgments for those transactions that are not yet complete. Such estimates and judgments affect the reported amounts in the consolidated financial statements. Those estimates and judgments most critical to the preparation of the financial statements involved the following: (i) reserves for losses and loss expenses; (ii) deferred policy acquisition costs; (iii) pension and post-retirement benefit plan actuarial assumptions; (iv) other-than-temporary investment impairments; and (v) reinsurance. These estimates and judgments require the use of assumptions about matters that are highly uncertain and, therefore, are subject to change as facts and circumstances develop. If different estimates and judgments had been applied, materially different amounts might have been reported in the financial



statements. For additional information regarding our critical accounting policies, refer to our 2009 Annual Report, pages 42 through 51.

## Financial Highlights of Results for Third Quarter 2010 and Nine Months 2010

| (Shares and \$ in thousands, except per share amount)      | Quarter ended<br>September 30,<br>2010 | 2009    | Change<br>% or<br>Points | Nine Months ended<br>September 30,<br>2010 | 2009      | Change<br>% or<br>Points |
|------------------------------------------------------------|----------------------------------------|---------|--------------------------|--------------------------------------------|-----------|--------------------------|
| <b>GAAP measures:</b>                                      |                                        |         |                          |                                            |           |                          |
| Revenues                                                   | \$ 389,702                             | 390,175 | -%                       | \$ 1,170,532                               | 1,124,216 | 4%                       |
| Pre-tax net investment income                              | 32,986                                 | 36,585  | (10)                     | 104,237                                    | 78,670    | 32                       |
| Pre-tax net income                                         | 19,546                                 | 10,081  | 94                       | 46,787                                     | 1,790     | 2,514                    |
| Net income                                                 | 17,197                                 | 13,007  | 32                       | 41,766                                     | 15,818    | 164                      |
| Diluted net income per share                               | 0.32                                   | 0.24    | 33                       | 0.77                                       | 0.30      | 157                      |
| Diluted weighted-average outstanding shares <sup>2</sup>   | 54,573                                 | 53,548  | 2                        | 54,390                                     | 53,312    | 2                        |
| GAAP combined ratio                                        | 101.1%                                 | 100.0   | 1.1pts                   | 102.0%                                     | 99.7      | 2.3pts                   |
| Statutory combined ratio                                   | 100.3%                                 | 99.8    | 0.5                      | 101.4%                                     | 99.6      | 1.8                      |
| Annualized return on average equity                        | 6.4%                                   | 5.4     | 1.0                      | 5.3%                                       | 2.2       | 3.1                      |
| <b>Non-GAAP measures:</b>                                  |                                        |         |                          |                                            |           |                          |
| Operating income <sup>3</sup>                              | \$ 18,794                              | 23,845  | (21)%                    | \$ 47,641                                  | 49,211    | (3)%                     |
| Diluted operating income per share <sup>3</sup>            | 0.35                                   | 0.44    | (20)                     | 0.88                                       | 0.92      | (4)                      |
| Annualized operating return on average equity <sup>3</sup> | 7.0                                    | 9.9     | (2.9)pts                 | 6.1                                        | 7.0       | (0.9)pts                 |

1 Refer to the Glossary of Terms attached to our 2009 Annual Report as Exhibit 99.1 for definitions of terms used in this financial review.

2 Diluted weighted-average shares outstanding represents weighted-average common shares outstanding adjusted for the impact of dilutive common stock equivalents, if any.

3 Operating income is used as an important financial measure by us, analysts, and investors, because the realization of investment gains and losses on sales in any given period is largely discretionary as to timing. In addition, these realized investment gains and losses, as well as other-than-temporary impairments (“OTTI”) that are charged to earnings, and the results of discontinued operations, could distort the analysis of trends. See below for a reconciliation of operating income to net income in accordance with U.S. generally accepted accounting principles (“GAAP”).

Net income increased by \$9.5 million, pre-tax, and \$4.2 million, after-tax, in Third Quarter 2010 compared to Third Quarter 2009 primarily due to:

- Net realized gains, pre-tax, which increased by \$5.0 million, to a net realized gain of \$0.1 million. Realized gains associated with the sale of certain securities increased \$3.6 million when compared to the same period last year, from a \$0.7 million loss in Third Quarter 2009 to a \$2.9 million gain in Third Quarter 2010 while realized losses resulting from OTTI charges decreased \$1.4 million. These improvements were a reflection of overall market improvements in the valuations of certain securities as well as increased liquidity in the financial markets. OTTI charges for the period were \$2.8 million pre-tax, compared to \$4.2 million last year. See Note 6. “Investments” in Item 1. “Financial Statements” of this Form 10-Q for additional information on net realized gains and losses.
- Discontinued operations experienced a pre-tax loss of \$2.5 million, which was \$9.2 million less than the loss in the prior year. The loss this quarter was the result of a reduction in our anticipated proceeds related to receivables

associated with certain contingencies that have been modified to reflect lower levels of post sale worksite life retention and new business. During Third Quarter 2009, our discontinued operations experienced a pre-tax loss of \$11.7 million, which reflected a goodwill impairment charge that was based on the valuation of the pending sale of Selective HR Solutions, Inc. (“Selective HR”) at that time. For additional information concerning the discontinuance and sale of Selective HR, see Note 15. “Discontinued Operations” in Item 1. “Financial Statements” of this Form 10-Q.

Partially offsetting these items are:

- Pre-tax underwriting losses, which increased by \$3.8 million, to \$3.9 million, primarily attributable to an increase of \$10.0 million in catastrophe losses partially offset by an increase of \$4 million in favorable prior year casualty reserve development of \$12 million compared to \$8 million in Third Quarter 2009.
  - Pre-tax net investment income earned, which decreased by \$3.6 million, to \$33.0 million, primarily driven by reduced fixed maturity security income resulting from lower reinvestment yields.

Net income increased by \$45.0 million, pre-tax, and \$25.9 million, after-tax, in Nine Months 2010 compared to Nine Months 2009 primarily due to:

- An improvement in net realized losses of \$37.0 million, pre-tax, driven by lower pre-tax non-cash OTTI charges of \$17.2 million compared to \$43.8 million in the prior year. In addition, net realized gains resulting from sales increased by \$10.4 million, to \$14.0 million, compared to Nine Months 2009. See Note 6. "Investments" in Item 1. "Financial Statements" of this Form 10-Q for additional information on net realized gains and losses.
- Pre-tax net investment income earned, which increased by \$25.6 million, to \$104.2 million, primarily driven by income of \$11.1 million on the alternative investment portion of our investment portfolio compared to a loss on these investments of \$26.7 million in the prior year. This increase was also partially offset by lower fixed maturity security income of \$9.1 million resulting from lower reinvestment yields, coupled with increased investment expenses due to approximately \$2.1 million of costs incurred related to our decision to outsource our investment portfolio management operations. For additional information on our other investment portfolio and a discussion of the related strategies associated with this portfolio, see Note 5. "Investments" in Item 8. "Financial Statements and Supplementary Data." of our 2009 Annual Report.

Partially offsetting these items are:

- Pre-tax underwriting losses, which increased by \$24.6 million, to \$21.7 million compared to pre-tax underwriting income of \$2.9 million in the prior year, primarily attributable to an increase of \$43.6 million in catastrophe losses partially offset by an increase of \$9 million related to favorable prior year casualty development of \$32 million compared to \$23 million in the prior year.

Tax expense from continuing operations was \$7.0 million in Nine Months 2010 compared to a benefit of \$9.9 million in Nine Months 2009. This increase was primarily driven by the increase in the components of net income from continuing operations as discussed above.

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

| (\$ in thousands, except per share amounts)            | Quarter ended |         | Nine Months ended |          |
|--------------------------------------------------------|---------------|---------|-------------------|----------|
|                                                        | 2010          | 2009    | 2010              | 2009     |
| Operating income                                       | \$ 18,794     | 23,845  | 47,641            | 49,211   |
| Net realized gain (losses), after tax                  | 37            | (3,239) | (2,126)           | (26,197) |
| Loss from discontinued operations, after tax           | -             | (7,599) | -                 | (7,196)  |
| Loss on disposal of discontinued operations, after tax | (1,634)       | -       | (3,749)           | -        |
| Net income                                             | \$ 17,197     | 13,007  | 41,766            | 15,818   |
| Diluted operating income per share                     | \$ 0.35       | 0.44    | 0.88              | 0.92     |
| Diluted net realized losses per share                  | -             | (0.06)  | (0.04)            | (0.49)   |
| Diluted loss on discontinued operations per share      | (0.03)        | (0.14)  | (0.07)            | (0.13)   |
| Diluted net income per share                           | \$ 0.32       | 0.24    | 0.77              | 0.30     |

Operating income in Third Quarter 2010 decreased due to the following, which were discussed in more detail above: (i) an increase in underwriting losses; and (ii) a decrease in net investment income. Operating income decreased in Nine Months 2010 primarily attributable to an increase in underwriting losses, partially offset by an increase in net investment income.

## Results of Operations and Related Information by Segment

## Insurance Operations

Our Insurance Operations segment writes property and casualty insurance business through seven insurance subsidiaries (the “Insurance Subsidiaries”). Our Insurance Operations segment sells property and casualty insurance products and services primarily in 22 states in the Eastern and Midwestern U.S. through approximately 980 independent insurance agencies. Our Insurance Operations segment consists of two components: (i) Commercial Lines, which markets primarily to businesses and represents approximately 82% of net premium written (“NPW”); and (ii) Personal Lines, which markets primarily to individuals and represents approximately 18% of NPW. The underwriting performance of these lines is generally measured by four different statutory ratios: (i) loss and loss expense ratio; (ii) underwriting expense ratio; (iii) dividend ratio; and (iv) combined ratio. For further details regarding these ratios, see the discussion in the “Insurance Operations” section of Item 1. “Business.” of our 2009 Annual Report.

## Summary of Insurance Operations

| All Lines<br>(\$ in thousands)            | Quarter ended<br>September 30, |         | Change<br>% or<br>Points | Nine Months ended<br>September 30, |           | Change<br>% or<br>Points |
|-------------------------------------------|--------------------------------|---------|--------------------------|------------------------------------|-----------|--------------------------|
|                                           | 2010                           | 2009    |                          | 2010                               | 2009      |                          |
| <b>GAAP Insurance Operations Results:</b> |                                |         |                          |                                    |           |                          |
| NPW                                       | \$ 367,114                     | 376,718 | (3) %                    | 1,088,729                          | 1,117,764 | (3) %                    |
| Net premiums earned (“NPE”)               | 354,709                        | 355,906 | -                        | 1,063,101                          | 1,078,090 | (1)                      |
| <b>Less:</b>                              |                                |         |                          |                                    |           |                          |
| Losses and loss expenses incurred         | 245,019                        | 242,032 | 1                        | 739,142                            | 733,275   | 1                        |
| Net underwriting expenses incurred        | 112,895                        | 113,025 | -                        | 342,791                            | 339,620   | 1                        |
| Dividends to policyholders                | 728                            | 991     | (27)                     | 2,867                              | 2,268     | 26                       |
| Underwriting (loss) income                | \$ (3,933)                     | (142)   | (2,670) %                | (21,699)                           | 2,927     | (841) %                  |
| <b>GAAP Ratios:</b>                       |                                |         |                          |                                    |           |                          |
| Loss and loss expense ratio               | 69.1%                          | 68.0    | 1.1 pts                  | 69.5%                              | 68.0      | 1.5 pts                  |
| Underwriting expense ratio                | 31.8%                          | 31.7    | 0.1                      | 32.2%                              | 31.5      | 0.7                      |
| Dividends to policyholders ratio          | 0.2%                           | 0.3     | (0.1)                    | 0.3%                               | 0.2       | 0.1                      |
| Combined ratio                            | 101.1%                         | 100.0   | 1.1                      | 102.0%                             | 99.7      | 2.3                      |
| <b>Statutory Ratios:</b>                  |                                |         |                          |                                    |           |                          |
| Loss and loss expense ratio               | 68.9%                          | 68.1    | 0.8                      | 69.5%                              | 68.0      | 1.5                      |
| Underwriting expense ratio                | 31.2%                          | 31.4    | (0.2)                    | 31.6%                              | 31.4      | 0.2                      |
| Dividends to policyholders ratio          | 0.2%                           | 0.3     | (0.1)                    | 0.3%                               | 0.2       | 0.1                      |
| Combined ratio                            | 100.3%                         | 99.8    | 0.5 pts                  | 101.4%                             | 99.6      | 1.8 pts                  |

- NPW decreased in both Third Quarter and Nine Months 2010 compared to Third Quarter and Nine Months 2009 due to economic conditions despite Commercial Lines renewal pure price increases of 2.8% in Third Quarter 2010 and 3.1% in Nine Months 2010. Through Nine Months 2010, we have experienced the most significant NPW decreases in our general liability and workers compensation lines of business, which have experienced reduced levels of exposure given the reductions in payroll and sales consistent with the soft economy. These factors are reflected in the following:
  - o Reductions in new business premiums of \$13.1 million, to \$66.6 million, in Third Quarter 2010 and \$30.1 million, to \$214.8 million, in Nine Months 2010;
  - o Audit and endorsement return premium of \$13.3 million and \$49.5 million in Third Quarter and Nine Months 2010, respectively, compared to \$18.0 million and \$55.2 million in the comparable periods in 2009; and
  - o Reductions in net renewals of \$5.3 million, to \$319.5 million, in Third Quarter 2010 and \$8.3 million, to \$958.5 million, in Nine Months 2010.
- NPE decreases in Third Quarter and Nine Months 2010 compared to the same periods last year are consistent with the fluctuation in NPW for the 12-month period ended September 30, 2010 as compared to the 12-month period ended September 30, 2009.

- For Third Quarter 2010 compared to Third Quarter 2009, the GAAP loss and loss expense ratio increased by 1.1 points due to an increase in property losses of \$13.7 million, which included increased catastrophe losses of \$10.0 million, or 2.9 points, to \$12.0 million, in Third Quarter 2010. The catastrophe losses in Third Quarter 2010 were driven primarily by wind and thunderstorm events in several states. This was partially offset by favorable prior year casualty development of approximately \$12 million, or 3.3 points, compared to approximately \$8 million, or 2.3 points, in Third Quarter 2009. The development in Third Quarter 2010 was primarily due to favorable results in our 2008 and 2009 accident years on our commercial automobile line of business and our 2008 and prior accident years for our general liability line of business. This favorable development was partially offset by unfavorable development in our workers compensation line due to pressure in our 2008 and 2009 accident years resulting from higher claim severity. The favorable development in Third Quarter 2009 was driven by our 2006 and prior accident years on our general liability line of business.

The 1.5-point increase in the GAAP loss and loss expense ratio for Nine Months 2010 compared to Nine Months 2009 was primarily attributable to an increase in catastrophe losses of \$43.6 million, or 4.1 points, to \$52.1 million in Nine Months 2010. Partially offsetting this increase for Nine Months 2010 was: (i) favorable casualty prior year development of approximately \$32 million, or 3.1 points, in Nine Months 2010 compared to approximately \$23 million, or 2.2 points, in Nine Months 2009; (ii) a decrease in non-catastrophe property losses of \$4.0 million, or 0.2 points; and (iii) reduction of loss costs due to the mix of business. The Nine Months 2010 and 2009 development follows the same trends as the Third Quarter 2010 and Third Quarter 2009 development mentioned above.

- The GAAP underwriting expense ratio in Third Quarter 2010 was relatively flat compared to the same period in the prior year. For Nine Months 2010, the underwriting expense ratio increased by 0.7 points compared to the same period in the prior year primarily due to declines in earned premium.

#### Insurance Operations Outlook

The commercial lines insurance sector remains very competitive and commercial lines pricing power is weak overall. We continue to work to maintain a balance between increasing rate and maintaining retention. A recent report from the Commercial Lines Insurance Pricing Survey (“CLIPS”) showed that industry pricing declined by 0.9% during the second quarter of 2010. Some industry analysts predict that property and casualty insurance rates will harden later in 2011 as a result of: (i) declining reserve releases; (ii) increasing industrywide combined ratios; and (iii) reduced investment returns in the current low interest rate environment that are unable to support deteriorating underwriting results. Other industry analysts remain more pessimistic as to when commercial lines pricing and industry results will improve. Despite the competitive environment, our Commercial Lines renewal pure price increased 2.8% in Third Quarter 2010 and 3.1% in Nine Months 2010. Retention increased one point in Third Quarter 2010, to 75%, and was flat in Nine Months 2010 at 76%, as compared to the same periods in the prior year. We modified our pricing strategy earlier this year to focus our pricing efforts to improve profitability on our worst performing business while focusing on retention of our best performing business.

Our Personal Lines operations continue to experience NPW growth driven by: (i) ongoing rate increases that went into effect during 2009 and 2010, which are expected to generate an additional \$20.3 million in annual premium; (ii) higher levels of new business premium of \$7.1 million, to \$46.9 million through Nine Months 2010; and (iii) maintaining strong retention at 82% through Nine Months 2010.



The overall outlook on the industry for 2010 from key rating agencies is as follows:

- A.M. Best Company (“A.M. Best”) – A.M. Best is maintaining a stable outlook on the industry looking forward, as balance sheets have remained strong despite weak underwriting results. The industry experienced an increase in net income in the first half of 2010, compared to the same period in 2009, driven by improved investment results, but partially offset by unusually high catastrophe-related losses. NPW for the first six months of 2010 were essentially flat compared to the same period in 2009. NPW declines are stabilizing as a result of growth in personal lines; however, premium volume continues to be challenged by competitive market conditions in commercial lines, excess capacity, and weak macroeconomic conditions. The industry posted a combined ratio of 101.9% during the period, which is a result of higher than expected catastrophe losses primarily driven by wind and hail events across the country, offset by favorable prior year reserve development. A.M. Best noted that, while there has been a gradual increase in pricing in personal lines, there is no clear sign of a turnaround in pricing trends for commercial lines. They acknowledge that challenging market conditions, low investment yields, and the overall weak economic environment will make it difficult for property/casualty insurers to improve profitability in the near term, but believe the industry is sufficiently capitalized to withstand any further volatility in the financial markets. A.M. Best notes that 2010 could be the first year that NPW increases since 2006, but also cautions that recent releases of reserves could lead to reserve deficiencies in the industry in future periods.
- Fitch Ratings (“Fitch”) – During the first quarter of 2010, Fitch projected that they would be maintaining their negative outlook on the industry over the next year, reflecting lingering economic and financial uncertainty. In addition, Fitch projects an industry-wide statutory combined ratio of 104.0% for 2010, reflecting their belief that underwriting results will not improve significantly as they project premiums will have insignificant growth. Fitch anticipates that underwriting results will be impacted by higher expense ratios and less favorable reserve development, partially offset by a return to historical average catastrophe loss experience.
- Moody’s Investors Service (“Moody’s”) – Moody’s expects profitability in the remainder of 2010 to continue to be pressured by the soft pricing environment, lower investment yields, and swings in catastrophe losses and reserve development. Net income for the industry in the second quarter of 2010 was slightly below the second quarter of 2009, driven by significant catastrophe losses that added approximately five points to the industry combined ratio, partially offset by favorable prior year reserve development. Moody’s has noted a significant increase in share repurchases in the industry in the first half of 2010 compared to the same period in 2009, which may be a sign of capital stability.

Our Commercial Lines business reported a statutory combined ratio of 99.8% and 100.5% for Third Quarter and Nine Months 2010, respectively and our Personal Lines business reported a statutory combined ratio of 103.2% and 105.9% for the same periods. The Personal Lines statutory combined ratio included 8.0 points and 9.2 points of catastrophe losses in Third Quarter and Nine Months 2010, respectively, which reflects much higher levels than we have historically experienced. In an effort to write profitable business in the current commercial and personal lines market conditions, we continue to implement a defined plan of improving risk selection and mitigating higher frequency trends to complement our strong agency relationships and unique field-based model.

Our focus for 2010 continues to include the following:

- Continuing to concentrate on our long-term strategy to improve profitability by diversifying our mix of business and writing more non-contractor classes of business, which typically experience lower volatility during economic downturns. Through Nine Months 2010, non-contractor new business comprised 67% of Commercial Lines new business, up from 62% in Nine Months 2009.
- Deploying second generation Commercial Lines predictive modeling tools that give our underwriters additional information, enabling them to make better decisions regarding individual account underwriting. These tools also provide us with increased pricing granularity, allowing our agents the ability to compete for the most attractive accounts.

- Continuing to manage our book of business by balancing anticipated Commercial Lines pure price increases with retention in a very competitive marketplace.
- Personal Lines rate increases for 2010, which we believe could generate \$14.9 million in additional premium annually. Despite increases to our rates over the past several years, Personal Lines policy retention increased by three points, to 82%, and new policy counts increased nearly 17% from a year ago.

- Implementing our Claims Strategic Program, which focuses on enhancing areas of: (i) workers compensation best practices and targeted case management; (ii) litigation management; (iii) fraud detection and recovery recognition through use of advanced systems analytics; (iv) claims automation; and (v) vendor management. We believe that these initiatives will allow us to maintain our reputation for superior claims service while enabling us to leverage our current resources to increase the effectiveness and efficiency of the claims area.
- Sales management efforts, including our market planning tools. Our market planning tools allow us to identify and strategically appoint additional independent agencies and hire or redeploy agency management specialists (“AMS”) in under-penetrated territories. Our agency count now stands at approximately 980 agencies across our footprint. These independent insurance agencies are serviced by approximately 90 field-based AMSs who make hands-on underwriting decisions on a daily basis. In addition, we use our predictive modeling and business analytics to build tools that help our agents identify potential new customers.
- Technology that allows agents and our field teams to input business seamlessly into our systems, including our One & Done® small business system and our xSELeRate® straight-through processing system. Average premiums of approximately \$306,000 per workday were processed through our One & Done® small business system during Nine Months 2010, up 4% from Nine Months 2009. These technology-based systems complement our existing underwriting group, giving them more time to focus on underwriting more technical accounts.

## Review of Underwriting Results by Line of Business

## Commercial Lines Results

| Commercial Lines<br>(\$ in thousands)     | Quarter ended<br>September 30, |         | Change<br>% or<br>Points | Nine Months ended<br>September 30, |         | Change<br>% or<br>Points |
|-------------------------------------------|--------------------------------|---------|--------------------------|------------------------------------|---------|--------------------------|
|                                           | 2010                           | 2009    |                          | 2010                               | 2009    |                          |
| <b>GAAP Insurance Operations Results:</b> |                                |         |                          |                                    |         |                          |
| NPW                                       | \$ 297,004                     | 314,428 | (6)%                     | 895,795                            | 946,499 | (5) %                    |
| NPE                                       | 293,225                        | 301,279 | (3)                      | 884,134                            | 918,069 | (4)                      |
| <b>Less:</b>                              |                                |         |                          |                                    |         |                          |
| Losses and loss expenses incurred         | 197,046                        | 202,256 | (3)                      | 598,123                            | 613,822 | (3)                      |
| Net underwriting expenses incurred        | 95,477                         | 95,861  | -                        | 290,837                            | 291,794 | -                        |
| Dividends to policyholders                | 728                            | 991     | (27)                     | 2,867                              | 2,268   | 26                       |
| Underwriting (loss) income                | \$ (26)                        | 2,171   | (101)%                   | (7,693)                            | 10,185  | (176) %                  |
| <b>GAAP Ratios:</b>                       |                                |         |                          |                                    |         |                          |
| Loss and loss expense ratio               | 67.2%                          | 67.1    | 0.1pts                   | 67.7%                              | 66.9    | 0.8pts                   |
| Underwriting expense ratio                | 32.6%                          | 31.9    | 0.7                      | 32.9%                              | 31.8    | 1.1                      |
| Dividends to policyholders ratio          | 0.2%                           | 0.3     | (0.1)                    | 0.3%                               | 0.2     | 0.1                      |
| Combined ratio                            | 100.0%                         | 99.3    | 0.7                      | 100.9%                             | 98.9    | 2.0                      |
| <b>Statutory Ratios:</b>                  |                                |         |                          |                                    |         |                          |
| Loss and loss expense ratio               | 67.1%                          | 67.1    | -                        | 67.5%                              | 66.9    | 0.6                      |
| Underwriting expense ratio                | 32.4%                          | 32.1    | 0.3                      | 32.7%                              | 31.8    | 0.9                      |
| Dividends to policyholders ratio          | 0.3%                           | 0.3     | -                        | 0.3%                               | 0.2     | 0.1                      |
| Combined ratio                            | 99.8%                          | 99.5    | 0.3pts                   | 100.5%                             | 98.9    | 1.6pts                   |

- NPW decreased in Third Quarter and Nine Months 2010 compared to the same periods last year due to the continued economic weakness and an ongoing very competitive insurance marketplace. We have experienced the most significant decreases in our general liability, workers compensation, and commercial automobile lines of business due to reduced levels of exposure. This decrease is evidenced by the following:
  - o Audit and endorsement return premium during Third Quarter 2010 improved by \$4.8 million, to a return premium of \$13.4 million, compared to Third Quarter 2009 and improved by \$5.1 million, to a return premium of \$50.0 million, during Nine Months 2010 compared to Nine Months 2009;
  - o Reductions in direct new business of \$13.8 million, or 22%, to \$50.2 million in the Third Quarter 2010 and \$37.2 million, or 18%, to \$167.9 million in Nine Months 2010 compared to the same periods last year; and
  - o Reductions in net renewals of \$12.3 million, or 4%, to \$264.6 million, in Third Quarter 2010 compared to Third Quarter 2009. Net renewals decreased by \$21.8 million, or 3%, to \$808.4 million in Nine Months 2010. These decreases were partially offset by renewal pure price increases of 2.8% in Third Quarter 2010 compared to 1.5% in Third Quarter 2009 and increases of 3.1% during Nine Months 2010 compared to increases of 0.4% in Nine Months 2009.
- NPE decreased in Third Quarter and Nine Months 2010, consistent with the fluctuation in NPW for the 12-month period ended September 30, 2010 as compared to the 12-month period ended September 30, 2009.

The GAAP loss and loss expense ratio in Third Quarter 2010 compared to Third Quarter 2009 remained relatively flat; however loss activity included catastrophe losses of \$7.0 million, or 2.4 points, in Third Quarter 2010 compared to catastrophe losses of \$1.5 million, or 0.5 points, in Third Quarter 2009. Third Quarter 2010 catastrophe losses were driven by four wind and thunderstorm events. Partially offsetting the increases in losses was approximately \$12 million, or 4.0 points, of favorable casualty prior year development in Third Quarter 2010 compared to approximately \$8 million, or 2.7 points, in Third Quarter 2009. The development in Third Quarter 2010 was primarily due to favorable results in our commercial automobile and general liability lines, partially offset by adverse development in our workers compensation line. The development in Third Quarter 2009 was primarily due to favorable results in our 2006 and prior accident years for our general liability line.

The 0.8-point increase in the GAAP loss and loss expense ratio in Nine Months 2010 compared to Nine Months 2009 was primarily attributable to: (i) catastrophe losses of \$35.7 million, or 4.0 points, in Nine Months 2010 compared to catastrophe losses of \$6.2 million, or 0.7 points, in Nine Months 2009; and (ii) adverse loss trends in our workers' compensation line of business in the most recent accident year. Partially offsetting these increases was favorable casualty prior year development of \$33 million, or 3.8 points, in Nine Months 2010, compared to favorable casualty prior year development of approximately \$21 million, or 2.3 points, in Nine Months 2009. The development in Nine Months 2010 was primarily due to favorable results in our commercial automobile and general liability lines, partially offset by adverse prior year development in our workers compensation line. The development in Nine Months 2009 was primarily due to favorable activity in our workers' compensation line of business for the 2007 and prior accident years partially offset by unfavorable development in this line for the 2008 accident year.

- The GAAP underwriting expense ratio increases in Third Quarter and Nine Months 2010 compared to the same periods last year were primarily attributable to declines in premiums earned discussed above.

The following is a discussion of our most significant commercial lines of business:

#### General Liability

| (\$ in thousands)                   | Quarter ended         |                       | Change<br>% or<br>Points | Nine Months ended     |                       | Change<br>% or<br>Points |
|-------------------------------------|-----------------------|-----------------------|--------------------------|-----------------------|-----------------------|--------------------------|
|                                     | September 30,<br>2010 | September 30,<br>2009 |                          | September 30,<br>2010 | September 30,<br>2009 |                          |
| Statutory NPW                       | \$ 84,141             | 88,886                | (5)%                     | 257,188               | 281,119               | (9)%                     |
| Statutory NPE                       | 83,249                | 88,280                | (6)                      | 252,438               | 274,357               | (8)                      |
| Statutory combined ratio            | 99.1%                 | 103.9                 | (4.8)pts                 | 95.1%                 | 104.0                 | (8.9)pts                 |
| % of total statutory commercial NPW | 29%                   | 28                    |                          | 29%                   | 30                    |                          |

NPW for this line of business decreased in Third Quarter and Nine Months 2010 compared to the same periods last year as a result of the continued current economic weakness and competitive nature of the insurance marketplace. The decrease in Third Quarter 2010 was primarily driven by: (i) net renewal decreases of \$3.8 million, or 5%, to \$76.4 million; and (ii) new business decreases of \$3.7 million, or 21%, to \$13.8 million. In addition, endorsement and audit return premium was \$5.3 million compared to \$8.0 million in Third Quarter 2009.

The NPW decrease in Nine Months 2010 was primarily driven by: (i) net renewal decreases of \$12.5 million, or 5%, to \$240.9 million; (ii) new business decreases of \$9.9 million, or 18%, to \$45.3 million; and (iii) an increase in endorsement and audit return premium of \$21.4 million in Nine Months 2010, compared to return premium of \$20.9 million in the same period a year ago. As of September 30, 2010, approximately 50% of this line of business's premium is subject to audit, whereby actual exposure units (usually sales or payroll) are compared to estimates and a return premium, or additional premium, transaction occurs.

The decrease in the statutory combined ratio for Third Quarter and Nine Months 2010 compared to the same period in the prior year was driven by favorable prior year reserve development in accident years 2008 and prior of approximately \$5 million, or 6.2 points, in Third Quarter 2010 and \$24 million, or 9.6 points, in Nine Months 2010, compared to favorable prior year development of approximately \$4 million, or 4.5 points, in Third Quarter 2009 and favorable prior year development of approximately \$2 million, or 0.9 points, in Nine Months 2009.



## Workers Compensation

| (\$ in thousands)                      | Quarter ended<br>September 30, |        | Change<br>% or<br>Points | Nine Months ended<br>September 30, |         | Change<br>% or<br>Points |
|----------------------------------------|--------------------------------|--------|--------------------------|------------------------------------|---------|--------------------------|
|                                        | 2010                           | 2009   |                          | 2010                               | 2009    |                          |
| Statutory NPW                          | \$ 57,997                      | 66,101 | (12)%                    | 187,540                            | 202,973 | (8)%                     |
| Statutory NPE                          | 61,179                         | 64,742 | (6)                      | 187,889                            | 201,709 | (7)                      |
| Statutory combined ratio               | 130.2%                         | 110.9  | 19.3pts                  | 124.4%                             | 101.2   | 23.2pts                  |
| % of total statutory<br>commercial NPW | 20%                            | 21     |                          | 21%                                | 21      |                          |

In Third Quarter and Nine Months 2010, NPW on this line decreased compared to the same periods last year, primarily driven by a reduction in exposure due to the soft economy. This is reflected in: (i) net renewal decreases of \$7.2 million, or 11%, to \$56.6 million in Third Quarter 2010, and \$7.7 million, or 4%, to \$182.8 million in Nine Months 2010; and (ii) new business decreases of \$3.3 million, or 24%, to \$10.4 million in Third Quarter 2010, and \$13.6 million, or 27%, to \$36.9 million in Nine Months 2010. These decreases were partially offset by: (i) renewal pure price increases of 2.3% in Third Quarter 2010 compared to increases of 1.6% in Third Quarter 2009, and increases of 2.2% in Nine Months 2010 compared to increases of 0.2% in Nine Months 2009; and (ii) endorsement and audit return premium which was \$7.6 million in Third Quarter 2010 and \$26.1 million in Nine Months 2010, compared to \$9.6 million and \$30.2 million in Third Quarter and Nine Months 2009, respectively.

The increase in the statutory combined ratio of this line in Third Quarter and Nine Months 2010 compared to the same periods last year reflect: (i) unfavorable prior year reserve development of approximately \$3 million, or 4.9 points, in Third Quarter 2010 and unfavorable prior year development of approximately \$17 million, or 9.0 points, in Nine Months 2010 compared to favorable development of approximately \$2 million, or 3.1 points, in Third Quarter 2009 and favorable development of approximately \$13 million, or 6.4 points, in Nine Months 2009; (ii) increased loss cost estimates in the current accident year; and (iii) continued pressure on NPE driven by endorsement and audit return premium.

The unfavorable prior year reserve development in Third Quarter 2010 is primarily associated with increased severity in the 2008 and 2009 accident years. For Nine Months 2010, the prior year reserve development was driven by favorable emergence in the 2007 and prior accident years.

## Commercial Automobile

| (\$ in thousands)                      | Quarter ended<br>September 30, |        | Change<br>% or<br>Points | Nine Months ended<br>September 30, |         | Change<br>% or<br>Points |
|----------------------------------------|--------------------------------|--------|--------------------------|------------------------------------|---------|--------------------------|
|                                        | 2010                           | 2009   |                          | 2010                               | 2009    |                          |
| Statutory NPW                          | \$ 75,425                      | 80,183 | (6)%                     | 223,680                            | 236,229 | (5)%                     |
| Statutory NPE                          | 73,440                         | 75,513 | (3)                      | 220,932                            | 226,698 | (3)                      |
| Statutory combined ratio               | 83.3%                          | 98.5   | (15.2)pts                | 87.4%                              | 97.9    | (10.5)pts                |
| % of total statutory<br>commercial NPW | 26%                            | 26     |                          | 25%                                | 25      |                          |

The decrease in NPW in Third Quarter and Nine Months 2010 compared to the same periods last year was primarily driven by: (i) net renewals that decreased by \$3.5 million, or 5%, to \$61.8 million in Third Quarter 2010 and \$9.6 million, or 5%, to \$185.2 million in Nine Months 2010; and (ii) new business decreases of \$3.2 million, or 23%, to



\$10.3 million in Third Quarter 2010 and \$6.2 million, or 15%, to \$35.8 million in Nine Months 2010.

The decrease in the statutory combined ratio for Third Quarter and Nine Months 2010 compared to the same periods last year was primarily driven by favorable casualty prior year reserve development of approximately: (i) \$11 million, or 14.3 points, in Third Quarter 2010, due to lower than anticipated severity primarily in the 2008 and 2009 accident years; and (ii) \$27 million, or 12.2 points, in Nine Months 2010, due to lower than anticipated severity primarily in the 2005 through 2009 accident years. This is compared to favorable casualty prior year development in Third Quarter 2009 of approximately \$2 million, or 2.6 points, and favorable casualty prior year development of approximately \$7 million, or 2.9 points, in Nine Months 2009, due to favorable emergence in accident years 2007 and prior.

## Commercial Property

| (\$ in thousands)                      | Quarter ended<br>September 30, |        | Change<br>% or<br>Points | Nine Months ended<br>September 30, |         | Change<br>% or<br>Points |
|----------------------------------------|--------------------------------|--------|--------------------------|------------------------------------|---------|--------------------------|
|                                        | 2010                           | 2009   |                          | 2010                               | 2009    |                          |
| Statutory NPW                          | \$ 53,764                      | 55,522 | (3)%                     | 153,405                            | 155,972 | (2)%                     |
| Statutory NPE                          | 49,558                         | 49,879 | (1)                      | 150,188                            | 147,735 | 2                        |
| Statutory combined ratio               | 90.2%                          | 81.2   | 9.0Pts                   | 96.3%                              | 86.8    | 9.5pts                   |
| % of total statutory<br>commercial NPW | 18%                            | 18     |                          | 17%                                | 16      |                          |

NPW for this line of business decreased in Third Quarter and Nine Months 2010 compared to Third Quarter and Nine Months 2009 due to new business premium decreases of \$2.8 million, or 24%, to \$8.5 million in Third Quarter 2010, and \$6.5 million, or 19%, to \$28.0 million in Nine Months 2010. These decreases were partially offset by net renewal increases of \$1.1 million, or 2%, to \$48.8 million in Third Quarter 2010, and \$3.7 million, or 3%, to \$137.3 million in Nine Months 2010. These net renewal increases were driven by renewal pure price increases of 1.9% in Third Quarter 2010 compared to increases of 1.0% in Third Quarter 2009, and increases of 2.2% in Nine Months 2010 compared to decreases of 0.2% in Nine Months 2009.

The increase in the statutory combined ratio for Third Quarter and Nine Months 2010 compared to same periods last year was driven by an increase in catastrophe losses of \$4.4 million, or 9.0 points, to \$5.6 million, in Third Quarter 2010, and an increase of \$25.0 million, or 16.6 points, to \$29.4 million, in Nine Months 2010. This increased level of catastrophe losses is due largely to a high frequency of catastrophic events in our footprint area, the most significant of which occurred in the first and second quarters of 2010. While Third Quarter 2010 catastrophe losses returned to more normalized levels, the quarter included adverse development on some of the earlier storms primarily related to hail damage. The catastrophe losses in Nine Months 2010 were partially offset by decreases in non-catastrophe property losses of \$9.4 million, or 7.0 points.

## Personal Lines Results

| Personal Lines<br>(\$ in thousands)       | Quarter ended<br>September 30, |         | Change<br>% or<br>Points | Nine Months ended<br>September 30, |         | Change<br>% or<br>Points |
|-------------------------------------------|--------------------------------|---------|--------------------------|------------------------------------|---------|--------------------------|
|                                           | 2010                           | 2009    |                          | 2010                               | 2009    |                          |
| <b>GAAP Insurance Operations Results:</b> |                                |         |                          |                                    |         |                          |
| NPW                                       | \$ 70,110                      | 62,290  | 13%                      | 192,934                            | 171,265 | 13%                      |
| NPE                                       | 61,484                         | 54,627  | 13                       | 178,967                            | 160,021 | 12                       |
| <b>Less:</b>                              |                                |         |                          |                                    |         |                          |
| Losses and loss expenses incurred         | 47,973                         | 39,776  | 21                       | 141,019                            | 119,453 | 18                       |
| Net underwriting expenses incurred        | 17,418                         | 17,164  | 1                        | 51,954                             | 47,826  | 9                        |
| Underwriting loss                         | \$ (3,907)                     | (2,313) | (69)%                    | (14,006)                           | (7,258) | (93)%                    |
| <b>GAAP Ratios:</b>                       |                                |         |                          |                                    |         |                          |
| Loss and loss expense ratio               | 78.0%                          | 72.8    | 5.2pts                   | 78.8%                              | 74.6    | 4.2pts                   |
| Underwriting expense ratio                | 28.4%                          | 31.4    | (3.0)                    | 29.0%                              | 29.9    | (0.9)                    |
| Combined ratio                            | 106.4%                         | 104.2   | 2.2                      | 107.8%                             | 104.5   | 3.3                      |
| <b>Statutory Ratios:</b>                  |                                |         |                          |                                    |         |                          |
| Loss and loss expense ratio               | 78.0%                          | 72.9    | 5.2                      | 78.8%                              | 74.6    | 4.2                      |
| Underwriting expense ratio                | 25.2%                          | 28.9    | (3.8)                    | 27.1%                              | 29.0    | (1.9)                    |
| Combined ratio                            | 103.2%                         | 101.8   | 1.4pts                   | 105.9%                             | 103.6   | 2.3pts                   |

- NPW increased in Third Quarter and Nine Months 2010 compared to Third Quarter and Nine Months 2009 primarily due to:
  - o 32 rate increases, 26 of which are 5% or more, that went into effect across our Personal Lines footprint during Nine Months 2010 and are expected to generate an additional \$13.6 million in annual premium;
  - o New business direct premium written increases of \$0.6 million, or 4%, to \$16.4 million for Third Quarter 2010 and \$7.1 million, or 18%, to \$46.9 million for Nine Months 2010; and
  - o Net renewal direct premium written increases of \$7.0 million, or 15%, to \$54.8 million for Third Quarter 2010 and \$13.6 million, or 10%, to \$150.2 million for Nine Months 2010, which includes a policy retention increase of three points, to 82%, in Nine Months 2010.
- NPE increases in Third Quarter and Nine Months 2010, compared to the same periods last year, are consistent with the fluctuation in NPW for the 12-month period ended September 30, 2010 as compared to the 12-month period ended September 30, 2009.
- The 5.2-point increase in the GAAP loss and loss expense ratio in Third Quarter 2010 compared to Third Quarter 2009 was primarily attributable to increased property losses of \$7.7 million, or 9.3 points, which included an increase in catastrophe losses of \$4.5 million, or 7.2 points, driven by several wind and thunderstorm events. This was partially offset by premium earned outpacing loss costs.

The 4.2-point increase in the GAAP loss and loss expense ratio for Nine Months 2010 compared to Nine Months 2009 was attributable to an increase in catastrophe losses of \$14.1 million, or 7.7 points. This increase was partially offset by premium earned outpacing loss costs.

- The decrease in the GAAP underwriting expense ratio in Third Quarter and Nine Months 2010 compared to Third Quarter and Nine Months 2009 was attributable to an increase in premiums that has outpaced increases in

underwriting expenses.

37

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We continue to work to achieve the necessary rate increases across our footprint states to improve profitability. In addition, our strategy on this line includes: (i) writing new policies in our expansion states; (ii) continued diversification in our territory structure; and (iii) providing the excellent service that our policyholders and agents demand. The rate increases that we anticipate obtaining in 2010 are expected to generate an additional \$14.9 million in annual premium. Policy retention continues to be positive, despite increases to our rates over the past several years. We believe that this increase in policy retention reflects the hardening of the personal lines market as well as: (i) the ability of our pricing tools to comprehensively analyze where rate increases are appropriate; and (ii) our strategy to obtain high retention, low frequency accounts in our core book of business.

#### Reinsurance

We have successfully completed negotiations of our July 1, 2010 excess of loss treaties with highlights as follows:

#### Property Excess of Loss

The Property Excess of Loss treaty ("Property Treaty") was renewed with the same terms as the expiring treaty providing for per risk coverage of \$28.0 million in excess of a \$2.0 million retention.

- The per occurrence cap on the total program is \$64.0 million.
- The first layer continues to have unlimited reinstatements. The annual aggregate limit for the second, \$20.0 million in excess of \$10.0 million, layer remains at \$80.0 million.
- Consistent with the prior year treaty, the Property Treaty excludes nuclear, biological, chemical, and radiological terrorism losses.
- The renewal treaty rate decreased by 2%.

#### Casualty Excess of Loss

The Casualty Excess of Loss treaty ("Casualty Treaty") was renewed with the same terms as the expiring treaty providing the following per occurrence coverage:

- The first layer provides coverage for 85% of up to \$3.0 million in excess of a \$2.0 million retention.
- The next five layers provide coverage for 100% of up to \$85.0 million in excess of \$5.0 million.
- Consistent with the prior year, the Casualty Treaty excludes nuclear, biological, chemical, and radiological terrorism losses. Annual aggregate terrorism limits, net of co-participation, remained the same at \$198.8 million.
- The renewal treaty rate increased by 9%.

## Investments

Overall market expectations for U.S. growth have been revised downward from earlier in the year and unemployment is expected to be a concern over the next several years. In spite of this economic news, valuations in our overall investment portfolio have improved during Nine Months 2010.

Credit quality of our fixed maturity securities portfolio remains high, with an average S&P rating of “AA.” This is primarily due to the large allocation of the fixed maturity securities portfolio to high-quality municipal bonds, agency residential mortgage-backed securities (“RMBS”), and government and agency obligations. Although we maintain a high-quality municipal bond portfolio at an average S&P rating of “AA”, we continue to closely monitor this portfolio given the general uncertainty about states and municipalities and the ability of such issuers to fulfill their obligations in light of ongoing budget constraints. In addition, we are currently diversifying into investment-grade corporate bonds as part of our overall investment strategy due to the currently more attractive risk/return characteristics of this sector. Our recent increased allocation to corporate bonds reduced the overall portfolio S&P rating in Third Quarter 2010 from “AA+.” Exposure to non-investment grade bonds represents only 1% of the total fixed maturity securities portfolio. We have 20 non-investment grade rated securities in the investment portfolio with a total fair value of \$37.2 million and an unrealized/unrecognized loss balance of \$2.9 million as of September 30, 2010.

In early 2010, we decided to outsource our investment management operations to two external investment managers. This transition was successfully completed and is now fully operational. This outsourcing does not indicate a change to our overall investment strategy, only a change in the execution model. We expect to benefit from broader sector-specific knowledge, advanced risk management tools, and greater flexibility in trade execution.

Our investment philosophy includes certain return and risk objectives for the fixed maturity securities and equity portfolios. The primary objective of the fixed maturity securities portfolio return is to maximize after-tax investment yield and income while balancing risk. A secondary objective is to meet or exceed a weighted-average benchmark of public fixed income indices. The equity portfolio return objective is to meet or exceed a weighted-average benchmark of public equity indices while balancing risk. Although yield and income generation remain the key drivers to our investment strategy, our overall philosophy is to invest with a long-term horizon along with a “buy-and-hold” principle.

The following table presents information regarding our investment portfolio:

| (\$ in thousands)                              | Quarter ended         |         | Change<br>% or<br>Points | Nine Months ended     |           | Change<br>% or<br>Points |
|------------------------------------------------|-----------------------|---------|--------------------------|-----------------------|-----------|--------------------------|
|                                                | September 30,<br>2010 | 2009    |                          | September 30,<br>2010 | 2009      |                          |
| Total invested assets                          |                       |         |                          | \$ 3,970,634          | 3,766,696 | 5%                       |
| Net investment income – before tax             | \$ 32,986             | 36,585  | (10)%                    | 104,237               | 78,670    | 32                       |
| Net investment income – after tax              | 25,305                | 28,382  | (11)                     | 80,058                | 65,392    | 22                       |
| Unrealized gain during the period – before tax | 45,704                | 46,528  | (2)                      | 90,126                | 139,279   | (35)                     |
| Unrealized gain during the period – after tax  | 29,708                | 30,243  | (2)                      | 58,582                | 90,531    | (35)                     |
| Net realized gains (losses) – before tax       | 57                    | (4,983) | 101                      | (3,271)               | (40,302)  | 92                       |
| Net realized gains (losses) – after tax        | 37                    | (3,239) | 101                      | (2,126)               | (26,197)  | 92                       |

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|                                                     |       |      |        |       |      |        |
|-----------------------------------------------------|-------|------|--------|-------|------|--------|
| Effective tax rate                                  | 23.3% | 22.4 | 0.9pts | 23.2% | 16.9 | 6.3pts |
| Annual after-tax yield on fixed maturity securities |       |      |        | 2.8%  | 3.4  | (0.6)  |
| Annual after-tax yield on investment portfolio      |       |      |        | 2.8%  | 2.4  | 0.4    |

### Total Invested Assets

Our investment portfolio totaled \$4.0 billion at September 30, 2010, an increase of 5% compared to September 30, 2009. This increase was driven primarily by cash flows generated from insurance operations and valuation improvements within the fixed maturity securities portfolio, which resulted in an \$89.0 million improvement in unrealized gains, bringing the portfolio from a \$38.2 million gain position at September 30, 2009 to an \$127.2 million gain position at September 30, 2010.

Our investment portfolio consists primarily of fixed maturity investments (88%), but also contains short-term investments (7%), other investments (4%), and equity securities (1%). We structure our portfolio conservatively with a focus on: (i) asset diversification; (ii) investment quality; (iii) liquidity, particularly to meet the cash obligations of our Insurance Operations segment; (iv) consideration of taxes; and (v) preservation of capital. We believe that we have a high quality and liquid investment portfolio. The duration of the fixed maturity securities portfolio as of September 30, 2010, including short-term investments, was an average of 3.5 years compared to the Insurance Subsidiaries' liability duration of approximately 3.6 years, which was relatively consistent with the prior year. The current duration of the fixed maturity securities portfolio is within our historical range, and is monitored and managed to maximize yield and limit interest rate risk. We manage liquidity with a laddered maturity structure and an appropriate level of short-term investments to avoid liquidation of available-for-sale ("AFS") fixed maturities in the ordinary course of business. We typically have a long investment time horizon and every purchase or sale is made with the intent of improving future investment returns while balancing capital preservation.

As of September 30, 2010, alternative investments represented 4% of our total invested assets. In addition to the capital that we have already invested to date, we are contractually obligated to invest up to an additional \$92.1 million in these alternative investments through commitments that currently expire at various dates through 2023. See Note 6. "Investments" in Item 1. "Financial Statements" of this Form 10-Q and Note 5. "Investments" in Item 8. "Financial Statements and Supplementary Data." of our 2009 Annual Report for quantitative data on our alternative investments portfolio by strategy.

As mentioned above, our fixed maturity securities portfolio carries a weighted average credit rating of "AA" despite ratings migration over the past year due to general economic conditions and our recent heavier allocation to investment-grade corporate bonds. The following table presents the credit ratings of our fixed maturity securities portfolio:

| Fixed Maturity Security Rating | September 30, 2010 | December 31, 2009 |
|--------------------------------|--------------------|-------------------|
| Aaa/AAA                        | 48%                | 57%               |
| Aa/AA                          | 25%                | 25%               |
| A/A                            | 21%                | 14%               |
| Baa/BBB                        | 5%                 | 3%                |
| Ba/BB or below                 | 1%                 | 1%                |
| Total                          | 100%               | 100%              |

To manage and mitigate exposure to losses, we and our external investment managers analyze our mortgage-backed securities ("MBS") both at the time of purchase and as part of the ongoing portfolio evaluation. This analysis may include loan level reviews of average FICO® scores, loan-to-value ratios, geographic spread of the assets securing the bond, delinquencies in payments for the underlying mortgages, gains/losses on sales, evaluations of projected cash flows under various economic and default scenarios, as well as other information that aids in determining the health of the underlying assets. Other considerations include the overall credit environment, economic conditions, total projected return on the investment, and overall asset allocation of the portfolio in our decisions to purchase or sell



structured securities. For additional information regarding credit risk associated with our portfolio, see Item 7A. “Quantitative and Qualitative Disclosures About Market Risk.” in our 2009 Annual Report.

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The following table summarizes the fair value, unrealized gain (loss) balances, and the weighted average credit qualities of our AFS fixed maturity securities at September 30, 2010 and December 31, 2009:

| (\$ in millions)                             | September 30, 2010 |                        |                        | December 31, 2009 |                        |                        |
|----------------------------------------------|--------------------|------------------------|------------------------|-------------------|------------------------|------------------------|
|                                              | Fair Value         | Unrealized Gain (Loss) | Average Credit Quality | Fair Value        | Unrealized Gain (Loss) | Average Credit Quality |
| <b>AFS Fixed Maturity Portfolio:</b>         |                    |                        |                        |                   |                        |                        |
| U.S. government obligations <sup>1</sup>     | \$ 330.6           | 11.9                   | AAA                    | \$ 475.6          | 1.8                    | AAA                    |
| Foreign government obligations               | 8.5                | 0.6                    | AA-                    | -                 | -                      | -                      |
| State and municipal obligations              | 480.3              | 33.6                   | AA+                    | 379.8             | 20.3                   | AA+                    |
| Corporate securities                         | 869.5              | 48.5                   | A+                     | 379.6             | 14.1                   | A+                     |
| MBS                                          | 402.1              | 13.1                   | AA+                    | 382.9             | (17.1)                 | AA+                    |
| Asset-backed securities ("ABS")              | 24.0               | 0.7                    | AA+                    | 18.0              | 0.3                    | AA+                    |
| <b>Total AFS fixed maturity portfolio</b>    | <b>\$ 2,115.0</b>  | <b>108.4</b>           | <b>AA</b>              | <b>\$ 1,635.9</b> | <b>19.4</b>            | <b>AA+</b>             |
| <b>State and Municipal Obligations:</b>      |                    |                        |                        |                   |                        |                        |
| General obligations                          | \$ 281.8           | 19.5                   | AA+                    | \$ 222.6          | 11.0                   | AA+                    |
| Special revenue obligations                  | 198.5              | 14.1                   | A+                     | 157.2             | 9.3                    | AA+                    |
| <b>Total state and municipal obligations</b> | <b>\$ 480.3</b>    | <b>33.6</b>            | <b>AA+</b>             | <b>\$ 379.8</b>   | <b>20.3</b>            | <b>AA+</b>             |
| <b>Corporate Securities:</b>                 |                    |                        |                        |                   |                        |                        |
| Financial                                    | \$ 261.7           | 11.5                   | A+                     | \$ 67.4           | 3.0                    | AA-                    |
| Industrials                                  | 74.1               | 6.2                    | A-                     | 46.6              | 2.2                    | A                      |
| Utilities                                    | 49.7               | 2.4                    | A-                     | 18.9              | 0.9                    | A-                     |
| Consumer discretion                          | 70.2               | 3.9                    | A                      | 26.3              | 1.3                    | A-                     |
| Consumer staples                             | 87.2               | 5.0                    | A-                     | 51.6              | 1.4                    | A                      |
| Healthcare                                   | 132.1              | 8.7                    | AA-                    | 52.8              | 1.7                    | AA-                    |
| Materials                                    | 45.3               | 2.5                    | A-                     | 20.7              | 0.8                    | A-                     |
| Energy                                       | 39.9               | 2.4                    | A+                     | 42.4              | 1.3                    | AA-                    |
| Information technology                       | 47.8               | 2.0                    | A+                     | 10.8              | 0.1                    | AA                     |
| Telecommunications services                  | 37.5               | 1.5                    | A                      | 14.6              | 0.5                    | A                      |
| Other                                        | 24.0               | 2.4                    | A                      | 27.5              | 0.9                    | A                      |
| <b>Total corporate securities</b>            | <b>\$ 869.5</b>    | <b>48.5</b>            | <b>A+</b>              | <b>\$ 379.6</b>   | <b>14.1</b>            | <b>A+</b>              |
| <b>MBS:</b>                                  |                    |                        |                        |                   |                        |                        |
| Government guaranteed agency CMBS            | \$ 74.7            | 5.7                    | AAA                    | \$ 94.6           | 1.1                    | AAA                    |
| Non-agency CMBS                              | 27.3               | (2.0)                  | A-                     | 9.0               | 0.1                    | AA-                    |
| Government guaranteed agency RMBS            | 93.6               | 3.4                    | AAA                    | 105.2             | 0.1                    | AAA                    |
| Other agency RMBS                            | 160.2              | 7.4                    | AAA                    | 119.8             | 1.9                    | AAA                    |
| Non-agency RMBS                              | 36.0               | (1.1)                  | A-                     | 30.2              | (12.8)                 | A-                     |
| Alternative-A ("Alt-A") RMBS                 | 10.3               | (0.3)                  | AAA                    | 24.1              | (7.5)                  | A-                     |
| <b>Total MBS</b>                             | <b>\$ 402.1</b>    | <b>13.1</b>            | <b>AA+</b>             | <b>\$ 382.9</b>   | <b>(17.1)</b>          | <b>AA+</b>             |
| <b>ABS:</b>                                  |                    |                        |                        |                   |                        |                        |

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|                               |    |      |       |     |    |      |     |     |
|-------------------------------|----|------|-------|-----|----|------|-----|-----|
| ABS                           | \$ | 23.1 | 0.9   | AAA | \$ | 18.0 | 0.3 | AA+ |
| Sub prime ABS <sup>2, 3</sup> |    | 0.9  | (0.2) | D   |    | -    | -   | -   |
| Total ABS                     | \$ | 24.0 | 0.7   | AA+ | \$ | 18.0 | 0.3 | AA+ |

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

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

3 Subprime ABS includes one security which is currently expected to default on its obligations according to the rating agencies.

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The following tables provide information regarding our held-to-maturity (“HTM”) fixed maturity securities and their credit qualities at September 30, 2010 and December 31, 2009:

| September 30, 2010                           | Fair Value        | Carry Value    | Unrecognized Holding Gain (Loss) | Unrealized Gain (Loss) in Accumulated OCI | Total Unrealized/Unrecognized Gain (Loss) | Average Credit Quality |
|----------------------------------------------|-------------------|----------------|----------------------------------|-------------------------------------------|-------------------------------------------|------------------------|
| <b>HTM Portfolio:</b>                        |                   |                |                                  |                                           |                                           |                        |
| U.S. government obligations <sup>1</sup>     | \$ 107.1          | 99.6           | 7.5                              | 4.9                                       | 12.4                                      | AAA                    |
| State and municipal obligations              | 1,058.6           | 1,020.5        | 38.1                             | 25.0                                      | 63.1                                      | AA-                    |
| Corporate securities                         | 94.1              | 83.2           | 10.9                             | (4.0)                                     | 6.9                                       | A-                     |
| MBS                                          | 167.5             | 157.8          | 9.7                              | (4.5)                                     | 5.2                                       | AA+                    |
| ABS                                          | 12.8              | 11.6           | 1.2                              | (2.6)                                     | (1.4)                                     | A                      |
| <b>Total HTM portfolio</b>                   | <b>\$ 1,440.1</b> | <b>1,372.7</b> | <b>67.4</b>                      | <b>18.8</b>                               | <b>86.2</b>                               | <b>AA-</b>             |
| <b>State and Municipal Obligations:</b>      |                   |                |                                  |                                           |                                           |                        |
| General obligations                          | \$ 286.1          | 277.2          | 8.9                              | 11.2                                      | 20.1                                      | AA-                    |
| Special revenue obligations                  | 772.5             | 743.3          | 29.2                             | 13.8                                      | 43.0                                      | AA-                    |
| <b>Total state and municipal obligations</b> | <b>\$ 1,058.6</b> | <b>1,020.5</b> | <b>38.1</b>                      | <b>25.0</b>                               | <b>63.1</b>                               | <b>AA-</b>             |
| <b>Corporate Securities:</b>                 |                   |                |                                  |                                           |                                           |                        |
| Financial                                    | \$ 29.4           | 25.4           | 4.0                              | (2.4)                                     | 1.6                                       | BBB+                   |
| Industrials                                  | 23.1              | 19.3           | 3.8                              | (1.3)                                     | 2.5                                       | BBB+                   |
| Utilities                                    | 17.6              | 16.2           | 1.4                              | (0.1)                                     | 1.3                                       | A-                     |
| Consumer discretion                          | 12.8              | 12.2           | 0.6                              | 0.2                                       | 0.8                                       | A+                     |
| Consumer staples                             | 5.4               | 4.9            | 0.5                              | (0.1)                                     | 0.4                                       | A                      |
| Materials                                    | 2.2               | 1.9            | 0.3                              | (0.1)                                     | 0.2                                       | BBB-                   |
| Energy                                       | 3.6               | 3.3            | 0.3                              | (0.2)                                     | 0.1                                       | BBB-                   |
| <b>Total corporate securities</b>            | <b>\$ 94.1</b>    | <b>83.2</b>    | <b>10.9</b>                      | <b>(4.0)</b>                              | <b>6.9</b>                                | <b>A-</b>              |
| <b>MBS:</b>                                  |                   |                |                                  |                                           |                                           |                        |
| Government guaranteed agency CMBS            | \$ 10.2           | 9.9            | 0.3                              | -                                         | 0.3                                       | AAA                    |
| Other agency CMBS                            | 3.6               | 3.6            | -                                | -                                         | -                                         | AA                     |
| Non-agency CMBS                              | 50.5              | 44.8           | 5.7                              | (6.0)                                     | (0.3)                                     | AA+                    |
| Government guaranteed agency RMBS            | 4.4               | 4.0            | 0.4                              | -                                         | 0.4                                       | AA                     |
| Other agency RMBS                            | 98.7              | 95.4           | 3.3                              | 1.5                                       | 4.8                                       | AA                     |
| Non-agency RMBS                              | 0.1               | 0.1            | -                                | -                                         | -                                         | AA                     |
| <b>Total MBS</b>                             | <b>\$ 167.5</b>   | <b>157.8</b>   | <b>9.7</b>                       | <b>(4.5)</b>                              | <b>5.2</b>                                | <b>AA+</b>             |
| <b>ABS:</b>                                  |                   |                |                                  |                                           |                                           |                        |
| ABS                                          | \$ 9.9            | 9.1            | 0.8                              | (1.1)                                     | (0.3)                                     | A                      |
| Alt-A ABS                                    | 2.9               | 2.5            | 0.4                              | (1.5)                                     | (1.1)                                     | A+                     |

|           |    |      |      |     |       |       |   |
|-----------|----|------|------|-----|-------|-------|---|
| Total ABS | \$ | 12.8 | 11.6 | 1.2 | (2.6) | (1.4) | A |
|-----------|----|------|------|-----|-------|-------|---|

42

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| December 31, 2009                        |            |         | Unrecognized | Unrealized  | Total         | Average |
|------------------------------------------|------------|---------|--------------|-------------|---------------|---------|
| (\$ in millions)                         | Fair       | Carry   | Holding      | Gain        | Unrealized/   | Credit  |
|                                          | Value      | Value   | Gain         | (Loss) in   | Unrecognized/ | Quality |
|                                          |            |         | (Loss)       | Accumulated | Gain (Loss)   |         |
|                                          |            |         |              | OCI         |               |         |
| <b>HTM Portfolio:</b>                    |            |         |              |             |               |         |
| U.S. government obligations <sup>1</sup> | \$ 146.0   | 144.8   | 1.2          | 5.6         | 6.8           | AAA     |
| State and municipal obligations          | 1,210.8    | 1,201.4 | 9.4          | 33.9        | 43.3          | AA      |
| Corporate securities                     | 107.5      | 98.8    | 8.7          | (6.0)       | 2.7           | A-      |
| MBS                                      | 245.7      | 239.1   | 6.6          | (17.9)      | (11.3)        | AA+     |
| ABS                                      | 30.2       | 26.3    | 3.9          | (5.7)       | (1.8)         | AA-     |
| Total HTM portfolio                      | \$ 1,740.2 | 1,710.4 | 29.8         | 9.9         | 39.7          | AA+     |
| <b>State and Municipal Obligations:</b>  |            |         |              |             |               |         |
| General obligations                      | \$ 301.5   | 300.8   | 0.7          | 14.7        | 15.4          | AA+     |
| Special revenue obligations              | 909.3      | 900.6   | 8.7          | 19.2        | 27.9          | AA      |
| Total state and municipal obligations    | \$ 1,210.8 | 1,201.4 | 9.4          | 33.9        | 43.3          | AA      |
| <b>Corporate Securities:</b>             |            |         |              |             |               |         |
| Financial                                | \$ 35.4    | 31.8    | 3.6          | (4.0)       | (0.4)         | A       |
| Industrials                              | 29.1       | 25.7    | 3.4          | (2.0)       | 1.4           | A-      |
| Utilities                                | 16.5       | 16.3    | 0.2          | (0.1)       | 0.1           | A-      |
| Consumer discretion                      | 6.3        | 6.0     | 0.3          | -           | 0.3           | BBB+    |
| Consumer staples                         | 14.6       | 13.9    | 0.7          | 0.5         | 1.2           | AA-     |
| Materials                                | 2.1        | 1.9     | 0.2          | (0.1)       | 0.1           | BBB-    |
| Energy                                   | 3.5        | 3.2     | 0.3          | (0.3)       | -             | BB+     |
| Total corporate securities               | \$ 107.5   | 98.8    | 8.7          | (6.0)       | 2.7           | A-      |
| <b>MBS</b>                               |            |         |              |             |               |         |
| Government guaranteed agency CMBS        | \$ 11.1    | 10.8    | 0.3          | -           | 0.3           | AAA     |
| Other agency CMBS                        | 3.8        | 3.8     | -            | 0.1         | 0.1           | AAA     |
| Non-agency CMBS                          | 80.5       | 77.1    | 3.4          | (19.2)      | (15.8)        | AA+     |
| Government guaranteed agency RMBS        | 4.2        | 3.9     | 0.3          | (0.2)       | 0.1           | AAA     |
| Other agency RMBS                        | 140.2      | 137.7   | 2.5          | 2.5         | 5.0           | AAA     |
| Non-agency RMBS                          | 5.9        | 5.8     | 0.1          | (1.1)       | (1.0)         | AAA     |
| Total MBS                                | \$ 245.7   | 239.1   | 6.6          | (17.9)      | (11.3)        | AA+     |
| <b>ABS:</b>                              |            |         |              |             |               |         |
| ABS                                      | \$ 27.3    | 24.3    | 3.0          | (4.8)       | (1.8)         | AA      |
| Alt-A ABS                                | 1.8        | 1.0     | 0.8          | (0.5)       | 0.3           | CC      |
| Sub-prime ABS <sup>2</sup>               | 1.1        | 1.0     | 0.1          | (0.4)       | (0.3)         | A       |
| Total ABS                                | \$ 30.2    | 26.3    | 3.9          | (5.7)       | (1.8)         | AA-     |

<sup>1</sup>U.S. government includes corporate securities fully guaranteed by the FDIC.

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

A portion of our AFS and HTM municipal bonds contain insurance enhancements. The following table provides information regarding these insurance-enhanced securities as of September 30, 2010:

| Insurers of Municipal Bond Securities                                     |                   | Ratings<br>with | Ratings<br>without |
|---------------------------------------------------------------------------|-------------------|-----------------|--------------------|
| (\$ in thousands)                                                         | Fair Value        | Insurance       | Insurance          |
| National Public Finance Guarantee Corporation, a subsidiary of MBIA, Inc. | \$ 400,411        | AA-             | A+                 |
| Assured Guaranty                                                          | 257,453           | AA+             | AA-                |
| Ambac Financial Group, Inc.                                               | 107,870           | AA-             | AA-                |
| Other                                                                     | 21,523            | AA              | AA-                |
| <b>Total</b>                                                              | <b>\$ 787,257</b> | <b>AA</b>       | <b>AA-</b>         |

The following table details the top 10 state exposures of the municipal bond portion of our fixed maturity securities portfolio at September 30, 2010:

| State Exposures of Municipal Bonds<br>(\$ in thousands) | General<br>Obligation | Special<br>Revenue | Fair<br>Value    | Average<br>Credit<br>Quality |
|---------------------------------------------------------|-----------------------|--------------------|------------------|------------------------------|
| Texas                                                   | \$ 109,945            | 65,549             | 175,494          | AA                           |
| Washington                                              | 48,679                | 47,407             | 96,086           | A+                           |
| Florida                                                 | 515                   | 82,404             | 82,919           | A+                           |
| Arizona                                                 | 7,071                 | 70,483             | 77,554           | AA                           |
| North Carolina                                          | 42,567                | 28,930             | 71,497           | AA+                          |
| New York                                                | -                     | 70,463             | 70,463           | AA+                          |
| Illinois                                                | 20,865                | 46,612             | 67,477           | AA                           |
| Ohio                                                    | 21,579                | 38,318             | 59,897           | AA                           |
| Colorado                                                | 36,040                | 23,331             | 59,371           | A+                           |
| Other                                                   | 251,384               | 452,121            | 703,505          | AA                           |
|                                                         | \$ 538,645            | 925,618            | 1,464,263        | AA                           |
| Advanced refunded/escrowed to maturity<br>bonds         | 29,250                | 45,420             | 74,670           | AA                           |
| <b>Total</b>                                            | <b>\$ 567,895</b>     | <b>971,038</b>     | <b>1,538,933</b> | <b>AA</b>                    |

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

September 30, 2010

| (\$ in thousands)                  | Market<br>Value   | % of Special<br>Revenue<br>Bonds | Average<br>Rating |
|------------------------------------|-------------------|----------------------------------|-------------------|
| <b>Essential Services:</b>         |                   |                                  |                   |
| Transportation                     | \$ 194,474        | 21%                              | AA-               |
| Water and Sewer                    | 179,973           | 19%                              | AA                |
| Electric                           | 109,244           | 12%                              | AA-               |
| <b>Total Essential Services</b>    | <b>483,691</b>    | <b>52%</b>                       | <b>AA</b>         |
| Education                          | 144,444           | 16%                              | AA                |
| Special Tax                        | 116,898           | 13%                              | AA-               |
| Housing                            | 83,827            | 9%                               | AA-               |
| <b>Other:</b>                      |                   |                                  |                   |
| Leasing                            | 35,655            | 4%                               | AA                |
| Hospital                           | 20,122            | 2%                               | A+                |
| Other                              | 40,981            | 4%                               | AA-               |
| <b>Total Other</b>                 | <b>96,758</b>     | <b>10%</b>                       | <b>AA-</b>        |
| <b>Total Special Revenue Bonds</b> | <b>\$ 925,618</b> | <b>100%</b>                      | <b>AA-</b>        |

For details regarding our special revenue bond sectors, see Item 7A. “Quantitative and Qualitative Disclosures About Market Risk.” of our 2009 Annual Report.





### Net Investment Income

Net investment income, before tax, decreased by \$3.6 million for Third Quarter 2010 compared to Third Quarter 2009, and increased by \$25.6 million for Nine Months 2010 compared to Nine Months 2009. For Third Quarter 2010, the decrease was primarily driven by a \$3.0 million decrease in income on our fixed maturity securities due to lower yields as compared to the prior year. The improvement in Nine Months 2010 was primarily attributable to an increase in income on the alternative investment portion of our other investment portfolio compared to a loss on these investments in the comparable period during 2009, partially offset by: (i) lower fixed maturity reinvestment yields; and (ii) increased investment expense related to severance payments as a result of our decision to outsource the management of our investment portfolio.

Our alternative investments, which are accounted for under the equity method, primarily consist of investments in limited partnerships, the majority of which report results to us on a one quarter lag. The improvement in the returns on these investments is reflective of improved equity and credit markets, as well as increased stability in the financial markets.

### Realized Gains and Losses

#### Realized Gains and Losses (excluding OTTI)

Realized gains and losses, by type of security excluding OTTI charges, are determined on the basis of the cost of specific investments sold and are credited or charged to income. The components of net realized losses at September 30 were as follows:

| (\$ in thousands)                                         | Quarter ended<br>September 30, |                | Nine Months ended<br>September 30, |                 |
|-----------------------------------------------------------|--------------------------------|----------------|------------------------------------|-----------------|
|                                                           | 2010                           | 2009           | 2010                               | 2009            |
| <b>HTM fixed maturity securities</b>                      |                                |                |                                    |                 |
| Gains                                                     | \$ 123                         | 81             | 535                                | 219             |
| Losses                                                    | (296)                          | (236)          | (746)                              | (530)           |
| <b>AFS fixed maturity securities</b>                      |                                |                |                                    |                 |
| Gains                                                     | 2,961                          | 4,154          | 7,743                              | 17,752          |
| Losses                                                    | (15)                           | (4,441)        | (7,604)                            | (13,400)        |
| <b>AFS equity securities</b>                              |                                |                |                                    |                 |
| Gains                                                     | 912                            | 551            | 15,086                             | 29,257          |
| Losses                                                    | (821)                          | -              | (1,054)                            | (27,744)        |
| <b>Other Investments</b>                                  |                                |                |                                    |                 |
| Gains                                                     | -                              | -              | -                                  | -               |
| Losses                                                    | -                              | (850)          | -                                  | (2,039)         |
| <b>Total other net realized investment gains (losses)</b> | <b>2,864</b>                   | <b>(741)</b>   | <b>13,960</b>                      | <b>3,515</b>    |
| <b>Total OTTI charges recognized in earnings</b>          | <b>(2,807)</b>                 | <b>(4,242)</b> | <b>(17,231)</b>                    | <b>(43,817)</b> |
| <b>Total net realized gains (losses)</b>                  | <b>\$ 57</b>                   | <b>(4,983)</b> | <b>(3,271)</b>                     | <b>(40,302)</b> |

The following table presents the period of time that securities sold at a loss were continuously in an unrealized loss position prior to sale:

| Period of Time in an<br>Unrealized Loss Position | Quarter ended<br>September 30, 2010 |                  | Quarter ended<br>September 30, 2009 |                  |
|--------------------------------------------------|-------------------------------------|------------------|-------------------------------------|------------------|
|                                                  | Fair<br>Value on<br>Sale Date       | Realized<br>Loss | Fair<br>Value on<br>Sale Date       | Realized<br>Loss |
| (\$ in thousands)                                |                                     |                  |                                     |                  |
| <b>Fixed maturities:</b>                         |                                     |                  |                                     |                  |
| 0 – 6 months                                     | \$ -                                | -                | 9,119                               | 4,200            |
| 7 – 12 months                                    | -                                   | -                | -                                   | -                |
| Greater than 12 months                           | -                                   | -                | -                                   | -                |
| <b>Total fixed maturities</b>                    | <b>-</b>                            | <b>-</b>         | <b>9,119</b>                        | <b>4,200</b>     |
| <b>Equities:</b>                                 |                                     |                  |                                     |                  |
| 0 – 6 months                                     | 6,326                               | 332              | -                                   | -                |
| 7 – 12 months                                    | 3,173                               | 489              | -                                   | -                |
| <b>Total equity securities</b>                   | <b>9,499</b>                        | <b>821</b>       | <b>-</b>                            | <b>-</b>         |
| <b>Total</b>                                     | <b>\$ 9,499</b>                     | <b>821</b>       | <b>9,119</b>                        | <b>4,200</b>     |

| Period of Time in an<br>Unrealized Loss Position | Nine Months ended<br>September 30, 2010 |                  | Nine Months ended<br>September 30, 2009 |                  |
|--------------------------------------------------|-----------------------------------------|------------------|-----------------------------------------|------------------|
|                                                  | Fair<br>Value on<br>Sale Date           | Realized<br>Loss | Fair<br>Value on<br>Sale Date           | Realized<br>Loss |
| (\$ in thousands)                                |                                         |                  |                                         |                  |
| <b>Fixed maturities:</b>                         |                                         |                  |                                         |                  |
| 0 – 6 months                                     | \$ 11,462                               | 463              | 53,284                                  | 6,660            |
| 7 – 12 months                                    | -                                       | -                | 38,292                                  | 3,424            |
| Greater than 12 months                           | 10,257                                  | 7,098            | 36,418                                  | 3,247            |
| <b>Total fixed maturities</b>                    | <b>21,719</b>                           | <b>7,561</b>     | <b>127,994</b>                          | <b>13,331</b>    |
| <b>Equities:</b>                                 |                                         |                  |                                         |                  |
| 0 – 6 months                                     | 10,454                                  | 565              | 27,313                                  | 20,308           |
| 7 – 12 months                                    | 3,173                                   | 489              | 8,230                                   | 7,436            |
| <b>Total equity securities</b>                   | <b>13,627</b>                           | <b>1,054</b>     | <b>35,543</b>                           | <b>27,744</b>    |
| <b>Other investments</b>                         |                                         |                  |                                         |                  |
| 7 – 12 months                                    | -                                       | -                | 4,816                                   | 1,189            |
| <b>Total other investments</b>                   | <b>-</b>                                | <b>-</b>         | <b>4,816</b>                            | <b>1,189</b>     |
| <b>Total</b>                                     | <b>\$ 35,346</b>                        | <b>8,615</b>     | <b>168,353</b>                          | <b>42,264</b>    |

For a discussion of realized gains and losses, see Note 6. "Investments" in Item 1. "Financial Statements" of this Form 10-Q.

## Other-than-Temporary Impairments

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

| (\$ in thousands)                                | Quarter ended<br>September 30, |              | Nine Months ended<br>September 30, |               |
|--------------------------------------------------|--------------------------------|--------------|------------------------------------|---------------|
|                                                  | 2010                           | 2009         | 2010                               | 2009          |
| <b>HTM securities</b>                            |                                |              |                                    |               |
| ABS                                              | \$ -                           | 68           | 31                                 | 2,421         |
| CMBS                                             | 90                             | -            | 4,215                              | 711           |
| RMBS                                             | 102                            | -            | 419                                | -             |
| <b>Total HTM securities</b>                      | <b>192</b>                     | <b>68</b>    | <b>4,665</b>                       | <b>3,132</b>  |
| <b>AFS securities</b>                            |                                |              |                                    |               |
| Corporate securities                             | -                              | -            | -                                  | 1,270         |
| CMBS                                             | 781                            | -            | 2,153                              | -             |
| RMBS                                             | 9                              | 3,882        | 7,916                              | 37,677        |
| <b>Total fixed maturity AFS securities</b>       | <b>790</b>                     | <b>3,882</b> | <b>10,069</b>                      | <b>38,947</b> |
| Equity securities                                | 1,825                          | 292          | 2,497                              | 1,738         |
| <b>Total AFS securities</b>                      | <b>2,615</b>                   | <b>4,174</b> | <b>12,566</b>                      | <b>40,685</b> |
| <b>Total OTTI charges recognized in earnings</b> | <b>\$ 2,807</b>                | <b>4,242</b> | <b>17,231</b>                      | <b>43,817</b> |

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

For discussion of our OTTI methodology, see Note 2. “Summary of Significant Accounting Policies” in Item 8. “Financial Statements and Supplementary Data.” of our 2009 Annual Report. In addition, for significant inputs used to measure OTTI and qualitative information regarding these charges, see Note 6. “Investments,” included in Item 1. “Financial Statements” of this Form 10-Q.

## Unrealized/Unrecognized Losses

The following table summarizes the aggregate fair value and gross pre-tax unrealized/unrecognized losses recorded, by asset class and by length of time, for all securities that have continuously been in an unrealized/unrecognized loss position at September 30, 2010 and December 31, 2009:

| September 30, 2010                               | 0 – 6 months |                                      | 7 – 11 months |                                      | 12 months or longer |                                      |
|--------------------------------------------------|--------------|--------------------------------------|---------------|--------------------------------------|---------------------|--------------------------------------|
|                                                  |              | Net                                  |               | Net                                  |                     | Net                                  |
|                                                  | Fair Value   | Unrecognized<br>Unrealized<br>Losses | Fair Value    | Unrecognized<br>Unrealized<br>Losses | Fair Value          | Unrecognized<br>Unrealized<br>Losses |
| (\$ in thousands)                                |              |                                      |               |                                      |                     |                                      |
| AFS securities                                   |              |                                      |               |                                      |                     |                                      |
| Obligations of states and political subdivisions | \$ 505       | (5)                                  | -             | -                                    | -                   | -                                    |
| Corporate securities                             | 41,792       | (113)                                | -             | -                                    | -                   | -                                    |
| ABS                                              | -            | -                                    | -             | -                                    | 933                 | (218)                                |
| CMBS                                             | -            | -                                    | -             | -                                    | 11,048              | (3,079)                              |
| RMBS                                             | 24,297       | (109)                                | -             | -                                    | 30,116              | (1,608)                              |
| Total fixed maturity securities                  | 66,594       | (227)                                | -             | -                                    | 42,097              | (4,905)                              |
| Equity securities                                | -            | -                                    | -             | -                                    | -                   | -                                    |
| Subtotal                                         | \$ 66,594    | (227)                                | -             | -                                    | 42,097              | (4,905)                              |
| HTM securities                                   |              |                                      |               |                                      |                     |                                      |
| Obligations of states and political subdivisions | \$ 4,105     | (7)                                  | 1,474         | (8)                                  | 33,546              | (1,104)                              |
| Corporate securities                             | -            | -                                    | -             | -                                    | 5,872               | (153)                                |
| ABS                                              | 534          | (961)                                | -             | -                                    | 6,723               | (702)                                |
| CMBS                                             | 3,640        | (2)                                  | -             | -                                    | 5,510               | (3,330)                              |
| RMBS                                             | -            | -                                    | -             | -                                    | 94                  | (39)                                 |
| Subtotal                                         | \$ 8,279     | (970)                                | 1,474         | (8)                                  | 51,745              | (5,328)                              |
| Total AFS and HTM                                | \$ 74,873    | (1,197)                              | 1,474         | (8)                                  | 93,842              | (10,233)                             |

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| December 31, 2009                                    | 0 – 6 months |              | 7 – 11 months <sup>1</sup> |              | 12 months or longer <sup>1</sup> |              |
|------------------------------------------------------|--------------|--------------|----------------------------|--------------|----------------------------------|--------------|
|                                                      | Fair         | Net          | Fair                       | Net          | Fair                             | Net          |
| (\$ in thousands)                                    | Value        | Unrecognized | Value                      | Unrecognized | Value                            | Unrecognized |
|                                                      |              | Losses       |                            | Losses       |                                  | Losses       |
| <b>AFS securities</b>                                |              |              |                            |              |                                  |              |
| U.S. government and government agencies <sup>2</sup> | \$ 187,283   | (1,210)      | -                          | -            | -                                | -            |
| Obligations of states and political subdivisions     | 8,553        | (120)        | -                          | -            | 3,059                            | (17)         |
| Corporate securities                                 | 74,895       | (829)        | -                          | -            | 10,550                           | (417)        |
| ABS                                                  | 2,983        | (17)         | -                          | -            | -                                | -            |
| CMBS                                                 | 36,447       | (637)        | -                          | -            | 3,960                            | (40)         |
| RMBS                                                 | 77,674       | (493)        | 654                        | (21)         | 53,607                           | (20,198)     |
| Total fixed maturity securities                      | 387,835      | (3,306)      | 654                        | (21)         | 71,176                           | (20,672)     |
| Equity securities                                    | 3,828        | (214)        | -                          | -            | 5,932                            | (396)        |
| Sub-total                                            | \$ 391,663   | (3,520)      | 654                        | (21)         | 77,108                           | (21,068)     |
| <b>HTM securities</b>                                |              |              |                            |              |                                  |              |
| U.S. government and government agencies <sup>2</sup> | \$ 19,746    | (29)         | 9,713                      | (288)        | -                                | -            |
| Obligations of states and political subdivisions     | 40,904       | (332)        | 5,767                      | (181)        | 74,360                           | (2,684)      |
| Corporate securities                                 | 6,124        | (102)        | -                          | -            | 19,233                           | (1,310)      |
| ABS                                                  | -            | -            | -                          | -            | 10,403                           | (2,436)      |
| CMBS                                                 | -            | -            | 316                        | (728)        | 24,984                           | (16,254)     |
| RMBS                                                 | 5,068        | (146)        | -                          | -            | 5,892                            | (935)        |
| Sub-total                                            | \$ 71,842    | (609)        | 15,796                     | (1,197)      | 134,872                          | (23,619)     |
| Total AFS and HTM                                    | \$ 463,505   | (4,129)      | 16,450                     | (1,218)      | 211,980                          | (44,687)     |

<sup>1</sup> The month count for aging of unrealized losses was reset back to historical unrealized loss month counts for securities impacted by the adoption of OTTI accounting guidance issued in 2009.

<sup>2</sup> U.S. government includes corporate securities fully guaranteed by the FDIC

Gross pre-tax unrealized/unrecognized losses decreased for our fixed maturity securities portfolio as compared to December 31, 2009, primarily driven by: (i) a general improvement in the overall marketplace; and (ii) \$14.3 million of fixed maturity security sales. For further details regarding these sales, see Note 6. “Investments” in Item 1. “Financial Statements” of this Form 10-Q. As of September 30, 2010, 72 fixed maturity securities and no equity securities were in an unrealized loss position with no individual security having an unrealized/unrecognized loss balance of more than \$2 million. At December 31, 2009, 173 fixed maturity securities and six equity securities were in an unrealized loss position.

We have reviewed the securities in the tables above in accordance with our OTTI policy, which is discussed in Note 2. “Summary of Significant Accounting Policies” in Item 8. “Financial Statements and Supplementary Data.” of our 2009 Annual Report. For qualitative information regarding our conclusion as to why these impairments are deemed temporary, see Note 6. “Investments,” in Item 1. “Financial Statements” of this Form 10-Q.



### Contractual Maturities

The following table presents amortized cost and fair value regarding our AFS fixed maturities that were in an unrealized loss position at September 30, 2010 by contractual maturity:

| Contractual Maturities<br>(\$ in thousands) | Amortized<br>Cost | Fair<br>Value  |
|---------------------------------------------|-------------------|----------------|
| One year or less                            | \$ 10,901         | 9,492          |
| Due after one year through five years       | 58,481            | 55,682         |
| Due after five years through ten years      | 44,441            | 43,517         |
| Due after ten years                         | -                 | -              |
| <b>Total</b>                                | <b>\$ 113,823</b> | <b>108,691</b> |

The following table presents information regarding our HTM fixed maturities that were in an unrealized/unrecognized loss position at September 30, 2010 by contractual maturity:

| Contractual Maturities<br>(\$ in thousands) | Amortized<br>Cost | Fair<br>Value |
|---------------------------------------------|-------------------|---------------|
| One year or less                            | \$ 9,865          | 8,483         |
| Due after one year through five years       | 44,217            | 39,959        |
| Due after five years through ten years      | 12,234            | 11,577        |
| Due after ten years                         | 1,488             | 1,479         |
| <b>Total</b>                                | <b>\$ 67,804</b>  | <b>61,498</b> |

### Investments Outlook

Overall market expectations for U.S. growth have been revised downward from the optimism seen earlier in the year and unemployment is expected to be a concern over the next several years. The Federal Reserve is currently evaluating a new round of stimulus and their actions are expected to be designed to improve the economy's near-term performance while balancing the impact of long-term inflationary conditions. Consensus is building that the Federal Reserve will announce additional purchases of U.S. treasury securities in the fourth quarter of 2010 with the intention of driving yields on those securities lower, which is intended to increase consumer spending and return to more normalized levels of inflation.

The outsourcing of our fixed income and equity investment portfolios to external investment managers was successfully completed. Our overall investment strategy has not changed, only the execution model. We are benefiting from broader sector-specific knowledge, advanced risk management tools, and greater flexibility in trade execution.

Our fixed income strategy remains focused on maintaining sufficient liquidity while maximizing yield within acceptable risk tolerances. We will invest in high quality instruments, while striving to reduce risk, including additions to investment grade corporate bonds with diversified maturities to manage incremental interest rate risk.

We have lowered our exposure to equities and will be pursuing a more index-neutral position for this asset class, in the near term, providing greater sector and sponsor diversification.

Our current outlook for the alternative investment strategy is positive despite the volatility in investment income over the past two years. Performance of the alternatives portfolio has rebounded as the merger and acquisition environment has improved and financing has become available. In the near term, given the volatility we have experienced in the recent past, we remain cautious and may investigate potential opportunities to limit our exposure in the alternative investment class through the use of a secondary market.





#### Federal Income Taxes

Federal income taxes from continuing operations increased by: (i) \$2.0 million for Third Quarter 2010, to an expense of \$3.2 million, compared to an expense of \$1.2 million for Third Quarter 2009; and (ii) \$17.0 million for Nine Months 2010, to an expense of \$7.0 million, compared to a benefit of \$9.9 million for Nine Months 2009. These increases, which are attributable to an increase in net investment income earned coupled with a reduction in net realized losses, resulted in an effective tax rate of approximately 15% for Third Quarter 2010 compared to an effective tax rate of 6% for Third Quarter 2009. The effective tax rate was 13% for Nine Months 2010, and the tax benefit in Nine Months 2009 of \$9.9 million resulted in an effective tax rate of (76)%. The Nine Months 2009 tax benefit resulted from lower pre-tax income associated with the decline in investment income and an increase in net realized losses. Our effective tax rate for continuing operations differs from the federal corporate rate of 35% primarily as a result of tax-advantaged investment income.

#### Financial Condition, Liquidity, and Capital Resources

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

#### Liquidity

We manage liquidity with a focus on generating sufficient cash flows to meet the short-term and long-term cash requirements of our business operations. Our cash and short-term investment position was \$265 million at September 30, 2010, primarily comprised of \$53 million at Selective Insurance Group, Inc. (the "Parent") and \$212 million at the Insurance Subsidiaries.

We continually evaluate our liquidity levels in light of market conditions and, given the financial market volatility over the past two years, we have continued to maintain higher than historical cash and short-term investment balances. During the second quarter of 2010, we intentionally increased our cash and short-term position as the Company transitioned the portfolio to its new external investment managers. During Third Quarter 2010, our outside managers began deploying funds to purchase investments and as a result, although still higher than historical levels, our cash and short-term investment position decreased compared to the prior quarter. Short-term investments are maintained in AAA rated money market funds approved by the National Association of Insurance Commissioners.

Sources of cash for the Parent have consisted of dividends from the Insurance Subsidiaries, borrowings under its line of credit and loan agreements with our Indiana-domiciled Insurance Subsidiaries ("Indiana Subsidiaries"), and the issuance of stock and debt securities. We continue to monitor these sources, giving consideration to our long-term liquidity and capital preservation strategies. The Parent had no private or public issuances of stock or debt during Nine Months 2010. In addition, there were no borrowings under its line of credit or any additional borrowings from its Indiana Subsidiaries.

We currently anticipate the Insurance Subsidiaries paying approximately \$48 million of dividends to the Parent in 2010, of which \$36.0 million was paid through Third Quarter 2010, compared to our allowable ordinary maximum dividend amount of approximately \$101 million. Any dividends to the Parent continue to be subject to the approval and/or review of the insurance regulators in the respective domiciliary states under insurance holding company acts, and are generally payable only from earned surplus as reported in the statutory annual statements of those subsidiaries as of the preceding December 31. Although past dividends have historically been met with regulatory approval, there is no assurance that future dividends that may be declared will be approved given current conditions. For additional information regarding dividend restrictions, refer to Note 10. "Indebtedness" and Note 11. "Stockholders' Equity" in Item 8. "Financial Statements and Supplementary Data." of our 2009 Annual Report.



The Indiana Subsidiaries are members in the Federal Home Loan Bank of Indianapolis (“FHLBI”), which provides these companies with access to additional liquidity. The Indiana Subsidiaries’ aggregate investment of \$0.8 million provides them with the ability to borrow up to 20 times the total amount of the FHLBI common stock purchased, at comparatively low borrowing rates. The Parent’s line of credit agreement permits collateralized borrowings by the Indiana Subsidiaries from the FHLBI so long as the aggregate amount borrowed does not exceed 10% of the respective Indiana Subsidiary’s admitted assets from the preceding calendar year. For additional information regarding the Parent’s line of credit, refer to the section below entitled “Short-term Borrowings.” The Indiana Department of Insurance has approved lending agreements from the Indiana Subsidiaries to the Parent. At September 30, 2010, the outstanding borrowings of the Indiana Subsidiaries from the FHLBI were \$13 million in fixed rate borrowings after pledging the required collateral. These funds have been loaned to the Parent under the approved lending agreements. For additional information regarding the required collateral, refer to Note 10. “Indebtedness” in Item 8. “Financial Statements and Supplementary Data.” of our 2009 Annual Report.

The Insurance Subsidiaries also generate liquidity through insurance float, which is created by collecting premiums and earning investment income before losses are paid. The period of the float can extend over many years. While current market conditions have limited the liquidity in our fixed maturity investments regarding sales, our laddered portfolio, in which some issues are always maturing, continues to provide a source of cash flows for claim payments in the ordinary course of business. The duration of the fixed maturity securities portfolio, including short-term investments, was 3.5 years as of September 30, 2010, while the liabilities of the Insurance Subsidiaries have a duration of approximately 3.6 years. In addition, the Insurance Subsidiaries purchase reinsurance coverage for protection against any significantly large claims or catastrophes that may occur during the year.

The liquidity generated from the sources discussed above is used, among other things, to pay dividends to our shareholders. Dividends on shares of the Parent’s common stock are declared and paid at the discretion of the Board of Directors (the “Board”) based on our operating results, financial condition, capital requirements, and other relevant factors. Our ability to declare dividends was restricted by covenants contained in our 8.87% Senior Notes that matured on May 4, 2010. All such covenants were met during 2010. For further information regarding our notes payable and the related covenants, see Note 10. “Indebtedness,” included in Item 8. “Financial Statements and Supplementary Data.” of our 2009 Annual Report.

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

#### Short-term Borrowings

Our \$30 million line of credit (“Line of Credit”) is syndicated between Wachovia Bank N.A., a subsidiary of Wells Fargo & Company, as administrative agent, and Branch Banking and Trust Company (BB&T). This Line of Credit, which can be increased to \$50 million with the approval of both lending parties, provides the Parent with an additional source of liquidity, if needed. The Line of Credit is not used in our daily cash management but is available if circumstances arise where additional short-term liquidity is necessary. The interest rate on our Line of Credit varies and is based on, among other factors, the Parent’s debt ratings from S&P and Moody’s. The Line of Credit expires on August 11, 2011. We continue to monitor current news regarding the banking industry, in general, and our lending partners, in particular, as, according to the syndicated line of credit agreement, the obligations of the lenders to make loans and to make payments are several and not joint. There were no balances outstanding under this credit facility as of September 30, 2010 or at any time during Nine Months 2010.

The Line of Credit agreement contains representations, warranties, and covenants that are customary for credit facilities of this type, including, without limitation, financial covenants under which we are obligated to maintain a minimum consolidated net worth, minimum combined statutory surplus, and maximum ratio of consolidated debt to total capitalization, as well as covenants limiting our ability to: (i) merge or liquidate; (ii) incur debt or liens; (iii) dispose of assets; (iv) make investments and acquisitions; (v) repurchase common stock; and (vi) engage in transactions with affiliates.

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

|                                     | Required as of<br>September 30, 2010 | Actual as of<br>September 30, 2010 |
|-------------------------------------|--------------------------------------|------------------------------------|
| Consolidated net worth              | \$798.9 million                      | \$1.1 billion                      |
| Statutory surplus                   | Not less than \$750 million          | \$1.0 billion                      |
| Debt-to-capitalization ratio        | Not to exceed 30%                    | 19.4%                              |
| A.M. Best financial strength rating | Minimum of A-                        | A+                                 |

#### Capital Resources

Capital resources provide protection for policyholders, furnish the financial strength to support the business of underwriting insurance risks, and facilitate continued business growth. At September 30, 2010, we had statutory surplus of \$1.0 billion and GAAP stockholders' equity of \$1.1 billion. We had total debt of \$262.3 million at September 30, 2010, which equates to a debt-to-capital ratio of approximately 19.4%.

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

We continually monitor our cash requirements and the amount of capital resources that we maintain at the holding company and operating subsidiary levels. As part of our long-term capital strategy, we strive to maintain an approximate 25% debt-to-capital ratio and a premiums-to-surplus ratio sufficient to maintain an "A+" (Superior) financial strength rating from A.M. Best for the Insurance Subsidiaries. Our premiums-to-surplus ratio was 1.4x and 1.5x on September 30, 2010 and December 31, 2009, respectively. Based on our analysis and market conditions, we may take a variety of actions, including, but not limited to, contributing capital to our subsidiaries in our Insurance Operations, issuing additional debt and/or equity securities, repurchasing shares of the Parent's common stock, and increasing stockholders' dividends.

We continue to maintain liquidity at the Insurance Subsidiary levels. Our capital management strategy is intended to protect the interests of the policyholders of the Insurance Subsidiaries and the Parent's stockholders, while enhancing our financial strength and underwriting capacity.

Book value per share increased to \$20.41 as of September 30, 2010 from \$18.83 as of December 31, 2009, primarily driven by: (i) unrealized gains on our investment portfolio, which led to an increase in book value per share of \$1.09; and (ii) net income, which led to an increase in book value per share of \$0.78. Partially offsetting these increases was the impact of dividends paid to our shareholders, which resulted in decreases in book value per share of \$0.40.

#### Ratings

We are rated by major rating agencies, which issue opinions on our financial strength, operating performance, strategic position, and ability to meet policyholder obligations. We believe that our ability to write insurance business is most influenced by our rating from A.M. Best, which was reaffirmed in the second quarter of 2010 as "A+ (Superior)," their second highest of 15 ratings, with a "negative" outlook. They cited our strong capitalization, solid level of operating profitability, and established presence within our targeted regional markets. We have been rated "A" or higher by A.M. Best for the past 80 years, with our current rating of "A+ (Superior)" being in place for the last 49 consecutive years. The financial strength reflected by our A.M. Best rating is a competitive advantage in the marketplace and influences where independent insurance agents place their business. A downgrade from A.M. Best, could: (i) affect our ability to write new business with customers and/or agents, some of whom are required (under

various third party agreements) to maintain insurance with a carrier that maintains a specified A.M. Best minimum rating; or (ii) be an event of default under our line of credit.

Our ratings by other major rating agencies are as follows:

- S&P Insurance Rating Services — Our “A” financial strength rating was reaffirmed in Third Quarter 2010. S&P cited our strong competitive position in Mid-Atlantic markets, effective use of well-developed predictive modeling, strong financial flexibility, conservative financial leverage, and strong agency relationships. At the same time, S&P revised our outlook to “stable” from “negative,” citing strong cycle management, careful risk selection, improved capital adequacy, and continuing price increases across most commercial and personal lines along with strong retention.
- Moody’s — Our “A2” financial strength rating was reaffirmed in the third quarter of 2008, citing our strong regional franchise with good independent agency support, along with our conservative balance sheet, moderate financial leverage, and consistent profitability. At the same time, Moody’s revised our outlook from “positive” to “stable” reflecting an increasingly competitive commercial lines market and continued weakness in our personal lines book of business.
- Fitch Ratings — Our “A+” rating was reaffirmed in Third Quarter 2010, citing our disciplined underwriting culture, conservative balance sheet, good capitalization, strong independent agency relationships, strong loss reserve position, and improved diversification through our continued efforts to reduce our concentration in New Jersey. At the same time, Fitch revised our outlook to “stable” from “negative”.

Our S&P and Moody’s financial strength ratings affect our ability to access capital markets. In addition, our interest rate under our Line of Credit varies based on the Parent’s debt ratings from S&P and Moody’s. There can be no assurance that our ratings will continue for any given period of time or that they will not be changed. It is possible that positive or negative ratings actions by one or more of the rating agencies may occur in the future. We review our financial debt agreements for any potential rating triggers that could dictate a material change in terms if our credit ratings were to change.

#### Accounting Pronouncements to be Adopted

In October 2010, the FASB issued ASU Update 2010-26, Financial Services-Insurance (Topic 944) – Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts. This guidance requires that only costs that are incremental or directly related to the successful acquisition of new or renewal insurance contracts are to be capitalized as a deferred acquisition cost. This would include, among other items, sales commissions paid to agents, premium taxes, and the portion of employee salaries and benefits directly related to time spent on acquired contracts. This guidance is effective, either with a prospective or retrospective application, for interim and annual periods beginning after December 15, 2011, with early adoption permitted. Although we are currently evaluating the impact of this guidance, we anticipate that a significant portion of our deferred policy acquisition costs balance may be eliminated under the newly issued guidance, resulting in a reduction to GAAP equity. Deferred policy acquisition cost totaled \$218.6 million as of September 30, 2010.

#### Off-Balance Sheet Arrangements

At September 30, 2010 and December 31, 2009, we did not have any relationships with unconsolidated entities or financial partnerships, such entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or for other contractually narrow or limited purposes. As such, we are not exposed to any financing, liquidity, market, or credit risk that could arise if we had engaged in such relationships.

#### Contractual Obligations and Contingent Liabilities and Commitments

Our future cash payments associated with loss and loss expense reserves, and contractual obligations pursuant to operating leases for office space and equipment, and notes payable have not materially changed since December 31, 2009. We expect to have the capacity to repay and/or refinance these obligations as they come due.



At September 30, 2010, we had contractual obligations that expire at various dates through 2023 that may require us to invest up to an additional \$92.1 million in other investments. There is no certainty that any such additional investment will be required. We have issued no material guarantees on behalf of others and have no trading activities involving non-exchange traded contracts accounted for at fair value. We have no material transactions with related parties other than those disclosed in Note 18. "Related Party Transactions" included in Item 8. "Financial Statements and Supplementary Data." of our 2009 Annual Report.

### ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

There have been no material changes in the information about market risk set forth in our 2009 Annual Report.

### ITEM 4. CONTROLS AND PROCEDURES

Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, have evaluated the effectiveness of our disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (“Exchange Act”)), as of the end of the period covered by this report. Based on such evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of such period, our disclosure controls and procedures are: (i) effective in recording, processing, summarizing, and reporting information on a timely basis that we are required to disclose in the reports that we file or submit under the Exchange Act; and (ii) effective in ensuring that information that we are required to disclose in the reports that we file or submit under the Exchange Act is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. No changes in our internal control over financial reporting (as such term is defined in Rule 13a-15(f) of the Exchange Act) occurred during Third Quarter or Nine Months 2010 that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## PART II - OTHER INFORMATION

### ITEM 1. LEGAL PROCEEDINGS

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

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

## ITEM 1A. RISK FACTORS

Certain risk factors exist that can have a significant impact on our business, liquidity, capital resources, results of operations, and financial condition. The impact of these risk factors could also impact certain actions that we take as part of our long-term capital strategy including, but not limited to, contributing capital to our subsidiaries in our Insurance Operations, issuing additional debt and/or equity securities, repurchasing shares of the Parent's common stock, or changing stockholders' dividends. We operate in a continually changing business environment and new risk factors emerge from time to time. Consequently, we can neither predict such new risk factors nor assess the impact, if any, they might have on our business in the future.

There have been no material changes from the risk factors disclosed in Item 1A. "Risk Factors" in our 2009 Annual Report except for the modification of the following risk factors:

We are heavily regulated and changes in regulation may reduce our profitability and limit our growth. Our Insurance Operations are heavily regulated and subject to extensive laws and regulations that are subject to change. By virtue of the McCarran-Ferguson Act, Congress has traditionally ceded insurance regulation to the various states. We, however, are subject to federal regulators, such as the SEC, for securities issues, and the Federal Trade Commission, for privacy issues. We also are subject to non-governmental regulators, such as the NASDAQ Stock Market and the New York Stock Exchange, where we list our securities. Many of these regulators, to some degree, have overlap with each other on various matters. They also have different regulations on the same legal issues that are subject to their individual interpretative discretion. Consequently, we have the risk that one regulator's position may conflict with another regulator's position on the same issue. As compliance is generally reviewed in hindsight, we also are subject to the risk that interpretations will change over time.

The primary public policy behind state insurance regulation is the protection of policyholders and claimants over all other constituencies, including shareholders. By virtue of the McCarran-Ferguson Act, Congress has traditionally delegated insurance regulation to the various states. For Insurance Subsidiaries, the primary regulators of their business and financial condition are the departments of insurance in the states in which they are organized and are licensed. The broad regulatory, administrative, and supervisory powers of the various state departments of insurance include:

- Related to our financial condition, review and approval of such matters as minimum capital and surplus requirements, standards of solvency, security deposits, methods of accounting, form and content of statutory financial statements, reserves for unpaid loss and loss expenses, reinsurance, payment of dividends and other distributions to shareholders, periodic financial examinations and annual and other report filings.
- Related to our general business, review and approval of such matters as certificates of authority and other insurance company licenses, licensing and compensation of agents, premium rates (which may not be excessive, inadequate, or unfairly discriminatory), policy forms, policy terminations, reporting of statistical information regarding our premiums and losses, periodic market conduct examinations, unfair trade practices, participation in mandatory shared market mechanisms, such as assigned risk pools and reinsurance pools, participation in mandatory state guaranty funds, and mandated continuing workers compensation coverage post-termination of employment.
- Related to our ownership of the Insurance Subsidiaries, we are required to register as an insurance holding company system and report information concerning all of our operations that may materially affect the operations, management, or financial condition of the insurers. As an insurance holding company, the appropriate state regulatory authority may: (i) examine us or our insurance subsidiaries at any time; (ii) require disclosure or prior approval of material transactions of any of the insurance subsidiaries with us or each other; and (iii) require prior approval or notice of certain transactions, such as payment of dividends or distributions to us.

Although the federal government traditionally has not regulated insurance, federal legislation and administrative policies do affect us, including the Terrorism Risk Insurance Act of 2002 and the Terrorism Risk Insurance Program Reauthorization Act of 2007, Office of Foreign Assets Control, and various privacy laws, including the Gramm-Leach-Bliley Act, the Fair Credit Reporting Act, the Drivers Privacy Protection Act, and the Health Insurance Portability and Accountability Act. As a result of issuing workers compensation policies, we also are subject to Mandatory Medicare Secondary Payer Reporting under the Medicare, Medicaid and SCHIP Extension Act of 2007.

In July 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). Among other things, the Dodd-Frank Act, created a Financial Stability and Oversight Council that may designate certain insurance companies and insurance holding companies as nonbank financial companies subject to prudential regulation by the Board of Governors of the U.S. Federal Reserve (the "Federal Reserve Board of Governors") on a variety of issues, including capital requirements, leverage limits, liquidity requirements, and examinations. If the Federal Reserve Board of Governors deems any nonbank financial company under its supervision to pose a grave threat to the financial stability of the United States, it may limit the company's ability to enter into merger transactions, restrict its ability to offer financial products, require it to terminate one or more activities, or impose conditions on the manner in which it conducts activities.

The Dodd-Frank Act also established a Federal Insurance Office in the U.S. Treasury Department to monitor all aspects of the insurance industry and lines of business other than certain health insurance, certain long-term care insurance, and crop insurance. The director of the Federal Insurance Office will have the ability to recommend that an insurance company or an insurance holding company be subject to heightened prudential standards. The Dodd-Frank Act also provides in certain instances for the pre-emption of state laws regulating reinsurance and other limited insurance matters. At this time, it is not possible to predict with any degree of certainty whether any other proposed legislation or regulatory changes will be adopted or what impact, if any, the Dodd-Frank Act or any other such legislation or changes could have on our business, financial condition or results of operations.

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

As a result of the financial markets crises in 2008 and 2009, the issues regarding the AIG scandal, and public concerns over health insurance, there have been a number of legislative proposals discussed and introduced in Congress that could result in the federal government becoming directly involved in the regulation of insurance:

- **Repeal of the McCarran-Ferguson Act.** While proposals for McCarran-Ferguson Act repeal recently have been primarily directed at health insurers, if enacted and applicable to property and casualty insurers, such repeal would significantly reduce our ability to compete and materially affect our results of operations because we rely on the anti-trust exemptions the law provides to obtain loss data from third party aggregators such as ISO to predict future losses.
- **National Catastrophe Funds.** Various legislative proposals have been introduced that would establish a federal reinsurance catastrophic fund as a federal backstop for future natural disasters. These bills generally encourage states to create catastrophe funds by creating a federal backstop for states that create the funds. While homeowners' insurance is primarily handled at the state level, the federal government may decide to play a role, including the establishment of a national catastrophic fund.
- **Reform of the National Flood Insurance Program ("NFIP").** There have been legislative proposals to reform the NFIP by: (i) expanding coverage to include coverage for losses from wind damage; and (ii) forgiving the nearly \$20 billion in debt amassed by the NFIP from the catastrophic storms of 2004 and 2005. We believe that the expansion of coverage to include wind losses would significantly increase the cost and availability of NFIP insurance. On September 30, 2010 President Obama signed S 3814 into law extending the National Flood Insurance Program through September 30, 2011.

We cannot predict whether any of these or any related proposal will be adopted, or what impact, if any, such proposals, could have on our business, financial condition or results of operations if enacted.



There can be no assurance that the Dodd-Frank Act or any other actions of the U.S. Government, Federal Reserve, and other governmental and regulatory bodies to reform the financial markets and provide future financial stability, will achieve their intended effect.

A primary objective of the Dodd-Frank Act, which was signed into law on July 21, 2010, is to reform the financial markets and provide future financial stability. Among other things, the Dodd-Frank Act heightens supervision and regulation of financial institutions, requires strengthened capital levels, tightens oversight of credit rating agencies, requires an overhaul of the regulation of the derivatives market, and reforms and requires more transparency in governance and executive compensation. The Dodd-Frank Act covers almost every aspect of financial regulation and analysis of its practical implications is in its early stages. Implementation of the Dodd-Frank Act will require an extraordinary amount of rulemaking and regulators are given significant discretion. Consequently, its final shape and practical impact are, in many respects, still to be determined. As a result, it is presently unclear the full impact this legislation will have on our operations.

However, if, even in the short-term, the Dodd-Frank Act is not perceived by the investing public as a means to effectively reform and provide stability to the financial markets, it could result in a further deterioration of investor confidence in the U.S. economy and financial markets, which could further increase constraints on the liquidity available in the banking system and financial markets and increase pressure on the price of our fixed income securities and equity portfolios. These results could materially and adversely affect our results of operations, financial condition, liquidity, and the trading price of the Parent's Common Stock. In the event of future material deterioration in business conditions, we may need to raise additional capital or consider other transactions to manage its capital position and liquidity.

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

## ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

The following table provides information regarding our purchases of the Parent's common stock in Third Quarter 2010:

| Period                 | Total Number<br>of<br>Shares<br>Purchased <sup>1</sup> | Average<br>Price Paid<br>per Share | Total Number of<br>Shares<br>Purchased<br>as Part of<br>Publicly<br>Announced<br>Programs | Maximum<br>Number<br>of Shares that May<br>Yet<br>Be Purchased<br>Under the<br>Announced<br>Programs |
|------------------------|--------------------------------------------------------|------------------------------------|-------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------|
| July 1 – 31, 2010      | -                                                      | \$ -                               | -                                                                                         | -                                                                                                    |
| August 1 – 31, 2010    | -                                                      | -                                  | -                                                                                         | -                                                                                                    |
| September 1 – 30, 2010 | 603                                                    | 16.20                              | -                                                                                         | -                                                                                                    |
| Total                  | 603                                                    | 16.20                              | -                                                                                         | -                                                                                                    |

<sup>1</sup>During Third Quarter 2010, 603 shares were purchased from employees in connection with the vesting of restricted stock. These repurchases were made in connection with satisfying tax withholding obligations with respect to those employees and were purchased at the closing price on the dates of purchase. These shares were not purchased as part of any publicly announced program.



ITEM 6. EXHIBITS

(a) Exhibits:

Exhibit No.

- \* 10.1 Selective Insurance Company of America Deferred Compensation Plan (2005), as Amended and Restated Effective as of January 1, 2010.
- \* 11 Statement Re: Computation of Per Share Earnings.
- \* 31.1 Rule 13a-14(a) Certification of the Chief Executive Officer of Selective Insurance Group, Inc. (Section 302 of the Sarbanes-Oxley Act of 2002).
- \* 31.2 Rule 13a-14(a) Certification of the Chief Financial Officer of Selective Insurance Group, Inc. (Section 302 of the Sarbanes-Oxley Act of 2002).
- \* 32.1 Certification of Chief Executive Officer of Selective Insurance Group, Inc. pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- \* 32.2 Certification of Chief Financial Officer of Selective Insurance Group, Inc. pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- \*\* 101.INS XBRL Instance Document.
- \*\* 101.SCH XBRL Taxonomy Extension Schema Document.
- \*\* 101.CAL XBRL Taxonomy Extension Calculation Linkbase Document.
- \*\* 101.LAB XBRL Taxonomy Extension Label Linkbase Document.
- \*\* 101.PRE XBRL Taxonomy Extension Presentation Linkbase Document.
- \*\* 101.DEF XBRL Taxonomy Extension Definition Linkbase Document.

\* Filed herewith

\*\* Furnished and not filed herewith

SIGNATURES

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

SELECTIVE INSURANCE GROUP, INC.

Registrant

By: /s/ Gregory E. Murphy  
Gregory E. Murphy  
Chairman of the Board, President and Chief Executive Officer

October 28, 2010

By: /s/ Dale A. Thatcher  
Dale A. Thatcher  
Executive Vice President and Chief Financial Officer  
(principal accounting officer and principal financial officer)

October 28, 2010