

HANOVER INSURANCE GROUP, INC.

Form 10-Q

May 01, 2013

[Table of Contents](#)

**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 March 31, 2013

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 1-13754

**THE HANOVER INSURANCE GROUP, INC.**

(Exact name of registrant as specified in its charter)

Edgar Filing: HANOVER INSURANCE GROUP, INC. - Form 10-Q

**Delaware**  
(State or other jurisdiction of  
incorporation or organization)

**04-3263626**  
(I.R.S. Employer  
Identification No.)

**440 Lincoln Street, Worcester, Massachusetts 01653**  
(Address of principal executive offices) (Zip Code)

**(508) 855-1000**  
(Registrant's telephone number, including area code)

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

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

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

Large accelerated filer  Accelerated filer   
Non-accelerated filer  (Do not check if a smaller reporting company) Smaller reporting company   
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

The number of shares outstanding of the registrant's common stock was 44,012,080 as of April 26, 2013.

**Table of Contents**

**TABLE OF CONTENTS**

PART I.	<u>FINANCIAL INFORMATION</u>	
Item 1.	<u>Financial Statements</u>	
	<u>Consolidated Statements of Income</u>	2
	<u>Consolidated Statements of Comprehensive Income</u>	3
	<u>Consolidated Balance Sheets</u>	4
	<u>Consolidated Statements of Shareholders' Equity</u>	5
	<u>Consolidated Statements of Cash Flows</u>	6
	<u>Notes to Interim Consolidated Financial Statements</u>	7
Item 2.	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	29
Item 3.	<u>Quantitative and Qualitative Disclosures About Market Risk</u>	49
Item 4.	<u>Controls and Procedures</u>	50
PART II.	<u>OTHER INFORMATION</u>	
Item 1.	<u>Legal Proceedings</u>	51
Item 1A.	<u>Risk Factors</u>	51
Item 2.	<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	53
Item 6.	<u>Exhibits</u>	54
	<u>SIGNATURES</u>	55

**Table of Contents****PART I FINANCIAL INFORMATION****ITEM 1 FINANCIAL STATEMENTS****THE HANOVER INSURANCE GROUP, INC. AND SUSIDIARIES****CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)**

<i>(In millions, except per share data)</i>	<b>Three Months Ended March 31,</b>	
	<b>2013</b>	<b>2012</b>
<b>Revenues</b>		
Premiums	<b>\$ 1,094.3</b>	\$ 1,035.6
Net investment income	<b>67.3</b>	68.8
Net realized investment gains (losses):		
Net realized gains from sales and other	<b>8.6</b>	5.0
Net other than temporary impairment losses on investments recognized in earnings	<b>(0.5)</b>	(1.9)
<b>Total net realized investment gains</b>	<b>8.1</b>	3.1
Fees and other income	<b>10.6</b>	14.3
<b>Total revenues</b>	<b>1,180.3</b>	1,121.8
<b>Losses and expenses</b>		
Losses and loss adjustment expenses	<b>683.4</b>	661.4
Amortization of deferred acquisition costs	<b>242.5</b>	228.1
Interest expense	<b>14.7</b>	16.2
Other operating expenses	<b>150.8</b>	145.3
<b>Total losses and expenses</b>	<b>1,091.4</b>	1,051.0
Income before income taxes	<b>88.9</b>	70.8
Income tax expense (benefit):		
Current	<b>4.0</b>	39.0
Deferred	<b>18.5</b>	(18.9)
<b>Total income tax expense (benefit)</b>	<b>22.5</b>	20.1
Income from continuing operations	<b>66.4</b>	50.7
Net loss from discontinued operations (net of income tax benefit of \$0.1 for the three months ended March 31, 2013 and 2012)	<b>(0.2)</b>	(1.0)
<b>Net income</b>	<b>\$ 66.2</b>	\$ 49.7
<b>Earnings per common share:</b>		
<b>Basic:</b>		
Income from continuing operations	<b>\$ 1.49</b>	\$ 1.13
Net loss from discontinued operations		(0.02)

Edgar Filing: HANOVER INSURANCE GROUP, INC. - Form 10-Q

Net income per share	\$ 1.49	\$ 1.11
Weighted average shares outstanding	44.6	44.9
<b>Diluted:</b>		
Income from continuing operations	\$ 1.47	\$ 1.11
Net loss from discontinued operations	(0.01)	(0.02)
Net income per share	\$ 1.46	\$ 1.09
Weighted average shares outstanding	45.3	45.5

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

Table of Contents

**THE HANOVER INSURANCE GROUP, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (UNAUDITED)**

<i>(In millions)</i>	<b>Three Months Ended March 31,</b>	
	<b>2013</b>	<b>2012</b>
Net income	<b>\$ 66.2</b>	<b>\$ 49.7</b>
Other comprehensive income (loss), net of tax:		
Available-for-sale securities and derivative instruments:		
Net appreciation during the period	<b>5.5</b>	40.9
Portion of other-than-temporary impairment losses transferred from (to) other comprehensive income	<b>(0.1)</b>	3.0
Total available-for-sale securities and derivative instruments	<b>5.4</b>	43.9
Pension and postretirement benefits:		
Amortization recognized as net periodic benefit and postretirement cost	<b>1.9</b>	1.5
Cumulative foreign currency translation adjustment:		
Amount recognized as cumulative foreign currency translation during the period	<b>(10.0)</b>	9.3
Total other comprehensive income (loss), net of tax	<b>(2.7)</b>	54.7
Comprehensive income	<b>\$ 63.5</b>	<b>\$ 104.4</b>

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

**Table of Contents****THE HANOVER INSURANCE GROUP, INC. AND SUBSIDIARIES****CONSOLIDATED BALANCE SHEETS (UNAUDITED)**

<i>(In millions, except share data)</i>	March 31, 2013	December 31, 2012
<b>Assets</b>		
Investments:		
Fixed maturities, at fair value (amortized cost of \$6,310.6 and \$6,529.5)	\$ 6,723.5	\$ 6,952.2
Equity securities, at fair value (cost of \$391.2 and \$299.0)	435.0	315.8
Other investments	207.5	210.3
Total investments	7,366.0	7,478.3
Cash and cash equivalents	691.0	564.8
Accrued investment income	68.9	69.0
Premiums and accounts receivable, net	1,318.1	1,308.8
Reinsurance recoverable on paid and unpaid losses and unearned premiums	2,435.5	2,479.7
Deferred acquisition costs	494.7	489.5
Deferred income taxes	238.5	267.6
Goodwill	184.4	184.9
Other assets	524.4	511.8
Assets of discontinued operations	120.6	130.5
Total assets	\$ 13,442.1	\$ 13,484.9
<b>Liabilities</b>		
Loss and loss adjustment expense reserves	\$ 6,092.5	\$ 6,197.0
Unearned premiums	2,488.1	2,474.8
Expenses and taxes payable	660.3	775.8
Reinsurance premiums payable	475.9	466.2
Debt	978.1	849.4
Liabilities of discontinued operations	123.2	126.3
Total liabilities	10,818.1	10,889.5
Commitments and contingencies		
<b>Shareholders' Equity</b>		
Preferred stock, par value \$0.01 per share; 20.0 million shares authorized; none issued		
Common stock, par value \$0.01 per share; 300.0 million shares authorized; 60.5 million shares issued	0.6	0.6
Additional paid-in capital	1,785.3	1,787.1
Accumulated other comprehensive income	323.1	325.8
Retained earnings	1,252.8	1,211.6
Treasury stock at cost (16.5 and 16.2 million shares)	(737.8)	(729.7)
Total shareholders' equity	2,624.0	2,595.4
Total liabilities and shareholders' equity	\$ 13,442.1	\$ 13,484.9

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





**Table of Contents****THE HANOVER INSURANCE GROUP, INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY (UNAUDITED)**

<i>(In millions)</i>	Three Months Ended March 31,	
	2013	2012
<b>Preferred Stock</b>		
Balance at beginning and end of period	\$	\$
<b>Common Stock</b>		
Balance at beginning and end of period	0.6	0.6
<b>Additional Paid-in Capital</b>		
Balance at beginning of period	1,787.1	1,784.8
Employee and director stock-based awards and other	(1.8)	(4.7)
Balance at end of period	1,785.3	1,780.1
<b>Accumulated Other Comprehensive Income (Loss), net of tax</b>		
<b>Net Unrealized Appreciation (Depreciation) on Investments and Derivative Instruments:</b>		
Balance at beginning of period	426.0	308.7
Net appreciation during the period:		
Net appreciation on available-for-sale securities and derivative instruments	5.4	43.9
Balance at end of period	431.4	352.6
<b>Defined Benefit Pension and Postretirement Plans:</b>		
Balance at beginning of period	(96.6)	(86.8)
Amortization recognized as net periodic benefit cost	1.9	1.5
Balance at end of period	(94.7)	(85.3)
<b>Cumulative Foreign Currency Translation Adjustment:</b>		
Balance at beginning of period	(3.6)	(11.5)
Amount recognized as cumulative foreign currency translation during the period	(10.0)	9.3
Balance at end of period	(13.6)	(2.2)
Total accumulated other comprehensive income	323.1	265.1
<b>Retained Earnings</b>		
Balance at beginning of period	1,211.6	1,211.3
Net income	66.2	49.7
Dividends to shareholders	(14.8)	(13.5)
Stock-based compensation	(10.2)	1.3
Balance at end of period	1,252.8	1,248.8
<b>Treasury Stock</b>		
Balance at beginning of period	(729.7)	(723.1)
Shares purchased at cost	(25.2)	
Net shares reissued at cost under employee stock-based compensation plans	17.1	7.5

Edgar Filing: HANOVER INSURANCE GROUP, INC. - Form 10-Q

Balance at end of period	(737.8)	(715.6)
Total shareholders' equity	<b>\$ 2,624.0</b>	<b>\$ 2,579.0</b>

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

- 5 -

**Table of Contents**

**THE HANOVER INSURANCE GROUP, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)**

<i>(In millions)</i>	<b>Three Months Ended March 31,</b>	
	<b>2013</b>	<b>2012</b>
<b>Cash Flows From Operating Activities</b>		
Net income	\$ 66.2	\$ 49.7
Adjustments to reconcile net income to net cash provided by operating activities:		
Net realized investment gains	(8.1)	(2.3)
Net amortization and depreciation	8.4	9.1
Stock-based compensation expense	3.6	4.1
Amortization of defined benefit plan costs	2.9	2.3
Deferred income taxes expense (benefit)	18.4	(18.9)
Change in deferred acquisition costs	(5.2)	(9.4)
Change in premiums receivable, net of reinsurance premiums payable	0.3	49.3
Change in loss, loss adjustment expense and unearned premium reserves	(24.3)	109.9
Change in reinsurance recoverable	19.6	(158.4)
Change in expenses and taxes payable	(101.4)	(28.2)
Other, net	2.1	5.5
<b>Net cash provided by (used in) operating activities</b>	<b>(17.5)</b>	<b>12.7</b>
<b>Cash Flows From Investing Activities</b>		
Proceeds from disposals and maturities of fixed maturities	400.2	550.9
Proceeds from disposals of equity securities and other investments	36.7	2.6
Purchase of fixed maturities	(223.9)	(663.0)
Purchase of equity securities and other investments	(123.8)	(98.4)
Capital expenditures	(5.7)	(3.2)
<b>Net cash provided by (used in) investing activities</b>	<b>83.5</b>	<b>(211.1)</b>
<b>Cash Flows From Financing Activities</b>		
Proceeds from exercise of employee stock options	4.5	1.1
Proceeds from debt borrowings, net	169.5	7.4
Decrease in cash collateral related to securities lending program	(19.8)	(7.8)
Dividends paid to shareholders	(14.8)	(13.5)
Repurchases of debt	(46.3)	(0.8)
Repurchases of common stock	(25.2)	
Other financing activities	(1.0)	(0.2)
<b>Net cash provided by (used in) financing activities</b>	<b>66.9</b>	<b>(13.8)</b>
Effect of exchange rate changes on cash	(6.2)	20.1
<b>Net change in cash and cash equivalents</b>	<b>126.7</b>	<b>(192.1)</b>
Net change in cash related to discontinued operations	(0.5)	
Cash and cash equivalents, beginning of period	564.8	820.4
<b>Cash and cash equivalents, end of period</b>	<b>\$ 691.0</b>	<b>\$ 628.3</b>

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



---

**Table of Contents**

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

**NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

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

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

The interim consolidated financial statements of THG include the accounts of The Hanover Insurance Company ( Hanover Insurance ) and Citizens Insurance Company of America, THG's principal U.S. domiciled property and casualty companies; Chaucer Holdings plc ( Chaucer ), a specialist insurance underwriting group which operates through the Society and Corporation of Lloyd's ( Lloyd's ) and certain other insurance and non-insurance subsidiaries. These legal entities conduct their operations through several business segments discussed in Note 9 Segment Information . Additionally, the interim consolidated financial statements include the Company's discontinued operations, consisting primarily of the Company's former life insurance businesses, its accident and health business and its third party administrator. All intercompany accounts and transactions have been eliminated.

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

In the opinion of the Company's management, the accompanying interim consolidated financial statements reflect all adjustments, consisting of normal recurring items, necessary for a fair presentation of the financial position and results of operations. The results of operations for the three months ended March 31, 2013 are not necessarily indicative of the results to be expected for the full year. These financial statements should be read in conjunction with the Company's 2012 Annual Report on Form 10-K filed with the Securities and Exchange Commission ( SEC ) on February 26, 2013.

**2. New Accounting Pronouncements**

***Recently Implemented Standards***

In February 2013, the Financial Accounting Standards Board ( FASB ) issued Accounting Standards Codification ( ASC ) Update No. 2013-02 (Topic 220) *Comprehensive Income Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income*. This guidance requires an entity to provide information about the amounts reclassified out of accumulated other comprehensive income ( AOCI ) either on the face of the Statement of Income or in the Notes to the Consolidated Financial Statements. Significant amounts reclassified out of AOCI should be provided by the respective line items of net income but only if the amount reclassified is required under U.S. GAAP to be reclassified in its entirety to net income in the same reporting period. For amounts not required to be reclassified in their entirety to net income, a cross-reference to other disclosures provided for in accordance with U.S. GAAP is required. This guidance is applicable for reporting periods beginning after December 15, 2012. The Company implemented the guidance effective January 1, 2013. The effect of implementing the guidance relates to financial statement presentation and disclosures. (See disclosures in Note 8 Other Comprehensive Income.)

In July 2012, the FASB issued ASC Update No. 2012-02 (Topic 350) *Testing Indefinite Lived Intangible Assets for Impairment*. This ASC update allows an entity to first assess qualitative factors to determine whether the existence of events and circumstances indicates that it is more likely than not that the indefinite lived intangible asset is impaired. This assessment should be used as a basis for determining whether it is necessary to perform the quantitative impairment test. An entity would not be required to calculate the fair value of the intangible asset and perform the quantitative test unless the entity determines, based upon its qualitative assessment, that it is more likely than not that its fair value is less than its carrying value. The update further improves previous guidance by expanding upon the examples of events and circumstances that an entity should consider in determining whether it is more likely than not that the fair value of an indefinite lived intangible asset is less than its carrying amount. The update also allows an entity the option to bypass the qualitative assessment for any indefinite-lived intangible asset in any period and proceed directly to performing the quantitative impairment test. An entity will be able to resume performing the qualitative assessment in any subsequent period. This ASC update is effective for annual and interim periods beginning after September 15, 2012, with early adoption permitted. The Company implemented this guidance effective October 1, 2012. The effect of implementing this guidance was not material to the Company's financial position or results of operations.



**Table of Contents****Recently Issued Standards**

In March 2013, the FASB issued ASC Update No. 2013-05 (Topic 830) *Foreign Currency Matters-Parent's Accounting for the Cumulative Translation Adjustment upon Derecognition of Certain Subsidiaries or Groups of Assets within a Foreign Entity or of an Investment in a Foreign Entity (a consensus of the FASB Emerging Issues Task Force)*. This ASC update clarifies the applicable guidance for the release of the cumulative translation adjustment into net income when a parent either sells all or a portion of its investment in a foreign entity. This guidance is also required to be applied when an entity no longer holds a controlling financial interest in a subsidiary or group of assets that is a nonprofit activity or a business within a foreign entity (with certain exceptions). Additionally, this update clarifies that the sale of an investment in a foreign entity includes events that result in an acquirer obtaining control of an acquiree in which it held an equity interest immediately before the acquisition date in a business combination achieved in stages. This ASC update is effective for annual and interim periods beginning after December 15, 2013, with early adoption permitted, and is to be applied prospectively to derecognition events occurring after the effective date. The Company does not expect the adoption of ASC Update 2013-05 to have a material impact on its financial position or results of operations.

**3. Income Taxes**

Income tax expense for the three months ended March 31, 2013 and 2012 has been computed using estimated effective tax rates. These rates are revised, if necessary, at the end of each successive interim period to reflect current estimates of the annual effective tax rates.

For the three months ended March 31, 2013, the tax provision is comprised of a \$13.2 million U.S. federal income tax expense and \$9.3 million foreign income tax expense. For the three months ended March 31, 2012, the tax provision was comprised of a \$12.1 million U.S. federal income tax expense and \$8.0 million in foreign income tax expense.

Although most of the Company's non-U.S. income is subject to U.S. federal income tax, certain of its non-U.S. income is not subject to U.S. federal income tax until repatriated. Foreign taxes on this non-U.S. income are accrued at the local foreign tax rate, as opposed to the higher U.S. statutory rate, since these earnings currently are expected to be permanently reinvested overseas. This assumption could change, as a result of a sale of the subsidiaries, the receipt of dividends from the subsidiaries, a change in management's intentions, or as a result of various other events. The Company has not made a provision for U.S. taxes on \$6.4 million of non-U.S. income for the three months ended March 31, 2013. All of the Company's non-U.S. income was subject to U.S. taxes during the same period in 2012.

The Company or its subsidiaries files income tax returns in the U.S. federal jurisdiction and various state jurisdictions, as well as foreign jurisdictions. With few exceptions, the Company and its subsidiaries are no longer subject to U.S. federal income tax examinations by tax authorities for years before 2007. The IRS audits of the years 2009 and 2010 commenced in June 2012. The Company and its subsidiaries are still subject to U.S. state income tax examinations by tax authorities for years after 2006 and foreign examinations for years after 2010.

**4. Debt**

Debt consists of the following:

<i>(in millions)</i>	<b>March 31, 2013</b>	<b>December 31, 2012</b>
Senior debentures maturing June 15, 2021	<b>\$ 300.0</b>	\$ 300.0
Senior debentures maturing March 1, 2020	<b>200.0</b>	200.0
Senior debentures maturing October 15, 2025	<b>120.9</b>	120.9
Subordinated debentures maturing March 30, 2053	<b>175.0</b>	
Subordinated debentures maturing February 3, 2027	<b>59.7</b>	59.7
FHLBB borrowings (secured)	<b>125.0</b>	171.3
<b>Total principal debt</b>	<b>\$ 980.6</b>	\$ 851.9
Unamortized debt discount	<b>(2.5)</b>	(2.5)
<b>Total</b>	<b>\$ 978.1</b>	\$ 849.4

## Edgar Filing: HANOVER INSURANCE GROUP, INC. - Form 10-Q

On March 20, 2013, the Company issued \$175.0 million aggregate principal amount of 6.35% subordinated unsecured debentures due March 30, 2053. These debentures pay interest quarterly. The Company may redeem these debentures in whole at any time, or in part from time to time, on or after March 30, 2018, at a redemption price equal to their principal amount plus accrued and unpaid interest. If the debentures are not redeemed in whole, at least \$25.0 million aggregate principal amount of the debentures must remain outstanding. In addition, in certain circumstances, the Company may redeem the debentures in whole, but not in part, prior to March 30, 2018.

- 8 -



**Table of Contents**

In 2009, the Company received a \$125.0 million Federal Home Loan Bank of Boston ( FHLBB ) advance through the Company's membership in the FHLBB. This collateralized advance bears interest at a fixed rate of 5.50% per annum over a twenty-year term. In July 2010, the Company committed to an additional \$46.3 million of FHLBB advances. These advances were drawn in several increments from July 2010 to January 2012 and carried fixed interest rates with a weighted average of 3.88%. In January 2013, the Company repaid the \$46.3 million of FHLBB advances plus prepayment fees of \$7.8 million for a total payment of \$54.1 million. These advances would have matured on July 30, 2020.

As collateral to FHLBB, Hanover Insurance pledged government agency securities with a fair value of \$145.3 million and \$200.8 million, for the aggregate borrowings of \$125.0 million and \$171.3 million as of March 31, 2013 and December 31, 2012, respectively. The amount of required collateral decreased in conjunction with the repayment of the \$46.3 million of FHLBB advances. The fair value of the collateral pledged must be maintained at certain specified levels of the borrowed amount, which can vary depending on the type of assets pledged. If the fair value of this collateral declines below these specified levels, Hanover Insurance would be required to pledge additional collateral or repay outstanding borrowings. Hanover Insurance is permitted to voluntarily repay the outstanding borrowings at any time, subject to a repayment fee. As a requirement of membership in the FHLBB, Hanover Insurance maintains a certain level of investment in FHLBB stock. Total holdings of FHLBB stock were \$9.3 million and \$9.7 million at March 31, 2013 and December 31, 2012, respectively.

At March 31, 2013, the Company was in compliance with the covenants associated with all of its debt indentures and credit arrangements.

**Table of Contents****5. Investments****A. Fixed maturities and equity securities**

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

<i>(in millions)</i>	Amortized Cost or Cost	Gross Unrealized Gains	March 31, 2013		OTTI Unrealized Losses
			Gross Unrealized Losses	Fair Value	
Fixed maturities:					
U.S. Treasury and government agencies	\$ 314.0	\$ 8.1	\$ 0.6	\$ 321.5	\$
Foreign government	299.7	6.0	0.1	305.6	
Municipal	988.2	89.3	1.4	1,076.1	
Corporate	3,443.3	268.8	13.3	3,698.8	9.2
Residential mortgage-backed	720.3	37.3	3.3	754.3	2.0
Commercial mortgage-backed	340.6	18.8	0.6	358.8	
Asset-backed	204.5	3.9		208.4	
<b>Total fixed maturities</b>	<b>\$ 6,310.6</b>	<b>\$ 432.2</b>	<b>\$ 19.3</b>	<b>\$ 6,723.5</b>	<b>\$ 11.2</b>
Equity securities	\$ 391.2	\$ 46.0	\$ 2.2	\$ 435.0	\$

<i>(in millions)</i>	Amortized Cost or Cost	Gross Unrealized Gains	December 31, 2012		OTTI Unrealized Losses
			Gross Unrealized Losses	Fair Value	
Fixed maturities:					
U.S. Treasury and government agencies	\$ 317.2	\$ 8.8	\$ 0.4	\$ 325.6	\$
Foreign government	348.5	4.6	0.2	352.9	
Municipal	1,010.2	87.2	1.1	1,096.3	
Corporate	3,512.8	275.4	14.8	3,773.4	9.3
Residential mortgage-backed	769.0	39.4	3.2	805.2	1.7
Commercial mortgage-backed	373.3	23.2	0.3	396.2	
Asset-backed	198.5	4.1		202.6	
<b>Total fixed maturities</b>	<b>\$ 6,529.5</b>	<b>\$ 442.7</b>	<b>\$ 20.0</b>	<b>\$ 6,952.2</b>	<b>\$ 11.0</b>
Equity securities	\$ 299.0	\$ 21.6	\$ 4.8	\$ 315.8	\$

Other-than-temporary impairments ( OTTI ) unrealized losses in the tables above represent OTTI recognized in accumulated other comprehensive income. This amount excludes net unrealized gains on impaired securities relating to changes in the value of such securities subsequent to the impairment measurement date of \$20.4 million and \$20.5 million as of March 31, 2013 and December 31, 2012, respectively.

**Table of Contents**

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

<i>(in millions)</i>	March 31, 2013	
	Amortized Cost	Fair Value
Due in one year or less	\$ 430.2	\$ 437.4
Due after one year through five years	2,216.7	2,344.4
Due after five years through ten years	1,718.1	1,879.3
Due after ten years	680.2	740.9
	5,045.2	5,402.0
Mortgage-backed and asset-backed securities	1,265.4	1,321.5
Total fixed maturities	\$ 6,310.6	\$ 6,723.5

**Table of Contents****B. Securities in an unrealized loss position**

The following tables provide information about the Company's fixed maturities and equity securities that were in an unrealized loss position at March 31, 2013 and December 31, 2012.

<i>(in millions)</i>	March 31, 2013					
	12 months or less		Greater than 12 months		Total	
	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value
Fixed maturities:						
Investment grade:						
U.S. Treasury and government agencies	\$ 0.5	\$ 98.1	\$ 0.1	\$ 6.5	\$ 0.6	\$ 104.6
Foreign governments		23.9	0.1	0.4	0.1	24.3
Municipal	0.7	65.5	0.6	16.3	1.3	81.8
Corporate	2.1	181.3	6.9	34.4	9.0	215.7
Residential mortgage-backed	0.8	66.7	2.0	9.5	2.8	76.2
Commercial mortgage-backed	0.5	52.4	0.1	4.9	0.6	57.3
Asset-backed		24.0		0.2		24.2
Total investment grade	4.6	511.9	9.8	72.2	14.4	584.1
Below investment grade:						
Municipal			0.1	3.4	0.1	3.4
Corporate	0.9	30.0	3.4	35.5	4.3	65.5
Residential mortgage-backed	0.1	0.8	0.4	2.2	0.5	3.0
Total below investment grade	1.0	30.8	3.9	41.1	4.9	71.9
Total fixed maturities	5.6	542.7	13.7	113.3	19.3	656.0
Equity securities	1.4	15.4	0.8	7.9	2.2	23.3
Total	\$ 7.0	\$ 558.1	\$ 14.5	\$ 121.2	\$ 21.5	\$ 679.3

<i>(in millions)</i>	December 31, 2012					
	12 months or less		Greater than 12 months		Total	
	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value
Fixed maturities:						
Investment grade:						
U.S. Treasury and government agencies	\$ 0.2	\$ 89.5	\$ 0.2	\$ 8.5	\$ 0.4	\$ 98.0
Foreign governments	0.2	81.2		0.4	0.2	81.6
Municipal	0.5	61.9	0.6	24.0	1.1	85.9
Corporate	1.8	224.8	6.6	59.0	8.4	283.8
Residential mortgage-backed	0.5	47.3	2.0	9.4	2.5	56.7
Commercial mortgage-backed	0.2	29.9	0.1	4.9	0.3	34.8
Asset-backed		11.4		0.3		11.7
Total investment grade	3.4	546.0	9.5	106.5	12.9	652.5

Edgar Filing: HANOVER INSURANCE GROUP, INC. - Form 10-Q

Below investment grade:						
Municipal				2.0		2.0
Corporate	1.1	26.6	5.3	50.6	6.4	77.2
Residential mortgage-backed	0.1	1.6	0.6	2.5	0.7	4.1
<b>Total below investment grade</b>	<b>1.2</b>	<b>28.2</b>	<b>5.9</b>	<b>55.1</b>	<b>7.1</b>	<b>83.3</b>
<b>Total fixed maturities</b>	<b>4.6</b>	<b>574.2</b>	<b>15.4</b>	<b>161.6</b>	<b>20.0</b>	<b>735.8</b>
<b>Equity securities</b>	<b>4.8</b>	<b>74.4</b>			<b>4.8</b>	<b>74.4</b>
<b>Total</b>	<b>\$ 9.4</b>	<b>\$ 648.6</b>	<b>\$ 15.4</b>	<b>\$ 161.6</b>	<b>\$ 24.8</b>	<b>\$ 810.2</b>

The Company views the gross unrealized losses on fixed maturities and equity securities as being temporary since it is its assessment that these securities will recover in the near term, allowing the Company to realize the anticipated long-term economic value. The Company employs a systematic methodology to evaluate declines in fair value below amortized cost for fixed maturity securities or cost for equity securities. In determining OTTI of fixed maturity and equity securities, the Company evaluates several factors and circumstances, including the issuer's overall financial condition; the issuer's credit and financial strength ratings; the issuer's financial performance, including earnings trends, dividend payments and asset quality; any specific events which may influence the operations

**Table of Contents**

of the issuer; the general outlook for market conditions in the industry or geographic region in which the issuer operates; and the length of time and the degree to which the fair value of an issuer's securities remains below the Company's cost. With respect to fixed maturity investments, the Company considers any factors that might raise doubt about the issuer's ability to make contractual payments as they come due and whether the Company expects to recover the entire amortized cost basis of the security. With respect to equity securities, the Company considers its ability and intent to hold the investment for a period of time to allow for a recovery in value.

**C. Proceeds from sales**

The proceeds from sales of available-for-sale securities and gross realized gains and losses on those sales, were as follows:

<i>(in millions)</i>	Three Months Ended March 31,					
	2013			2012		
	Proceeds from Sales	Gross Gains	Gross Losses	Proceeds from Sales	Gross Gains	Gross Losses
Fixed maturities	\$ 137.2	\$ 1.6	\$ 0.6	\$ 279.2	\$ 4.7	\$ 1.1
Equity securities	\$ 34.5	\$ 6.6	\$	\$ 0.7	\$	\$ 0.2

**D. Other-than-temporary impairments**

For the three months ended March 31, 2013, total OTTI of fixed maturities were \$0.7 million. Of this amount, \$0.5 million was recognized in earnings and the remaining \$0.2 million was recorded as unrealized losses in accumulated other comprehensive income.

For the three months ended March 31, 2012, total OTTI of fixed maturities were \$1.6 million. Of this amount, \$1.9 million was recognized in earnings, including \$0.3 million that was transferred from unrealized losses in accumulated other comprehensive income.

The methodology and significant inputs used to measure the amount of credit losses on fixed maturities in 2013 and 2012 were as follows:

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

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

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

<i>(in millions)</i>	Three Months Ended March 31,	
	2013	2012
Credit losses at beginning of period	\$ 8.6	\$ 14.5
Credit losses for which an OTTI was not previously recognized	0.2	0.1
Additional credit losses on securities for which an OTTI was previously recognized	0.2	0.3
Reductions for securities sold, matured or called	(0.4)	(1.4)
Credit losses at end of period	\$ 8.6	\$ 13.5

**E. Funds at Lloyd's**

In accordance with Lloyd's operating guidelines, the Company deposits funds at Lloyd's to support underwriting operations. These funds are available only to fund claim obligations. These assets consisted of approximately \$468 million of fixed maturities and \$3 million of cash and

## Edgar Filing: HANOVER INSURANCE GROUP, INC. - Form 10-Q

cash equivalents as of March 31, 2013. The Company also deposits funds with various state and governmental authorities in the U.S. For a discussion of the Company's deposits with state and governmental authorities, see also Note 3 Investments of the Notes to Consolidated Financial Statements in our Annual Report on Form 10-K for the year ended December 31, 2012.

- 13 -

## **Table of Contents**

### **6. Fair Value**

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

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

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

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

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

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

#### **Cash and Cash Equivalents**

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

#### **Fixed Maturities**

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

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

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

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



## Edgar Filing: HANOVER INSURANCE GROUP, INC. - Form 10-Q

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

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

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

---

## **Table of Contents**

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

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

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

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

### **Equity Securities**

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

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

### **Other Investments**

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

### **Debt**

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

**Table of Contents**

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

<i>(in millions)</i>	March 31, 2013		December 31, 2012	
	Carrying Value	Fair Value	Carrying Value	Fair Value
<b>Financial Assets</b>				
Cash and cash equivalents	\$ 691.0	\$ 691.0	\$ 564.8	\$ 564.8
Fixed maturities	6,723.5	6,723.5	6,952.2	6,952.2
Equity securities	435.0	435.0	315.8	315.8
Other investments	186.5	186.8	188.9	189.4
Total financial assets	\$ 8,036.0	\$ 8,036.3	\$ 8,021.7	\$ 8,022.2
<b>Financial Liabilities</b>				
Debt	\$ 978.1	\$ 1,116.7	\$ 849.4	\$ 995.2

The Company has processes designed to ensure that the values received from its third party pricing service are accurately recorded, that the data inputs and valuation techniques utilized are appropriate and consistently applied and that the assumptions are reasonable and consistent with the objective of determining fair value. The Company performs a review of the fair value hierarchy classifications and of prices received from its pricing service on a quarterly basis. The Company reviews the pricing services' policies describing its methodology, processes, practices and inputs, including various financial models used to value securities. Also, the Company reviews the portfolio pricing, including securities with changes in prices that exceed a defined threshold are verified to independent sources, if available. If upon review, the Company is not satisfied with the validity of a given price, a pricing challenge would be submitted to the pricing service along with supporting documentation for its review. The Company does not adjust quotes or prices obtained from the pricing service unless the pricing service agrees with the Company's challenge. During 2013 and 2012, the Company did not adjust any prices received from brokers or its pricing service.

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

**Table of Contents**

The following tables provide, for each hierarchy level, the Company's assets at March 31, 2013 and December 31, 2012 that are measured at fair value on a recurring basis.

<i>(in millions)</i>	Total	March 31, 2013		
		Level 1	Level 2	Level 3
Fixed maturities:				
U.S. Treasury and government agencies	\$ 321.5	\$ 142.3	\$ 179.2	\$
Foreign government	305.6	48.5	257.1	
Municipal	1,076.1		1,047.3	28.8
Corporate	3,698.8		3,676.0	22.8
Residential mortgage-backed, U.S. agency backed	568.2		568.2	
Residential mortgage-backed, non-agency	186.1		185.5	0.6
Commercial mortgage-backed	358.8		334.0	24.8
Asset-backed	208.4		208.4	
Total fixed maturities	6,723.5	190.8	6,455.7	77.0
Equity securities	425.7	365.5	35.2	25.0
Other investments	172.1		168.5	3.6
Total investment assets at fair value	\$ 7,321.3	\$ 556.3	\$ 6,659.4	\$ 105.6

<i>(in millions)</i>	Total	December 31, 2012		
		Level 1	Level 2	Level 3
Fixed maturities:				
U.S. Treasury and government agencies	\$ 325.6	\$ 144.2	\$ 181.4	\$
Foreign government	352.9	60.9	292.0	
Municipal	1,096.3		1,076.9	19.4
Corporate	3,773.4		3,747.0	26.4
Residential mortgage-backed, U.S. agency backed	610.8		610.8	
Residential mortgage-backed, non-agency	194.4		193.7	0.7
Commercial mortgage-backed	396.2		369.5	26.7
Asset-backed	202.6		201.1	1.5
Total fixed maturities	6,952.2	205.1	6,672.4	74.7
Equity securities	306.1	226.9	54.8	24.4
Other investments	172.8		169.2	3.6
Total investment assets at fair value	\$ 7,431.1	\$ 432.0	\$ 6,896.4	\$ 102.7

**Table of Contents**

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

<i>(in millions)</i>	Total	March 31, 2013		
		Level 1	Level 2	Level 3
<b>Assets:</b>				
Cash and cash equivalents	\$ 691.0	\$ 691.0	\$	\$
Equity securities	9.3		9.3	
Other investments	14.7		4.0	10.7
<b>Liabilities:</b>				
Debt	\$ 1,116.7	\$	\$ 1,116.7	\$

<i>(in millions)</i>	Total	December 31, 2012		
		Level 1	Level 2	Level 3
<b>Assets:</b>				
Cash and cash equivalents	\$ 564.8	\$ 564.8	\$	\$
Equity securities	9.7		9.7	
Other investments	16.6		4.8	11.8
<b>Liabilities:</b>				
Debt	\$ 995.2	\$	\$ 995.2	\$

**Table of Contents**

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

<i>(in millions)</i>	Fixed Maturities					Total	Equity and		Total Assets
	Municipal	Corporate	Residential mortgage- backed, non- agency	Commercial mortgage- backed	Asset-backed		Other		
<b>Three Months Ended</b>									
<b>March 31, 2013</b>									
Balance January 1, 2013	\$ 19.4	\$ 26.4	\$ 0.7	\$ 26.7	\$ 1.5	\$ 74.7	\$ 28.0	\$ 102.7	
Transfers into Level 3	9.7	0.2				9.9		9.9	
Transfers out of Level 3					(1.5)	(1.5)	(0.9)	(2.4)	
Total gains (losses):									
Included in earnings		0.4				0.4		0.4	
Included in other comprehensive income-net appreciation (depreciation) on available-for-sale securities	0.1	(0.1)		(0.5)		(0.5)	1.5	1.0	
Purchases and sales:									
Purchases									
Sales	(0.4)	(4.1)	(0.1)	(1.4)		(6.0)		(6.0)	
Balance March 31, 2013	\$ 28.8	\$ 22.8	\$ 0.6	\$ 24.8	\$	\$ 77.0	\$ 28.6	\$ 105.6	

<b>Three Months Ended</b>								
<b>March 31, 2012</b>								
Balance January 1, 2012	\$ 13.6	\$ 23.8	\$ 5.2	\$ 23.7	\$ 9.2	\$ 75.5	\$ 27.0	\$ 102.5
Transfers into Level 3		4.3				4.3	0.1	4.4
Transfers out of Level 3					(7.7)	(7.7)		(7.7)
Total gains (losses):								
Included in earnings		0.1			(0.1)		(0.2)	(0.2)
Included in other comprehensive income-net appreciation (depreciation) on available-for-sale securities	0.6	0.8	0.1	(1.0)		0.5	(1.2)	(0.7)
Purchases and sales:								
Purchases	3.0			5.2		8.2		8.2
Sales	(0.2)	(0.3)	(4.6)	(0.4)	(0.1)	(5.6)	(0.7)	(6.3)
Balance March 31, 2012	\$ 17.0	\$ 28.7	\$ 0.7	\$ 27.5	\$ 1.3	\$ 75.2	\$ 25.0	\$ 100.2

During the three months ended March 31, 2013 and 2012, the Company transferred fixed maturities between Level 2 and Level 3 primarily as a result of assessing the significance of unobservable inputs on the fair value measurement. There were no transfers between Level 1 and Level 2 during the three months ended March 31, 2013 or 2012.

**Table of Contents**

The following table summarizes gains and losses due to changes in fair value that are recorded in net income for Level 3 assets.

<i>(in millions)</i>	<b>2013</b>	<b>Three Months Ended March 31,</b>		<b>2012</b>	<b>Total</b>
	<b>Net realized investment gains</b>	<b>Other-than- temporary impairments</b>	<b>Net realized investment gains (losses)</b>		
<b>Level 3 Assets:</b>					
Fixed maturities:					
Corporate	<b>\$ 0.4</b>	\$	0.1	\$	\$ 0.1
Asset-backed		(0.1)			(0.1)
<b>Total fixed maturities</b>	<b>0.4</b>	(0.1)	0.1		
Equity securities			(0.2)		(0.2)
<b>Total assets</b>	<b>\$ 0.4</b>	\$ (0.1)	\$ (0.1)		\$ (0.2)

There were no Level 3 liabilities held by the Company for the three months ended March 31, 2013 and 2012.

**Table of Contents**

The following table provides quantitative information about the significant unobservable inputs used by the Company in the fair value measurements of Level 3 assets as of March 31, 2013. Where discounted cash flows are used in the valuation of fixed maturities, the internally-developed discount rate is adjusted by the significant unobservable inputs shown in the table. Valuations for securities based on broker quotes for which there is a lack of transparency as to inputs used to develop the valuations have been excluded.

<i>(in millions)</i>	Valuation Technique	Significant Unobservable Inputs	March 31, 2013		December 31, 2012	
			Fair Value	Range (Wtd Average)	Fair Value	Range (Wtd Average)
<b>Fixed maturities:</b>						
Municipal	Discounted cash flow	Discount for: Small issue size Above-market coupon Long maturity	\$ 28.8	<b>1.0-4.0% (2.4%)</b> <b>0.3-1.0% (0.5%)</b> <b>0.1-0.6% (0.3%)</b>	\$ 19.4	1.0-4.0% (3.1%) 0.3-1.0% (0.5%) 0.5% (0.5%)
Corporate	Discounted cash flow	Discount for: Credit stress Above-market coupon Small issue size Long maturity	22.6	<b>3.0% (3.0%)</b> <b>0.3-1.0% (0.7%)</b> <b>0.3-3.0% (0.6%)</b> <b>0.1% (0.1%)</b>	26.4	1.0-3.0% (1.1%) 0.3-1.0% (0.7%) 0.3-3.0% (0.5%) 0.5% (0.5%)
Residential mortgage-backed, non-agency	Discounted cash flow	Discount for: Small issue size	0.6	<b>0.5% (0.5%)</b>	0.7	0.5% (0.5%)
Commercial mortgage-backed	Discounted cash flow	Discount for: Credit stress Small issue size Above-market coupon Long maturity Lease structure	24.8	<b>1.0% (1.0%)</b> <b>0.5% (0.5%)</b> <b>0.3-0.8% (0.4%)</b> <b>0.2-0.5% (0.4%)</b> <b>0.3% (0.3%)</b>	26.7	1.0% (1.0%) 0.5% (0.5%) 0.3-0.8% (0.4%) 0.5-0.8% (0.7%) 0.3% (0.3%)
Asset backed	Discounted cash flow	Discount for: Small issue size		NA	1.5	0.7-2.0% (1.6%)
Equity securities	Market comparables	Net tangible asset market multiples	24.9	<b>1.0X (1.0X)</b>	24.3	0.9X (0.9X)
Other	Discounted cash flow	Discount rate	3.6	<b>18.0% (18.0%)</b>	3.6	18.0% (18.0%)

Significant increases (decreases) in any of the above inputs in isolation would result in a significantly lower (higher) fair value measurement. There are no interrelationships between these inputs which might magnify or mitigate the effect of changes in unobservable inputs on the fair value measurement.

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

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

<i>(in millions)</i>	Three Months Ended March 31,			
	2013	2012	2013	2012
	Pension Plans		Postretirement Plans	
Service cost	\$ 0.4	\$ 0.4	\$	\$
benefits earned during the period				
Interest cost	7.9	8.8	0.5	0.5
Expected return on plan assets	(8.9)	(9.7)		
Recognized net actuarial loss	3.7	3.2	0.1	
Amortization of prior service cost			(0.9)	(0.9)
Net periodic pension cost (benefit)	\$ 3.1	\$ 2.7	\$ (0.3)	\$ (0.4)





**Table of Contents****8. Other Comprehensive Income**

The following table provides changes in other comprehensive income.

<i>(in millions)</i>	Three Months Ended March 31,					
	2013			2012		
	Pre-Tax	Tax Benefit (Expense)	Net of Tax	Pre-Tax	Tax Benefit (Expense)	Net of Tax
Unrealized gains on available-for-sale securities and derivative instruments:						
Unrealized gains arising during period	\$ 25.0	\$ (8.8)	\$ 16.2	\$ 70.0	\$ (20.9)	\$ 49.1
Less:						
Amount of realized gains from sales and other	8.8	2.3	11.1	4.7	2.7	7.4
Portion of other-than-temporary impairment losses recognized in earnings	(0.5)	0.2	(0.3)	(2.9)	0.7	(2.2)
Net unrealized gains	16.7	(11.3)	5.4	68.2	(24.3)	43.9
Pension and postretirement benefits:						
Amortization of net actuarial loss and prior service cost recognized as net periodic benefit cost	2.9	(1.0)	1.9	2.3	(0.8)	1.5
Cumulative foreign currency translation adjustment:						
Foreign currency translation recognized during the period	(15.4)	5.4	(10.0)	14.3	(5.0)	9.3
Other comprehensive income (loss)	\$ 4.2	\$ (6.9)	\$ (2.7)	\$ 84.8	\$ (30.1)	\$ 54.7

Reclassifications out of accumulated other comprehensive income were as follows:

<i>(in millions)</i>	For the Three Months		Affected Line Item in the Statement
	Ended March 31, 2013	2012	
Details about Accumulated Other	Amount Reclassified from		
Comprehensive Income Components	Accumulated Other Comprehensive Income		Where Net Income is Presented
Unrealized gains on available-for-sale securities and derivative instruments	\$ 8.7	\$ 4.6	Net realized gains from sales and other
	(0.5)	(1.9)	Net other-than-temporary impairment losses on investments recognized in earnings
Other	0.1		
	8.3	2.7	Total before tax
	2.5	3.4	Tax benefit (expense)
	10.8	6.1	
		(0.9)	Discontinued operations, net of tax
	10.8	5.2	Net of tax
Amortization of defined benefit pension and postretirement plans	2.9	2.3	Loss adjustment expenses and other operating expenses

Edgar Filing: HANOVER INSURANCE GROUP, INC. - Form 10-Q

(1.0) (0.8) Tax benefit (expense)

1.9 1.5 Net of tax

Total reclassifications for the period \$ 12.7 \$ 6.7 Net of tax

The amount reclassified from accumulated other comprehensive income for the pension and postretirement benefits was allocated approximately 40% to loss adjustment expenses and 60% to other operating expenses.

- 22 -

**Table of Contents**

**9. Segment Information**

The Company's primary business operations include insurance products and services provided through four operating segments. These operating segments are Commercial Lines, Personal Lines, Chaucer and Other. Commercial Lines includes commercial multiple peril, commercial automobile, workers' compensation, and other commercial coverages, such as specialty program business, inland marine, management and professional liability and surety. Personal Lines includes personal automobile, homeowners and other personal coverages. Chaucer includes marine and aviation, energy, property, U.K. motor, and casualty and other coverages (which includes international liability, specialist coverages, and syndicate participations). Included in Other are Opus Investment Management, Inc., which markets investment management services to institutions, pension funds and other organizations; earnings on holding company assets; and, a voluntary pools business which is in run-off. The separate financial information is presented consistent with the way results are regularly evaluated by the chief operating decision maker in deciding how to allocate resources and in assessing performance.

The Company reports interest expense related to its debt separately from the earnings of its operating segments. This consists of interest on the Company's senior debentures, subordinated debentures, collateralized borrowings with the Federal Home Loan Bank of Boston, and letter of credit facility. Management evaluates the results of the aforementioned segments based on operating income before taxes (formerly referred to as segment income) which also excludes interest expense on debt. Operating income (loss) before taxes excludes certain items which are included in net income (loss), such as net realized investment gains and losses, including gains and losses from certain derivative instruments. Such gains and losses are excluded since they are determined by interest rates, financial markets and the timing of sales. Also, operating income (loss) before taxes excludes net gains and losses on disposals of businesses, discontinued operations, costs to acquire businesses, restructuring costs, extraordinary items, the cumulative effect of accounting changes and certain other items. Although the items excluded from operating income (loss) before taxes may be significant components in understanding and assessing the Company's financial performance, management believes that the presentation of operating income (loss) before taxes enhances an investor's understanding of the Company's results of operations by highlighting net income (loss) attributable to the core operations of the business. However, operating income (loss) before taxes should not be construed as a substitute for income (loss) before income taxes and operating income (loss) should not be construed as a substitute for net income (loss).

**Table of Contents**

Summarized below is financial information with respect to the Company's business segments.

<i>(in millions)</i>	Three Months Ended	
	2013	2012
Operating revenues:		
Commercial Lines	\$ 514.7	\$ 475.7
Personal Lines	391.1	388.4
Chaucer	263.9	251.7
Other	2.5	2.9
Total	1,172.2	1,118.7
Net realized investment gains	8.1	3.1
Total revenues	\$ 1,180.3	\$ 1,121.8
Operating income (loss) before income taxes:		
Commercial Lines:		
GAAP underwriting loss	\$ (3.1)	\$ (2.5)
Net investment income	36.1	35.7
Other income		0.7
Commercial Lines operating income	33.0	33.9
Personal Lines:		
GAAP underwriting income	10.1	4.2
Net investment income	19.0	21.6
Other income	1.4	1.7
Personal Lines operating income	30.5	27.5
Chaucer:		
GAAP underwriting income	33.0	14.7
Net investment income	10.5	9.4
Other income (loss)	(2.6)	1.4
Chaucer operating income	40.9	25.5
Other:		
GAAP underwriting loss	(1.1)	(0.4)
Net investment income	1.7	2.1
Other net expenses	(2.8)	(2.9)
Other operating loss	(2.2)	(1.2)
Operating income before interest expense and income taxes	102.2	85.7
Interest on debt	(14.7)	(16.2)
Operating income before income taxes	87.5	69.5
Adjustments to operating income:		
Net realized investment gains	8.1	3.1
Net loss from repayment of advances	(7.8)	
Net benefit (costs) related to acquired businesses	0.4	(1.5)

Edgar Filing: HANOVER INSURANCE GROUP, INC. - Form 10-Q

Net foreign exchange gains (losses)	<b>0.7</b>	(0.3)
Income before income taxes	<b>\$ 88.9</b>	\$ 70.8

The Company recognized \$2.1 million in net foreign currency transaction losses in the Statement of Income during the three months ended March 31, 2013 compared to \$2.9 million in net foreign currency gains during the three months ended March 31, 2012.

- 24 -

**Table of Contents**

The following table provides identifiable assets for the Company's business segments and discontinued operations:

<i>(in millions)</i>	March 31, 2013	December 31, 2012
	<b>Identifiable Assets</b>	
U.S. Companies	<b>\$ 8,908.5</b>	\$ 8,909.6
Chaucer	<b>4,413.0</b>	4,444.8
Discontinued operations	<b>120.6</b>	130.5
 Total	 <b>\$ 13,442.1</b>	 \$ 13,484.9

The Company reviews the assets of its U.S. Companies collectively and does not allocate them between the Commercial Lines, Personal Lines and Other segments.

**10. Stock-based Compensation**

Compensation cost and the related tax benefits were as follows:

<i>(in millions)</i>	Three Months Ended March 31,	
	2013	2012
Stock-based compensation expense	<b>\$ 3.6</b>	\$ 4.1
Tax benefit	<b>(1.3)</b>	(1.4)
 Stock-based compensation expense, net of taxes	 <b>\$ 2.3</b>	 \$ 2.7

*Stock Options*

Information on the Company's stock option plans is summarized below.

<i>(in whole shares and dollars)</i>	Three Months Ended March 31,			
	2013		2012	
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Outstanding, beginning of period	<b>2,892,882</b>	\$ 38.28	2,715,430	\$ 38.57
Granted	<b>535,300</b>	<b>42.49</b>	517,500	36.81
Exercised	<b>(213,645)</b>	<b>30.26</b>	(33,224)	32.24
Expired			(158,850)	44.04
 Outstanding, end of period	 <b>3,214,537</b>	 <b>39.52</b>	 3,040,856	 38.06

**Table of Contents***Restricted Stock Units*

The following tables summarize activity information about employee restricted stock units:

	2013		Three Months Ended March 31, 2012	
	Shares	Weighted Average Grant Date Fair Value	Shares	Weighted Average Grant Date Fair Value
<i>(in whole shares and dollars)</i>				
Time-based restricted stock units:				
Outstanding, beginning of period	750,837	\$ 40.15	768,529	\$ 40.17
Granted	124,850	42.49	168,750	36.93
Vested	(245,185)	39.42	(117,522)	35.27
Forfeited	(1,625)	39.32	(10,309)	39.67
Outstanding, end of period	628,877	40.90	809,448	40.21
Performance-based and market-based restricted stock units:				
Outstanding, beginning of period	132,775	\$ 39.97	69,500	\$ 45.37
Granted	79,850	41.67	99,500	36.61
Outstanding, end of period	212,625	40.61	169,000	40.21

Performance based restricted stock units are based upon the achievement of the performance metric at 100%. These units have the potential to range from 0% to 200% of the shares disclosed, which varies based on grant year and individual award. Increases above the 100% target level are reflected as granted in the period in which performance-based stock unit goals are achieved. Decreases below the 100% target level are reflected as forfeited.

In the first three months of 2013 and 2012, the Company granted market-based awards totaling 76,175 and 90,250, respectively, to certain members of senior management, which are included in the table above as performance and market-based restricted stock activity. The vesting of these stock units is based on the relative total shareholder return (TSR) of the Company. This metric is generally based on a three-year average relative TSR as compared to a Property and Casualty Index of peer companies. The fair value of market based awards was estimated at the date of grant using a valuation model. These units have the potential to range from 0% to 150% of the shares disclosed.

**11. Earnings Per Share and Shareholders' Equity Transactions**

The following table provides weighted average share information used in the calculation of the Company's basic and diluted earnings per share:

<i>(in millions, except per share data)</i>	Three Months Ended March 31,	
	2013	2012
Basic shares used in the calculation of earnings per share	44.6	44.9
Dilutive effect of securities:		
Employee stock options	0.3	0.2
Non-vested stock grants	0.4	0.4
Diluted shares used in the calculation of earnings per share	45.3	45.5
Per share effect of dilutive securities on income from continuing operations	\$ (0.02)	\$ (0.02)



Per share effect of dilutive securities on income from net income	<b>\$ (0.03)</b>	\$ (0.02)
---	------------------	-----------

Diluted earnings per share for the three months ended March 31, 2013 and 2012 excludes 1.3 million and 1.8 million, respectively, of common shares issuable under the Company's stock compensation plans, because their effect would be antidilutive.

- 26 -

---

## **Table of Contents**

Since October 2007 and through March 2013, the Company's Board of Directors has authorized aggregate repurchases of the Company's common stock of up to \$500 million. As of March 31, 2013, the Company has \$90.0 million available for repurchases under these repurchase authorizations. Repurchases may be executed using open market purchases, privately negotiated transactions, accelerated repurchase programs or other transactions. The Company is not required to purchase any specific number of shares or to make purchases by any certain date under this program. During the first three months of 2013, the Company purchased 0.5 million shares of the Company's common stock through a privately negotiated transaction and open market purchases at a cost of \$25.2 million. Total repurchases under this program as of March 31, 2013 were 9.6 million shares at a cost of \$410.0 million.

## **12. Commitments and Contingencies**

### ***Legal Proceedings***

#### ***Durand Litigation***

On March 12, 2007, a putative class action suit captioned Jennifer A. Durand v. The Hanover Insurance Group, Inc., and The Allmerica Financial Cash Balance Pension Plan was filed in the United States District Court for the Western District of Kentucky. The named plaintiff, a former employee who received a lump sum distribution from the Company's Cash Balance Plan (the Plan) at or about the time of her termination, claims that she and others similarly situated did not receive the appropriate lump sum distribution because in computing the lump sum, the Company understated the accrued benefit in the calculation. The plaintiff claims that the Plan understated her distributions and those of similarly situated participants by failing to pay an additional so-called "whipsaw" amount reflecting the present value of an estimate of future interest credits from the date of the lump sum distribution to each participant's retirement age of 65 discounted by applicable IRS rates.

The Plaintiff filed an Amended Complaint adding two new named plaintiffs and additional claims on December 11, 2009. In response, the Company filed a Motion to Dismiss on January 30, 2010. In addition to the pending claim challenging the calculation of lump sum distributions, the Amended Complaint included: (a) a claim that the Plan failed to calculate participants' account balances and lump sum payments properly because interest credits were based solely upon the performance of each participant's selection from among various hypothetical investment options (as the Plan provided) rather than crediting the greater of that performance or the 30 year Treasury rate; (b) a claim that the 2004 Plan amendment, which changed interest crediting for all participants from the performance of participant's investment selections to the 30 year Treasury rate, reduced benefits in violation of the Employee Retirement Income Security Act of 1974 (ERISA) for participants who had account balances as of the amendment date by not continuing to provide them performance-based interest crediting on those balances; and (c) claims against the Company for breach of fiduciary duty and ERISA notice requirements arising from the various interest crediting and lump sum distribution matters of which Plaintiffs complain. The District Court granted the Company's Motion to Dismiss the additional claims on statute of limitations grounds by a Memorandum Opinion dated March 31, 2011, leaving the claims substantially as set forth in the original March 12, 2007 complaint. Plaintiffs filed a Motion for Reconsideration of the District Court's decision to dismiss the additional claims, which was denied with respect to the claims set forth in (a) and (b) above; however, the Court did allow the fiduciary duty claim regarding plaintiffs' "whipsaw" claim to stand. On June 22, 2012, the Company and the Plan filed a Motion for Summary Judgment to dismiss the claims of one of the plaintiffs who received his lump sum distribution after December 31, 2003, on the basis that certain amendments to the Plan effective January 1, 2004 eliminated any basis for payment of an additional "whipsaw" amount to participants who received lump sum distributions after December 31, 2003. On December 13, 2012, the Court held this motion in abeyance pending a ruling on Plaintiffs' Motion for Class Certification. Plaintiffs filed their Motion for Class Certification on January 14, 2013. On February 8, 2013, the Company and the Plan informed the Court that they did not oppose the certification of a class.

At this time, the Company is unable to provide a reasonable estimate of the potential range of ultimate liability if the outcome of the suit is unfavorable. The extent to which any of the Plaintiffs' multiple theories of liability, some of which are overlapping and others of which are quite complex and novel, are accepted and upheld on appeal will significantly affect the Plan's or the Company's potential liability. The statute of limitations applicable to the alleged class has not yet been finally determined and the extent of potential liability, if any, will depend on this final determination. In addition, assuming for these purposes that the Plaintiffs prevail with respect to claims that benefits accrued or payable under the Plan were understated, then there are numerous possible theories and other variables upon which any revised calculation of benefits as requested under Plaintiffs' claims could be based. Any adverse judgment in this case against the Plan would be expected to create a liability for the Plan, with resulting effects on the Plan's assets available to pay benefits. The Company's future required funding of the Plan could also be impacted by such a liability.

#### ***Other Matters***

The Company has been named a defendant in various other legal proceedings arising in the normal course of business. In addition, the Company is involved, from time to time, in examinations, investigations and proceedings by governmental and self-regulatory agencies. The potential outcome of any such action or regulatory proceedings in which the Company has been named a defendant or



**Table of Contents**

the subject of an inquiry or investigation, and its ultimate liability, if any, from such action or regulatory proceedings, is difficult to predict at this time. The ultimate resolutions of such proceedings are not expected to have a material effect on its financial position, although they could have a material effect on the results of operations for a particular quarter or annual period.

**13. Subsequent Events**

There were no subsequent events requiring adjustment to the financial statements and no additional disclosures required in the notes to the interim consolidated financial statements.

**Table of Contents**

**PART I**

**ITEM 2**

**MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

**TABLE OF CONTENTS**

<u>Introduction</u>	30
<u>Executive Overview</u>	30
<u>Description of Operating Segments</u>	31
<u>Results of Operations – Net Income</u>	31
<u>Results of Operations – Segments</u>	33
<u>Investments</u>	38
<u>Other Items</u>	44
<u>Income Taxes</u>	44
<u>Critical Accounting Estimates</u>	45
<u>Statutory Surplus of U.S. Insurance Subsidiaries</u>	45
<u>Lloyd's Capital Requirement</u>	45
<u>Liquidity and Capital Resources</u>	46
<u>Off-Balance Sheet Arrangements</u>	48
<u>Contingencies and Regulatory Matters</u>	48
<u>Risks and Forward-Looking Statements</u>	48

---

## **Table of Contents**

### **Introduction**

The following Management's Discussion and Analysis of Financial Condition and Results of Operations is intended to assist readers in understanding the interim consolidated results of operations and financial condition of The Hanover Insurance Group, Inc. and its subsidiaries ( THG ). Consolidated results of operations and financial condition are prepared in accordance with generally accepted accounting principles in the United States of America ( U.S. GAAP ). This discussion should be read in conjunction with the interim consolidated financial statements and related footnotes included elsewhere in this Quarterly Report on Form 10-Q and Management's Discussion and Analysis of Financial Condition and Results of Operations contained in our 2012 Annual Report on Form 10-K filed with the Securities and Exchange Commission on February 26, 2013.

Results of operations include the accounts of The Hanover Insurance Company ( Hanover Insurance ) and Citizens Insurance Company of America ( Citizens ), our principal U.S. domiciled property and casualty companies; Chaucer Holdings plc ( Chaucer ), our United Kingdom (U.K.) domiciled specialist insurance underwriting group which operates through the Society and Corporation of Lloyd's ( Lloyd's ), and certain other insurance and non-insurance subsidiaries. Additionally, results of operations include our discontinued operations, consisting primarily of our former life insurance businesses, accident and health business and third party administration business.

### **Executive Overview**

Business operations consist of four operating segments: Commercial Lines, Personal Lines, Chaucer and Other.

Operating income (formerly referred to as segment income) excluding income taxes and interest was \$102.2 million for the three months ended March 31, 2013 compared to \$85.7 million in the same period in 2012, an increase of \$16.5 million. This increase is primarily due to lower catastrophe and non-catastrophe related losses in the first three months of 2013, partially offset by lower favorable development on prior years loss and loss adjustment expense ( LAE ) reserves ( prior years loss reserves ). Pre-tax catastrophe losses were \$21.7 million for the three months ended March 31, 2013 compared to \$40.6 million in the same period in 2012, a decrease of \$18.9 million. Favorable development on prior years loss reserves was \$6.9 million for the three months ended March 31, 2013, compared to favorable development of \$17.2 million in the same period in 2012.

In several recent years, weather-related catastrophe and non-catastrophe losses have been in excess of longer term averages for the insurance industry. Pricing in our Commercial and Personal Lines and certain lines in Chaucer, continues to improve as the industry responds to these increased weather-related losses, as well as to the earnings impact of reduced investment income as a result of low interest rates, and other factors. We are continuing efforts to improve our underwriting results in both our Commercial and Personal Lines, including through rate increases and improvements to our mix of business.

### **Commercial Lines**

We believe our unique approach to the small commercial market, distinctiveness in the middle market, and continued development of specialty lines provides us with a diversified portfolio of products and delivers significant value to agents and policyholders. The small commercial and middle market businesses are expected to contribute to premium growth in Commercial Lines over the next several years as we continue to pursue our core strategy of developing strong partnerships with agents, distinctive products, franchise value through limited distribution, and industry segmentation. Growth in our specialty lines continues to be an important part of our strategy, with the expansion of our product offerings in these lines supported by several acquisitions of specialized business.

We believe these efforts have driven, and will continue to drive, improvement in our overall mix of business and ultimately our underwriting profitability. Commercial Lines net written premium grew by 3.1% in the first three months of 2013, driven by both our core commercial businesses and specialty businesses. This growth is primarily due to rate increases, strong retention and targeted new business expansion. Underwriting results in the first three months of 2013 were relatively consistent with the same period in 2012, primarily due to increased current year non-catastrophe weather-related losses and LAE, partially offset by a decrease in catastrophe related losses. In addition, the current quarter's results benefited from growth in earned premium and the resulting positive effect on our expense ratio.

The competitive nature of the Commercial Lines market requires us to be highly disciplined in our underwriting process to ensure that we write business at acceptable margins. Also, we continue to seek rate increases across our lines of business. Rate actions in our commercial automobile and workers' compensation lines, and our property coverages in our commercial multiple peril line have been supported by industry wide loss trends and severity. In our surety business, we continue to shift the business mix toward commercial surety from contract surety, and to enhance the underwriting tools and standards that we employ.

**Personal Lines**

In our Personal Lines business, we focus on partnering with high quality, value-added agencies that deliver consultative selling and stress the importance of account rounding (the conversion of single policy customers to accounts with multiple policies and additional

---

## **Table of Contents**

coverages). Approximately 72% of our policies in force are account business. We are focused on making investments that help maintain profitability, build a distinctive position in the market, help diversify us geographically from our historical core states of Michigan, Massachusetts, New York and New Jersey, and provide us with profitable growth opportunities.

Underwriting results improved in the first three months of 2013, as compared to the same period in 2012, primarily due to decreased catastrophe related losses, partially offset by increased non-catastrophe weather-related losses and unfavorable development on prior years' loss reserves. Unfavorable development on prior years' loss reserves for the three months ended March 31, 2013 was \$5.6 million, compared to unfavorable development of \$3.8 million for the three months ended March 31, 2012. Similar to our strategy in Commercial Lines, we continue to seek additional rate increases, subject to regulatory considerations, in our personal automobile line, particularly as a result of recent trends of higher loss severity in bodily injury and homeowners lines as a result of the catastrophe and non-catastrophe weather-related losses that the industry experienced in recent years.

### **Chaucer**

In our Chaucer business, we deploy specialist underwriters in over 30 major insurance and reinsurance classes, including energy, marine and aviation, U.K. motor, property, and casualty and other coverages. We obtain business through Lloyd's, the leading international insurance and reinsurance market, which provides us with access to specialist business in over 200 countries and territories worldwide through its international licenses, brand reputation and strong security rating. Our underwriting strength, diverse portfolio and Lloyd's membership underpin our ability to actively manage the scale, composition and profitable development of this business.

Underwriting results improved in the first three months of 2013, as compared to the same period in 2012, primarily due to lower loss activity in most lines and an absence of significant man-made and natural catastrophe losses. Chaucer net written premium increased by 25.6% in the first three months of 2013, primarily due to our decision to increase our economic interest in Syndicate 1084 to 98% for 2013, up from 84% in 2012, primarily resulting from the non-renewal of the capital provision reinsurance treaty with Flagstone Re. Additionally, changes to our 2013 ceded reinsurance program, including increased net retentions for certain major lines, increased net written premiums. We also benefited from favorable rates in our marine and property lines, following recent high levels of insured market losses. The energy market began to experience reduced rate increases following an absence of major losses in 2012, and pricing in the aviation and casualty markets remained under pressure as a result of low loss activity, the challenging economic environment and continuing industry over-capacity. U.K. motor market rates continued to decline modestly, following the significant increases in 2010 and 2011.

The focus of our capital and underwriting capabilities remains in those areas where we expect rates to be more favorable, in particular, for catastrophe-exposed marine and property risks, with emphasis away from business where rates are currently under most pressure, notably casualty and aviation.

### **Description of Operating Segments**

Primary business operations include insurance products and services currently provided through four operating segments. Our domestic operating segments are Commercial Lines, Personal Lines and Other. Our international operating segment is Chaucer. Commercial Lines includes commercial multiple peril, commercial automobile, workers' compensation and other commercial coverages, such as specialty program business, inland marine, management and professional liability and surety. Personal Lines includes personal automobile, homeowners and other personal coverages. Chaucer includes marine and aviation, energy, property, U.K. motor, and casualty and other coverages (which includes international liability, specialist coverages, and syndicate participations). Included in Other are Opus Investment Management, Inc., which markets investment management services to institutions, pension funds and other organizations; earnings on holding company assets; and, a voluntary pools business which is in run-off. We present the separate financial information of each segment consistent with the manner in which our chief operating decision maker evaluates results in deciding how to allocate resources and in assessing performance.

We report interest expense related to our debt separately from the earnings of our operating segments. This consists of interest on our senior debentures, junior debentures, subordinated debentures, collateralized borrowings with the Federal Home Loan Bank of Boston (FHLBB), and letter of credit facility.

### **Results of Operations – Net Income**

Consolidated net income includes the results of our four operating segments (operating income (loss)), which we evaluate on a pre-tax basis and we exclude interest expense on debt. Operating income (loss) before taxes (formerly referred to as segment income (loss)) excludes certain other items which we believe are not indicative of our core operations, such as net realized investment gains and losses, including net gains and losses on certain derivative instruments. Such gains and losses are excluded since they are determined by interest rates, financial markets and the



timing of sales. Also, operating income (loss) before taxes excludes net gains and losses on

**Table of Contents**

disposals of businesses, discontinued operations, costs to acquire businesses, restructuring costs, extraordinary items, the cumulative effect of accounting changes and certain other items. Although the items excluded from operating income (loss) before taxes may be significant components in understanding and assessing our financial performance, we believe a discussion of operating income before taxes enhances an investor's understanding of our results of operations by segregating income attributable to the core operations of the business. However, operating income (loss) before taxes should not be construed as a substitute for income (loss) before income taxes and operating income (loss) should not be construed as a substitute for net income (loss).

Catastrophe losses and prior years' reserve development are significant components in understanding and assessing the financial performance of our business. Management reviews and evaluates catastrophes and prior years' reserve development separately from the other components of earnings. Catastrophes and prior years' reserve development are not predictable as to timing or the amount that will affect the results of our operations and have affected our results in the past few years. Management believes that providing certain financial metrics and trends excluding the effects of catastrophes and prior years' reserve development helps investors to understand the variability in periodic earnings and to evaluate the underlying performance of our operations.

Consolidated net income for the three months ended March 31, 2013 was \$66.2 million, compared to \$49.7 million for the three months ended March 31, 2012. The \$16.5 million increase is primarily due to improved operating results after taxes, which was principally attributable to an improvement in underwriting results primarily due to decrease in catastrophe losses.

The following table reflects operating income (loss) for each operating segment and a reconciliation of operating income to consolidated net income.

<i>(in millions)</i>	<b>Three Months Ended</b>	
	<b>March 31,</b>	
	<b>2013</b>	<b>2012</b>
Operating income (loss) before interest expense and income taxes:		
Commercial Lines	<b>\$ 33.0</b>	\$ 33.9
Personal Lines	<b>30.5</b>	27.5
Chaucer	<b>40.9</b>	25.5
Other	<b>(2.2)</b>	(1.2)
Operating income before interest expense and income taxes	<b>102.2</b>	85.7
Interest expense on debt	<b>(14.7)</b>	(16.2)
Operating income before income taxes	<b>87.5</b>	69.5
Income tax expense on operating income	<b>(27.6)</b>	(23.5)
Operating income	<b>59.9</b>	46.0
Net realized investment gains	<b>8.1</b>	3.1
Net loss from repayment of advances	<b>(7.8)</b>	
Net benefit (costs) related to acquired businesses	<b>0.4</b>	(1.5)
Net foreign exchange gains (losses)	<b>0.7</b>	(0.3)
Income tax benefit on non-operating items	<b>5.1</b>	3.4
Income from continuing operations, net of taxes	<b>66.4</b>	50.7
Net loss from discontinued operations, net of taxes	<b>(0.2)</b>	(1.0)
Net income	<b>\$ 66.2</b>	\$ 49.7

**Table of Contents****Results of Operations – Segments**

The following is our discussion and analysis of the results of operations by business segment. The operating results are presented before interest expense, taxes and other items which management believes are not indicative of our core operations, including realized gains and losses.

The following table summarizes the results of operations for the periods indicated:

<i>(in millions)</i>	<b>Three Months Ended March 31,</b>	
	<b>2013</b>	<b>2012</b>
Operating revenues		
Net premiums written	<b>\$ 1,076.7</b>	\$ 1,016.8
Net premiums earned	<b>1,094.3</b>	1,035.6
Net investment income	<b>67.3</b>	68.8
Other income	<b>10.6</b>	15.9
Total operating revenues	<b>1,172.2</b>	1,120.3
Losses and operating expenses		
Losses and LAE	<b>683.4</b>	661.4
Amortization of deferred acquisition costs	<b>242.5</b>	228.1
Other operating expenses	<b>144.1</b>	145.1
Total losses and operating expenses	<b>1,070.0</b>	1,034.6
Operating income before interest expense and income taxes	<b>\$ 102.2</b>	\$ 85.7

**Three Months Ended March 31, 2013 Compared to Three Months Ended March 31, 2012**

Operating income before interest expense and income taxes was \$102.2 million in the three months ended March 31, 2013, compared to \$85.7 million in the three months ended March 31, 2012, an increase in earnings of \$16.5 million. Catastrophe related activity in the quarter was \$21.7 million compared to \$40.6 million in the same period of 2012, a decrease of \$18.9 million. Excluding the impact of catastrophe related activity, operating earnings decreased by \$2.4 million. This decrease was primarily due to lower favorable development on prior years' loss reserves, partially offset by lower current accident year losses and underwriting expenses. Favorable development on prior years' loss reserves was \$6.9 million in the quarter, compared to \$17.2 million in the same period in 2012. This decrease was driven by lower favorable development in our Chaucer segment.

Net premiums written grew by \$59.9 million in the three months ended March 31, 2013, compared to the three months ended March 31, 2012, and net premiums earned grew by \$58.7 million. Chaucer accounted for \$51.3 million of the net premiums written increase and \$11.9 million of the net premiums earned increase. The balance of the growth is primarily attributable to Commercial Lines, resulting from rate increases, strong retention and targeted new business expansion.

**Table of Contents****Production and Underwriting Results**

The following table summarizes net premiums written and loss, LAE, expense and combined ratios for the Commercial Lines, Personal Lines and Chaucer segments. Loss and LAE, catastrophe loss and combined ratios include prior year reserve development. These items are not meaningful for our Other segment.

**Three Months Ended March 31, 2013**

<i>(dollars in millions)</i>	Gross Written	Net Written	Net Earned	Catastrophe Loss	Loss & LAE	Expense	Combined
	Premium	Premium	Premium	Ratios	Ratios	Ratios	Ratios
Commercial Lines	\$ 561.4	\$ 483.6	\$ 476.6	1.6	62.5	38.0	100.5
Personal Lines	367.2	341.6	368.8	3.2	69.3	27.2	96.5
Chaucer	389.5	251.5	248.9	1.0	52.0	34.7	86.7
Total	\$ 1,318.1	\$ 1,076.7	\$ 1,094.3	2.0	62.4	33.7	96.1

**Three Months Ended March 31, 2012**

<i>(dollars in millions)</i>	Gross Written	Net Written	Net Earned	Catastrophe Loss	Loss & LAE	Expense	Combined
	Premium	Premium	Premium	Ratios	Ratios	Ratios	Ratios
Commercial Lines	\$ 532.6	\$ 468.9	\$ 434.9	2.6	61.6	38.7	100.3
Personal Lines	373.2	347.4	363.3	6.3	70.7	27.3	98.0
Chaucer	381.7	200.2	237.0	2.7	57.6	36.2	93.8
Total	\$ 1,287.5	\$ 1,016.5	\$ 1,035.2	3.9	63.9	34.2	98.1

The following table summarizes net premiums written and loss and LAE and catastrophe loss ratios by line of business for the Commercial Lines and Personal Lines segments. Loss and LAE and catastrophe loss ratios include prior year reserve development.

**Three Months Ended March 31,**

<i>(dollars in millions)</i>	2013			2012		
	Net Premiums Written	Loss & LAE Ratios	Catastrophe Loss Ratios	Net Premiums Written	Loss & LAE Ratios	Catastrophe Loss Ratios
Commercial Lines:						
Commercial multiple peril	\$ 154.0	60.2	3.4	\$ 148.0	56.8	6.8
Commercial automobile	72.8	73.1	0.1	70.7	71.4	0.8
Workers compensation	62.2	63.4		55.0	72.6	
Other commercial	194.6	60.1	1.0	195.2	59.1	0.5
Total Commercial Lines	\$ 483.6	62.5	1.6	\$ 468.9	61.6	2.6
Personal Lines:						
Personal automobile	\$ 227.1	76.5		\$ 233.1	75.2	1.1
Homeowners	105.4	58.5	8.8	105.0	63.7	15.8
Other personal	9.1	47.2	5.7	9.3	55.6	5.6
Total Personal Lines	\$ 341.6	69.3	3.2	\$ 347.4	70.7	6.3

Edgar Filing: HANOVER INSURANCE GROUP, INC. - Form 10-Q

The following table summarizes premiums written on a gross and net basis and net premiums earned by line of business for the Chaucer segment.

<i>(in millions)</i>	Three Months Ended March 31,					
	2013			2012		
	Gross Written Premium	Net Written Premium	Net Earned Premium	Gross Written Premium	Net Written Premium	Net Earned Premium
Chaucer:						
Marine and aviation	\$ 108.3	\$ 81.3	\$ 58.8	\$ 99.5	\$ 58.5	\$ 54.2
U.K. motor	79.7	60.1	66.5	66.6	45.5	61.5
Energy	51.8	17.7	44.8	71.3	23.3	39.4
Property	92.2	47.8	44.5	87.7	29.6	46.7
Casualty and other	57.5	44.6	34.3	56.6	43.3	35.2
<b>Total Chaucer</b>	<b>\$ 389.5</b>	<b>\$ 251.5</b>	<b>\$ 248.9</b>	<b>\$ 381.7</b>	<b>\$ 200.2</b>	<b>\$ 237.0</b>

**Table of Contents**

The following table summarizes GAAP underwriting results for the Commercial Lines, Personal Lines, Chaucer and Other segments and reconciles it to operating income.

<i>(in millions)</i>	2013					2012				
	Commercial Lines	Personal Lines	Chaucer	Other	Total	Commercial Lines	Personal Lines	Chaucer	Other	Total
GAAP underwriting profit (loss), excluding prior year reserve development and catastrophes	\$ 4.5	\$ 27.4	\$ 22.3	\$ (0.5)	\$ 53.7	\$ 9.1	\$ 31.0	\$ (0.5)	\$ (0.2)	\$ 39.4
Prior year favorable (unfavorable) loss and LAE reserve development	(0.2)	(5.6)	13.3	(0.6)	6.9	(0.5)	(3.8)	21.7	(0.2)	17.2
Pre-tax catastrophe effect	(7.4)	(11.7)	(2.6)		(21.7)	(11.1)	(23.0)	(6.5)		(40.6)
GAAP underwriting profit (loss)	(3.1)	10.1	33.0	(1.1)	38.9	(2.5)	4.2	14.7	(0.4)	16.0
Net investment income	36.1	19.0	10.5	1.7	67.3	35.7	21.6	9.4	2.1	68.8
Fees and other income	2.0	3.3	4.5	0.8	10.6	5.1	3.5	5.3	2.0	15.9
Other operating expenses	(2.0)	(1.9)	(7.1)	(3.6)	(14.6)	(4.4)	(1.8)	(3.9)	(4.9)	(15.0)
Operating income (loss) before income taxes	\$ 33.0	\$ 30.5	\$ 40.9	\$ (2.2)	\$ 102.2	\$ 33.9	\$ 27.5	\$ 25.5	\$ (1.2)	\$ 85.7

**Commercial Lines**

Commercial Lines net premiums written was \$483.6 million in the three months ended March 31, 2013, compared to \$468.9 million in the three months ended March 31, 2012. This \$14.7 million increase was primarily driven by rate increases, strong retention and targeted new business expansion.

Commercial Lines underwriting loss in the three months ended March 31, 2013 was \$3.1 million, relatively consistent with \$2.5 million for the three months ended March 31, 2012. This reflects increased current year non-catastrophe losses offset by decreased catastrophe losses. In addition, the current quarter's results benefited from growth in earned premium and the resulting positive effect on our expense ratio. Catastrophe losses for the three months ended March 31, 2013 were \$7.4 million, compared to \$11.1 million for the three months ended March 31, 2012, a decrease of \$3.7 million. Current accident year losses increased in our commercial multiple peril and commercial automobile lines, partially offset by lower losses in our workers' compensation line. Unfavorable development on prior years' loss reserves for the three months ended March 31, 2013 was \$0.2 million compared to unfavorable development of \$0.5 million for the three months ended March 31, 2012.

Commercial Lines current accident year underwriting profit, excluding catastrophes, was \$4.5 million for the three months ended March 31, 2013, compared to \$9.1 million for the three months ended March 31, 2012. This \$4.6 million decrease in non-catastrophe current accident year results was primarily due to higher non-catastrophe weather-related losses in our commercial multiple peril and commercial automobile lines.

Pricing in Commercial Lines continues to improve. We believe that industry pricing is increasing due to recent weather-related losses, as well as to reduced investment income as a result of low interest rates, and other factors. We are continuing efforts to improve our underwriting results, including through increased rates; however, our ability to increase Commercial Lines net premiums written while maintaining or improving underwriting results may be affected by price competition and the current challenging economic environment. We also expect to continue our efforts to reduce our property exposures in certain geographic areas and classes of business, with a goal of improving our longer-term profitability and reducing earnings volatility. Also, in recent years, weather-related catastrophe and non-catastrophe losses have been in excess of longer term averages for the insurance industry. We continue to monitor these trends and consider them in our rate actions.

**Personal Lines**

Personal Lines net premiums written was \$341.6 million in the three months ended March 31, 2013, compared to \$347.4 million in the three months ended March 31, 2012, a decrease of \$5.8 million. The primary factors contributing to this decrease were our continued property-focused exposure management actions. Our actions to reduce homeowners policy exposures, including increases in rate, have resulted in an increase in policy attrition. These decreases were partially offset by higher rates in both our homeowners and personal automobile lines.

## Edgar Filing: HANOVER INSURANCE GROUP, INC. - Form 10-Q

Net premiums written in the personal automobile line of business for the three months ended March 31, 2013 were \$227.1 million compared to \$233.1 million for the three months ended March 31, 2012, a decrease of \$6.0 million. This decrease was primarily due to a decline in policies in force of 3.4%, primarily from exposure management actions and actions to improve underwriting results,

- 35 -

---

**Table of Contents**

partially offset by rate increases. Net premiums written in the homeowners line of business for the three months ended March 31, 2013 were \$105.4 million compared to \$105.0 million for the three months ended March 31, 2012, an increase of \$0.4 million. This increase was primarily from rate increases, partially offset by a 4.4% decline in policies in force from the aforementioned exposure management actions.

Personal Lines underwriting profit for the three months ended March 31, 2013 was \$10.1 million, compared to \$4.2 million for the three months ended March 31, 2012, an improvement of \$5.9 million. This was primarily due to decreased catastrophe losses and from earned premium growth. These items were partially offset by increased non-catastrophe weather-related losses and unfavorable development on prior years' loss reserves. Catastrophe losses for the three months ended March 31, 2013 were \$11.7 million, compared to \$23.0 million for the three months ended March 31, 2012, a decrease of \$11.3 million. Unfavorable development on prior years' loss reserves for the three months ended March 31, 2013 was \$5.6 million, compared to \$3.8 million for the three months ended March 31, 2012, a change of \$1.8 million.

Personal Lines current accident year underwriting profit, excluding catastrophes, was \$27.4 million in the three months ended March 31, 2013, compared to \$31.0 million for the three months ended March 31, 2012. This \$3.6 million decrease in non-catastrophe current accident year results was primarily due to higher non-catastrophe weather-related losses in our homeowners and personal automobile lines, partially offset by earned premium growth.

Although we have been able to obtain rate increases in our Personal Lines markets and believe that our ability to obtain these increases will continue, our ability to maintain Personal Lines net written premium and to maintain and improve underwriting results may be affected by price competition, recent weather-related losses, our exposure management actions, recent loss trends in bodily injury and personal injury protection claims, and regulatory and legal developments. In several recent years, weather-related catastrophe and non-catastrophe losses have been in excess of longer term averages. We monitor these trends and consider them in our rate actions. Our rate and exposure management actions could adversely affect our ability to increase our policies in force and new business. There is no assurance that we will be able to maintain our current level of production or maintain or increase rates.

**Chaucer**

Chaucer's net premiums written was \$251.5 million in the three months ended March 31, 2013, compared to \$200.2 million in the three months ended March 31, 2012, an increase of \$51.3 million, or 25.6%. Approximately \$33 million of this growth was due to an increase in Chaucer's economic interests in Syndicate 1084 to 98% for 2013, up from 84% in 2012, primarily due to our non-renewal of the capital provision reinsurance treaty with Flagstone Re. Additionally, changes to our 2013 ceded reinsurance program, including increased net retentions for certain major lines, contributed to the growth in net written premium. See Reinsurance in Item I Business of our December 31, 2012 Form 10-K for additional information. Net written premium increases also includes growth in our U.K. motor line, primarily as a result of an increase in policies in force.

Chaucer's underwriting profit for the three months ended March 31, 2013 was \$33.0 million, compared to \$14.7 million for the three months ended March 31, 2012, an improvement of \$18.3 million. These improved results were primarily due to lower loss activity in most lines and an absence of significant man-made and natural catastrophe losses.

Due to continued high levels of capacity across the international insurance industry, we expect few rate increases in 2013. Opportunities for rate increases will likely be limited to those marine and property markets most affected by recent high levels of insured market losses. Current pricing conditions for energy are weakening, while aviation and casualty markets continue to be affected by the challenging economic environment and over-capacity. U.K. motor rates decreased modestly in 2012 and this decline has continued in 2013, as expected, following significant increases in 2010 and 2011. There can be no assurance that we will be able to maintain or increase our rates in light of economic and regulatory conditions in our markets.

**Other**

Other operating loss before interest expense and income taxes was \$2.2 million for the three months ended March 31, 2013, compared to a \$1.2 million loss for the three months ended March 31, 2012. The \$1.0 million increased loss is primarily due to lower net investment income in our holding company, and increased losses in our voluntary pools business.



**Table of Contents****Reserve for Losses and Loss Adjustment Expenses**

The following table provides a reconciliation of the gross beginning and ending reserve for unpaid losses and loss adjustment expenses.

<i>(in millions)</i>	Three Months Ended March 31,	
	2013	2012
Gross loss and LAE reserves, beginning of period	\$ 6,197.0	\$ 5,760.3
Reinsurance recoverable on unpaid losses	2,074.3	1,931.8
Net loss and LAE reserves, beginning of period	4,122.7	3,828.5
Net incurred losses and LAE in respect of losses occurring in:		
Current year	690.3	678.6
Prior years	(6.9)	(17.2)
Total incurred losses and LAE	683.4	661.4
Net payments of losses and LAE in respect of losses occurring in:		
Current year	165.7	161.9
Prior years	517.0	509.3
Total payments	682.7	671.2
Effect of foreign exchange rate changes	(47.0)	19.4
Net reserve for losses and LAE, end of period	4,076.4	3,838.1
Reinsurance recoverable on unpaid losses	2,016.1	1,989.2
Gross reserve for losses and LAE, end of period	\$ 6,092.5	\$ 5,827.3

The table below summarizes the gross reserve for losses and LAE by line of business.

<i>(in millions)</i>	March 31, 2013	December 31, 2012
Commercial multiple peril	\$ 618.9	\$ 629.7
Workers compensation	574.6	571.8
Commercial automobile	273.8	269.7
AIX	328.7	321.6
Other commercial	428.9	454.2
Total Commercial	2,224.9	2,247.0
Personal automobile	1,398.2	1,400.7
Homeowners and other	146.8	141.3
Total Personal	1,545.0	1,542.0
Total Chaucer	2,322.6	2,408.0
Total loss and LAE reserves	\$ 6,092.5	\$ 6,197.0

Other commercial lines are primarily comprised of our monoline general liability, umbrella, marine, professional liability, and healthcare lines. Included in the above table, in the Chaucer segment, are \$255.0 million and \$272.4 million of reserves related to Chaucer's liabilities in Syndicate 4000, consisting of financial and professional liability lines written in 2008 and prior, as of March 31, 2013 and December 31, 2012, respectively. Also included in the above table, primarily in other commercial lines, are \$60.7 million and \$60.5 million of asbestos and environmental reserves as of March 31, 2013 and December 31, 2012, respectively.

**Table of Contents**

*Prior Year Development*

Loss and LAE reserves for claims occurring in prior years developed favorably by \$6.9 million for the three months ended March 31, 2013 compared to favorable development of \$17.2 million for the three months ended March 31, 2012.

The primary drivers for reserve development during the three months ended March 31, 2013 were as follows:

Lower than expected losses in Chaucer's property line, primarily in the 2011 and 2012 accident years.

Higher than expected losses within our personal automobile line, primarily related to bodily injury severity in the 2011 and 2012 accident years and physical damage in the 2012 accident year.

Higher than expected losses within our other commercial lines, primarily related to the 2012 accident year.

Higher than expected large losses within our commercial automobile line, primarily related to liability coverage in the 2011 accident year.

Partially offsetting the unfavorable development within Commercial Lines was lower than expected losses within our workers compensation line related to the 2008 through 2012 accident years.

The primary drivers for reserve development during the three months ended March 31, 2012 were as follows:

Lower than expected losses in Chaucer's lines of business as follows:

marine and aviation lines, primarily in the 2007 and 2008 accident years,

energy line, primarily in the 2009 and 2010 accident years, and

property line, primarily in the 2011 accident year.

Higher than expected losses within our personal automobile line, primarily related to liability coverage in the 2011 accident year.

Within other commercial lines, higher than expected losses in our surety line was partially offset by lower than expected losses in our marine lines.

Higher than expected losses within our commercial automobile line, primarily related to liability coverage in the 2011 accident year.

## Edgar Filing: HANOVER INSURANCE GROUP, INC. - Form 10-Q

Partially offsetting the unfavorable development within Commercial Lines was lower than expected losses within our commercial multiple peril line related to the 2008 through 2011 accident years.

It is not possible to know whether the factors that affected loss reserves in the first three months of 2013 will also occur in future periods. As discussed in detail in our Form 10-K for the year ended December 31, 2012, there are inherent uncertainties in estimating reserves for losses and loss adjustment expenses. We encourage you to read our Form 10-K for more information about our reserving process and the judgments, uncertainties and risks associated therewith.

### **Investments**

#### ***Investment Results***

Net investment income before taxes decreased \$1.5 million, or 2.2%, to \$67.3 million for the three months ended March 31, 2013, primarily due to the impact of lower new money yields. This decline was partially offset by higher income resulting from our investments in various higher yielding investment grade mortgage-backed securities and the investment of cash balances into fixed maturities beginning in the second quarter of 2012. Average pre-tax earned yields on fixed maturities were 4.03% and 4.38% for the three months ended March 31, 2013 and 2012, respectively. We expect average investment yields to continue to decline as new money rates remain at near-historic lows.

**Table of Contents****Investment Portfolio**

We held cash and investment assets diversified across several asset classes, as follows:

<i>(dollars in millions)</i>	March 31, 2013		December 31, 2012	
	Carrying Value	% of Total Carrying Value	Carrying Value	% of Total Carrying Value
Fixed maturities, at fair value	\$ 6,723.5	83.4%	\$ 6,952.2	86.5%
Equity securities, at fair value	435.0	5.4	315.8	3.9
Cash and cash equivalents	691.0	8.6	564.8	7.0
Other investments	207.5	2.6	210.3	2.6
<b>Total cash and investments</b>	<b>\$ 8,057.0</b>	<b>100.0%</b>	<b>\$ 8,043.1</b>	<b>100.0%</b>

**Cash and Investments**

Total cash and investments increased \$13.9 million, or 0.2%, for the three months ended March 31, 2013, of which cash and cash equivalents increased \$126.2 million, equities increased \$119.2 million and fixed maturities decreased \$228.7 million. The increase in cash and cash equivalents was primarily attributable to net proceeds of approximately \$170 million from the issuance of subordinated debentures, partially offset by the repayment of \$46.3 million in FHLBB advances. Equity securities increased due to purchases of dividend yielding stocks. The decrease in fixed maturities was primarily due to dispositions to fund operational cash flows, as well as a decline in value of the U.K. Pound sterling during the quarter, affecting the value of our investments denominated in that currency.

Our fixed maturity portfolio is comprised of corporate securities, taxable and tax-exempt municipal securities, residential mortgage-backed securities, commercial mortgage-backed securities, U.S. government securities, foreign government securities and asset-backed securities. Equity securities primarily consist of common stocks, exchange traded funds, non-redeemable preferred stocks and mutual funds.

The following table provides information about the investment types of our fixed maturities portfolio:

<i>(in millions)</i>	March 31, 2013			Change in Net Unrealized During 2013
	Amortized Cost	Fair Value	Net Unrealized Gain (Loss)	
<b>Investment Type</b>	<b>Cost</b>	<b>Fair Value</b>	<b>Gain (Loss)</b>	
U.S. Treasury and government agencies	\$ 314.0	\$ 321.5	\$ 7.5	\$ (0.9)
Foreign government	299.7	305.6	5.9	1.5
Municipals:				
Taxable	841.8	922.7	80.9	1.8
Tax exempt	146.4	153.4	7.0	
Corporate	3,443.3	3,698.8	255.5	(5.1)
Asset-backed:				
Residential mortgage-backed	720.3	754.3	34.0	(2.2)
Commercial mortgage-backed	340.6	358.8	18.2	(4.7)
Asset-backed	204.5	208.4	3.9	(0.2)
<b>Total fixed maturities</b>	<b>\$ 6,310.6</b>	<b>\$ 6,723.5</b>	<b>\$ 412.9</b>	<b>\$ (9.8)</b>

Net unrealized gains on fixed maturities decreased \$9.8 million to \$412.9 million at March 31, 2013, compared to \$422.7 million at December 31, 2012.



**Table of Contents**

Amortized cost and fair value by rating category were as follows:

<i>(dollars in millions)</i> NAIC Designation	Rating Agency Equivalent Designation	March 31, 2013			December 31, 2012		
		Amortized Cost	Fair Value	% of Total Fair Value	Amortized Cost	Fair Value	% of Total Fair Value
1	Aaa/Aa/A	\$ 4,613.0	\$ 4,886.3	72.7%	\$ 4,744.0	\$ 5,017.9	72.2%
2	Baa	1,350.8	1,466.0	21.8	1,443.5	1,569.3	22.6
3	Ba	147.0	159.0	2.3	143.1	156.2	2.2
4	B	138.3	147.5	2.2	135.1	143.5	2.1
5	Caa and lower	50.9	52.7	0.8	50.1	50.7	0.7
6	In or near default	10.6	12.0	0.2	13.7	14.6	0.2
<b>Total fixed maturities</b>		<b>\$ 6,310.6</b>	<b>\$ 6,723.5</b>	<b>100.0%</b>	<b>\$ 6,529.5</b>	<b>\$ 6,952.2</b>	<b>100.0%</b>

Based on ratings by the National Association of Insurance Commissioners ( NAIC ), approximately 95% of the fixed maturity portfolio consisted of investment grade securities at March 31, 2013 and at December 31, 2012. The quality of our fixed maturity portfolio remains strong based on ratings, capital structure position, support through guarantees, underlying security, issuer diversification and yield curve position.

Our fixed maturity and equity securities are classified as available-for-sale and are carried at fair value. Financial instruments whose value was determined using significant management judgment or estimation constituted less than 2% of the total assets we measured at fair value. (See also Note 5 Fair Value in the Notes to Interim Consolidated Financial Statements).

Other investments consisted primarily of overseas deposits, which are U.S. dollar and foreign denominated investments maintained in overseas funds and managed exclusively by Lloyd s. These funds are required in order to protect policyholders in overseas markets and enable our Chaucer segment to operate in those markets. Access to those funds is restricted and we have no control over the investment strategy. Also included in other investments were investments in limited partnerships, which were accounted for under the equity method of accounting or at cost.

Although we expect to invest new funds primarily in investment grade fixed maturities, we have invested, and expect to continue to invest, a portion of funds in common equity securities and below investment grade fixed maturities and other assets.

**Table of Contents****European sovereign and non-sovereign debt exposure**

Our European fixed maturity credit exposure at March 31, 2013 was as follows:

<i>(in millions)</i>	Sovereign		Foreign Agency		Non-Sovereign Financial		Non-Financial		Total	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value	Amortized Cost	Fair Value	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Country:										
United Kingdom	\$ 51.1	\$ 51.4	\$ 29.8	\$ 30.4	\$ 301.3	\$ 309.1	\$ 225.5	\$ 239.6	\$ 607.7	\$ 630.5
Germany			61.9	63.1			72.6	77.7	134.5	140.8
Switzerland					18.4	19.2	71.1	77.4	89.5	96.6
The Netherlands			22.1	22.5	31.8	33.0	23.0	24.8	76.9	80.3
France			4.8	5.0	11.5	11.2	55.5	59.9	71.8	76.1
Supranationals			72.3	75.0					72.3	75.0
Sweden					26.5	27.7	12.7	13.2	39.2	40.9
Spain					8.9	9.2	17.6	18.8	26.5	28.0
Ireland							15.5	17.0	15.5	17.0
Italy							16.2	16.6	16.2	16.6
Belgium							15.5	16.2	15.5	16.2
Norway			3.2	3.3	2.5	2.6	5.4	5.5	11.1	11.4
Luxembourg							7.6	7.9	7.6	7.9
Jersey							5.1	5.2	5.1	5.2
Portugal							4.2	4.5	4.2	4.5
Denmark							2.0	2.1	2.0	2.1
<b>Total fixed maturities</b>	<b>\$ 51.1</b>	<b>\$ 51.4</b>	<b>\$ 194.1</b>	<b>\$ 199.3</b>	<b>\$ 400.9</b>	<b>\$ 412.0</b>	<b>\$ 549.5</b>	<b>\$ 586.4</b>	<b>\$ 1,195.6</b>	<b>\$ 1,249.1</b>

Our sovereign debt totaled \$51.4 million, or 0.6% of investment assets, and was limited to the highly rated country of the U.K. We had no sovereign debt of lower rated countries such as Greece, Ireland, Italy, Portugal and Spain. In addition, our supranational and foreign agency exposure totaled \$199.3 million, or 2.5% of investment assets, and primarily consisted of debt securities from the highly rated countries of Germany, U.K., and the Netherlands. Exposure to European banks, excluding those that are based in the U.K., totaled \$102.9 million, or 1.3% of investment assets. Also, we held money market funds totaling \$156.2 million, or 1.9% of investment assets, which were comprised of a well-diversified portfolio of short-term debt securities of predominately large financial institutions domiciled in highly rated countries. The remainder of our European non-sovereign debt exposure, excluding the U.K., was \$346.8 million, which represented 4.3% of investment assets. Generally, these securities were high quality, large capitalization multi-national companies that were well diversified by sector, country and issuer. Included in our non-financial, non-sovereign exposure were issuers domiciled in Spain, Ireland, Italy and Portugal totaling \$56.9 million, or 0.7% of investment assets. These consisted of large market capitalization issuers that provide essential products and/or services.

The previous table represents all European countries in which we had exposure. We determined country exposures based on the country of domicile for the ultimate parent company of the various issuers we held as of March 31, 2013; however, in light of the economic and financial inter-relatedness and dependencies that exist among European countries and related financial systems, economic turmoil in one country could trigger a contagion effect on other countries. We believe the quality of our European credit exposure remains sound based on ratings and issuer strength, position in the capital structure, support through guarantees and partial government ownership by highly rated countries, diversity and quality of non-financial issuers and blend of industry exposures, and yield curve position. We believe that we do not have meaningful indirect exposures in our portfolio and we do not invest in credit derivatives.

We manage our country exposure using fundamental analysis coupled with relative value considerations. Investment decisions are based on the combination of a top-down macroeconomic perspective and bottom-up credit security analysis. We monitor political and economic developments; progress toward attainment of growth and budget targets; developments related to policy, reform and regulatory initiatives from European officials; progress toward funding objectives, including the availability and cost of funding; outlook for credit ratings; ability of banks to meet increased regulatory capital standards, operate in a weakened macroeconomic environment, and maintain adequate liquidity and sufficient access to capital to meet funding requirements; and contagion throughout the financial system as evidenced by increased costs for interbank funding, lower prices for stocks and corporate bonds, as well as the availability of capital.





**Table of Contents**

We actively manage our credit exposure and seek securities with the best combination of credit strength and valuation. As we invest new capital, we consider expectations for the strength and duration of economic recovery, risks associated with the European debt crisis and the possibility of additional volatility based on these challenges. Accordingly, we focus on providers of essential services or products best positioned to navigate the period of weak growth; industrials with greater international exposure, either locally or via exports, particularly to the developing world, which we view more favorably based on higher growth assumptions for emerging market economies; and financial institutions best positioned regarding asset quality, liquidity and capital adequacy.

Overall economic growth remains weak throughout Europe. Volatility, while currently suppressed, could increase suddenly as officials in Europe attempt to engineer a lasting solution to the debt crisis or find a way to address the twin objectives of stimulating economic growth while balancing fiscal budgets. We believe that leaders remain committed to protecting the currency union and improving financial stability. Although the timing and degree of success toward achieving sustained improvement regarding the European crisis remains highly uncertain, we do not anticipate that future developments related to our European sovereign and non-sovereign debt exposure will have a material effect on our financial condition, results of operations or liquidity.

**Other-than-Temporary Impairments**

For the three months ended March 31, 2013, we recognized in earnings \$0.5 million of other-than-temporary impairments ( OTTI ) on fixed maturities, primarily related to estimated credit losses on residential mortgage-backed securities. For the three months ended March 31, 2012, we recognized in earnings \$1.9 million of OTTI on fixed maturities, of which \$1.5 million related to below investment grade corporate bonds that we classified as intend to sell and \$0.4 million related to estimated credit losses on residential mortgage-backed and corporate securities.

**Unrealized Losses**

The following table provides information about our fixed maturities and equity securities that were in an unrealized loss position. (See also Note 5 Investments in the Notes to Interim Consolidated Financial Statements.)

<i>(in millions)</i>	March 31, 2013		December 31, 2012	
	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value
Fixed maturities:				
Investment grade:				
12 months or less	\$ 4.6	\$ 511.9	\$ 3.4	\$ 546.0
Greater than 12 months	9.8	72.2	9.5	106.5
<b>Total investment grade fixed maturities</b>	<b>14.4</b>	<b>584.1</b>	12.9	652.5
Below investment grade:				
12 months or less	1.0	30.8	1.2	28.2
Greater than 12 months	3.9	41.1	5.9	55.1
<b>Total below investment grade fixed maturities</b>	<b>4.9</b>	<b>71.9</b>	7.1	83.3
Equity securities:				
12 months or less	1.4	15.4	4.8	74.4
Greater than 12 months	0.8	7.9		
<b>Total equity securities</b>	<b>2.2</b>	<b>23.3</b>	4.8	74.4
<b>Total</b>	<b>\$ 21.5</b>	<b>\$ 679.3</b>	\$ 24.8	\$ 810.2

## Edgar Filing: HANOVER INSURANCE GROUP, INC. - Form 10-Q

Gross unrealized losses decreased \$3.3 million, or 13.3%, which was primarily attributable to stronger equity markets during the quarter. At March 31, 2013, gross unrealized losses consisted primarily of \$13.3 million of corporate fixed maturities, \$3.9 million of mortgage-backed securities, \$2.2 million of equity securities and \$1.4 million in municipal securities.

We view the gross unrealized losses on fixed maturities and equity securities as being temporary since it is our assessment that these securities will recover in the near term, allowing us to realize their anticipated long-term economic value. With respect to gross

- 42 -

**Table of Contents**

unrealized losses on fixed maturities, we do not intend to sell, nor is it more likely than not we will be required to sell, such debt securities before this expected recovery of amortized cost (See also *Liquidity and Capital Resources* ). With respect to equity securities, we have the intent and ability to retain such investments for the period of time anticipated to allow for this expected recovery in fair value. The risks inherent in our assessment methodology include the risk that, subsequent to the balance sheet date, market factors may differ from our expectations; the global economic recovery is less robust than we expect or reverts to recessionary trends; we may decide to subsequently sell a security for unforeseen business needs; or changes in the credit assessment or equity characteristics from our original assessment may lead us to determine that a sale at the current value would maximize recovery on such investments. To the extent that there are such adverse changes, an OTTI would be recognized as a realized loss. Although unrealized losses are not reflected in the results of financial operations until they are realized or deemed other-than-temporary, the fair value of the underlying investment, which does reflect the unrealized loss, is reflected in our Consolidated Balance Sheets.

The following table sets forth gross unrealized losses for fixed maturities by maturity period and for equity securities at March 31, 2013 and December 31, 2012. Actual maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations, with or without call or prepayment penalties, or we may have the right to put or sell the obligations back to the issuers.

<i>(in millions)</i>	<b>March 31, 2013</b>	<b>December 31, 2012</b>
Due in one year or less	\$	\$ 0.5
Due after one year through five years	<b>3.0</b>	4.7
Due after five years through ten years	<b>3.4</b>	2.5
Due after ten years	<b>9.0</b>	8.8
	<b>15.4</b>	16.5
Mortgage-backed and asset-backed securities	<b>3.9</b>	3.5
<b>Total fixed maturities</b>	<b>19.3</b>	20.0
Equity securities	<b>2.2</b>	4.8
<b>Total fixed maturities and equity securities</b>	<b>\$ 21.5</b>	<b>\$ 24.8</b>

The carrying values of defaulted fixed maturity securities on non-accrual status at March 31, 2013 and December 31, 2012 were not material. The effects of non-accruals compared with amounts that would have been recognized in accordance with the original terms of the fixed maturities, were reductions in net investment income of \$0.6 million for the three months ended March 31, 2013 and 2012. Any defaults in the fixed maturities portfolio in future periods may negatively affect investment income.

Our investment portfolio and shareholders' equity can be significantly impacted by changes in market values of our securities. As the U.S. and global financial markets and economies have not fully stabilized, market volatility could increase and defaults on fixed income securities could occur. As a result, we could incur additional realized and unrealized losses in future periods, which could have a material adverse impact on our results of operations and/or financial position.

Monetary policies in the developed economies, particularly in the United States, Europe and Japan, are supportive of moderate economic growth, while fiscal policies are more divergent and subject to change. The removal or modification of these policies could have an adverse effect on issuers' level of business activity or liquidity, increasing the probability of future defaults. While we may experience defaults on fixed income securities, particularly with respect to non-investment grade securities, it is difficult to foresee which issuers, industries or markets will be affected. As a result, the value of our fixed maturity portfolio could change rapidly in ways we cannot currently anticipate and we could incur additional realized and unrealized losses in future periods.

**Table of Contents****Other Items**

Net income also included the following items:

<i>(in millions)</i>	Three Months Ended March 31,					Total
	Commercial Lines	Personal Lines	Chaucer	Other	Discontinued Operations	
<b>2013</b>						
Net realized investment gains (losses)	\$ 5.4	\$ 2.8	\$ (0.1)	\$	\$	\$ 8.1
Net loss from repayment of advances	(5.2)	(2.6)				(7.8)
Net costs related to acquired businesses				0.4		0.4
Net foreign exchange gains				0.7		0.7
Discontinued operations, net of taxes					(0.2)	(0.2)
<b>2012</b>						
Net realized investment gains	\$ 1.7	\$ 1.2	\$ 0.1	\$ 0.1	\$	\$ 3.1
Net costs related to acquired businesses				(1.5)		(1.5)
Net foreign exchange losses				(0.3)		(0.3)
Discontinued operations, net of taxes					(1.0)	(1.0)

We manage investment assets for our Commercial Lines, Personal Lines, and Other segments based on the requirements of our U.S. combined property and casualty companies. We allocate the investment income, expenses and realized gains and losses to our Commercial Lines, Personal Lines and Other segments based on actuarial information related to the underlying businesses. We manage investment assets separately for our Chaucer segment.

Net realized gains on investments were \$8.1 million and \$3.1 million for the three months ended March 31, 2013 and 2012, respectively. Net realized gains in 2013 were primarily due to \$8.7 million of gains recognized from the sale of equities and fixed maturities, partially offset by \$0.5 million of other-than-temporary impairments. Net realized gains in 2012 were primarily due to \$4.1 million of net gains recognized from the sale of fixed maturities and equity securities and to gains on foreign currency hedges, partially offset by \$1.9 million of other-than-temporary impairments from fixed maturities.

In January 2013, we repaid \$46.3 million of our FHLBB advances plus prepayment fees of \$7.8 million for a total payment of \$54.1 million.

**Income Taxes**

We are subject to the tax laws and regulations of the U.S. and foreign countries in which we operate. We file a consolidated U.S. federal income tax return that includes the holding company and its U.S. subsidiaries. Generally, taxes are accrued at the U.S. statutory tax rate of 35% for income from the U.S. operations. Our primary non-U.S. jurisdiction is the U.K. In July 2012, the U.K. statutory rate decreased from 26% to 24% effective April 1, 2012 and from 24% to 23% effective April 1, 2013. We accrue taxes on certain non-U.S. income that is subject to U.S. tax as a result of being owned by a U.S. shareholder at the U.S. tax rate. Foreign tax credits, where available, are utilized to offset U.S. tax as permitted. Certain of our non-U.S. income is not subject to U.S. tax until repatriated. Foreign taxes on this non-U.S. income are accrued at the local foreign rate and do not have an accrual for U.S. deferred taxes since these earnings are intended to be permanently reinvested overseas.

The provision for income taxes from continuing operations was an expense of \$22.5 million in the three months ended March 31, 2013, compared to an expense of \$20.1 million during the same period in 2012. These provisions resulted in consolidated effective federal tax rates of 25.3% and 28.4% for the three months ended March 31, 2013 and 2012, respectively. These provisions reflect benefits related to tax planning strategies implemented in prior years of \$5.4 million and \$3.0 million during the three months ended March 31, 2013 and 2012, respectively. In addition, the provision for the three months ended March 31, 2012 reflects a decrease in our valuation allowance related to capital loss carryforwards of \$1.1 million. Absent these benefits, the provision for income taxes would have been \$27.9 million or 31.4% and \$24.2 million or 34.2% for the three months ended March 31, 2013 and 2012, respectively. The decrease in the effective tax rate is primarily due to higher non-U.S. income, which is taxed at the lower U.K. rate.

The income tax provision on operating income was an expense of \$27.6 million during the three months ended March 31, 2013, compared to \$23.5 million during the same period in 2012. These provisions resulted in effective tax rates for operating income of 31.5% and 33.8% in 2013 and 2012, respectively. The decrease in the effective tax rate is primarily due to higher non-U.S. income, which is taxed at the lower U.K. rate.



**Table of Contents****Critical Accounting Estimates**

Interim consolidated financial statements have been prepared in conformity with U.S. GAAP and include certain accounting policies that we consider to be critical due to the amount of judgment and uncertainty inherent in the application of those policies. While we believe that the amounts included in our consolidated financial statements reflect our best judgment, the use of different assumptions could produce materially different accounting estimates. As disclosed in our 2012 Annual Report on Form 10-K, we believe the following accounting estimates are critical to our operations and require the most subjective and complex judgment:

Reserve for losses and loss expenses

Reinsurance recoverable balances

Pension benefit obligations

Other-than-temporary impairments ( OTTI )

Deferred tax assets

For a more detailed discussion of these critical accounting estimates, see our Annual Report on Form 10-K for the year ended December 31, 2012.

**Statutory Surplus of U.S. Insurance Subsidiaries**

The following table reflects statutory surplus for our U.S. insurance subsidiaries:

<i>(in millions)</i>	March 31, 2013	December 31, 2012
Total Statutory Capital and Surplus U.S. Insurance Subsidiaries	\$ 1,623.3	\$ 1,523.4

The statutory capital and surplus for our U.S. insurance subsidiaries increased \$99.9 million during the first three months of 2013, primarily due to underwriting results and an increase in net unrealized gains from certain investment securities.

The NAIC prescribes an annual calculation regarding risk based capital ( RBC ). RBC ratios for regulatory purposes are expressed as a percentage of the capital required to be above the Authorized Control Level (the Regulatory Scale ); however, in the insurance industry, RBC ratios are widely expressed as a percentage of the Company Action Level. The following table reflects the Company Action Level, the Authorized Control Level and RBC ratios for Hanover Insurance (which includes Citizens and other U.S. insurance subsidiaries), as of March 31, 2013, expressed both on the Industry Scale (Total Adjusted Capital divided by the Company Action Level) and Regulatory Scale (Total Adjusted Capital divided by Authorized Control Level):

<i>(dollars in millions)</i>	Company Action Level	Authorized Control Level	RBC Ratio Industry Scale	RBC Ratio Regulatory Scale
The Hanover Insurance Company	\$ 663.6	\$ 331.8	243%	486%

**Lloyd's Capital Requirement**

## Edgar Filing: HANOVER INSURANCE GROUP, INC. - Form 10-Q

Chaucer corporate members operate in the Lloyd's market, which requires that these members deposit funds, referred to as Funds at Lloyd's, to support their underwriting interests. Lloyd's sets required capital annually for all participating syndicates based on each syndicate's business plans, the rating and reserving environment, and discussions with regulatory and rating agencies. Although the minimum capital levels are set by Lloyd's, it is the responsibility of Chaucer to continually monitor the risk profiles of its managed syndicates to ensure that the level of funding remains appropriate. Such capital is comprised of cash and cash equivalents, investments, undrawn letters of credit provided by various banks and other assets. At March 31, 2013, we are in compliance with the capital requirements. We have the following securities, assets and letters of credit pledged to Lloyd's to satisfy these capital requirements at March 31, 2013. In 2012, we decided not to renew the capital provision reinsurance treaty for the 2013 underwriting year with Flagstone Re. In accordance with the terms of the capital provision reinsurance treaty, Flagstone Re is obligated to provide funds at Lloyd's in relation to its participation during the 2009 through 2012 underwriting years, until such time that these years close. We expect to be able to meet these capital requirements in the future.

- 45 -



**Table of Contents***(in millions)*

Letters of credit	<b>\$ 180.0</b>
Reinsurance treaty	<b>94.9</b>
Fixed maturities, at fair value	<b>468.1</b>
Cash and cash equivalents	<b>2.6</b>
<b>Total securities, assets and letters of credit pledged to Lloyd's</b>	<b>\$ 745.6</b>

**Liquidity and Capital Resources**

Liquidity is a measure of our ability to generate sufficient cash flows to meet the cash requirements of business operations. As a holding company, our primary ongoing source of cash is dividends from our insurance subsidiaries. However, dividend payments to us by our U.S. insurance subsidiaries are subject to limitations imposed by regulators, such as prior notice periods and the requirement that dividends in excess of a specified percentage of statutory surplus or prior year's statutory earnings receive prior approval (so called "extraordinary dividends").

Dividend payments to the holding company by our Chaucer business are regulated by U.K. law. Dividends from Chaucer are dependent on dividends from its subsidiaries. Annual dividend payments from Chaucer are limited to retained earnings that are not restricted by capital and other requirements for business at Lloyd's. Also, Chaucer must provide advance notice to the U.K.'s Prudential Regulation Authority ("PRA"), one of the successors to the Financial Services Authority, of certain proposed dividends or other payments from PRA regulated entities. In connection with an intercompany borrowing arrangement with the holding company, interest on a \$300 million note is paid by Chaucer on a quarterly basis to the holding company. This interest may be deferred at the election of the holding company. If deferred, the interest is added to the principal. For the three months ended March 31, 2013, Chaucer paid \$5.6 million of interest to the holding company.

At March 31, 2013, THG, as a holding company, held approximately \$293.9 million of fixed maturities and cash. We believe our holding company assets are sufficient to meet our future obligations, which consists primarily of dividends to our shareholders (as and to the extent declared), the interest on our senior and subordinated debentures, additional funds relating to the purchase of Chaucer, certain costs associated with benefits due to our former life employees and agents, and to the extent required, payments related to indemnification of liabilities associated with the sale of various subsidiaries. We do not expect that it will be necessary to dividend additional funds from our insurance subsidiaries in order to fund 2013 holding company obligations; however, we may decide to do so.

Sources of cash for our insurance subsidiaries primarily consist of premiums collected, investment income and maturing investments. Primary cash outflows are paid claims, losses and loss adjustment expenses, policy and contract acquisition expenses, other underwriting expenses and investment purchases. Cash outflows related to losses and loss adjustment expenses can be variable because of uncertainties surrounding settlement dates for liabilities for unpaid losses and because of the potential for large losses either individually or in the aggregate. We periodically adjust our investment policy to respond to changes in short-term and long-term cash requirements.

Net cash used in operating activities was \$17.5 million during the first three months of 2013, as compared to net cash provided by operating activities of \$12.7 million during the first three months of 2012.

Net cash provided by investing activities was \$83.5 million during the first three months of 2013, as compared to net cash used in investing activities of \$211.1 million during the first three months of 2012. During 2013, cash provided was primarily related to net disposals of fixed maturities, partially offset by purchases of equity securities. In 2012, cash used was primarily related to net purchases of fixed maturities as we invested cash from Chaucer and net investments in equity securities.

Net cash provided by financing activities was \$66.9 million during the first three months of 2013, as compared to net cash used in financing activities of \$13.8 million during the first three months of 2012. During 2013, cash provided by financing activities primarily resulted from the issuance, on March 20, 2013, of \$175.0 million of unsecured subordinated debentures. Cash received from the issuance of debt was partially offset by the repayment of advances, repurchases of common stock and the payment of dividends to shareholders. During 2012, cash used in financing primarily resulted from the payment of dividends to shareholders and decreases in collateral held for the securities lending program, partially offset by the proceeds from the FHLBB debt borrowings.

Dividends to common shareholders are subject to quarterly board approval and declaration. During the first three months of 2013, as declared by the Board, we paid a quarterly dividend of \$0.33 per share to our shareholders totaling \$14.8 million. We believe that our holding company assets are sufficient to provide for future shareholder dividends should the Board of Directors declare them.



**Table of Contents**

We expect to continue to generate sufficient positive operating cash to meet all short-term and long-term cash requirements relating to current operations, including the funding of our qualified defined benefit pension plan and the Chaucer pension plan. Based upon the current estimate of liabilities and certain assumptions regarding investment returns and other factors, our qualified defined benefit pension plan and Chaucer pension plan are underfunded by approximately \$15 million and \$25 million, respectively, as of March 31, 2013. The ultimate payment amounts for both the defined benefit plan and the Chaucer pension plan are based on several assumptions, including but not limited to, the rate of return on plan assets, the discount rate for benefit obligations, mortality experience, interest crediting rates and the ultimate valuation and determination of benefit obligations. Since differences between actual plan experience and our assumptions are almost certain, changes both positive and negative to our funded status and ultimately our obligations in future periods are likely.

Our insurance subsidiaries maintain a high degree of liquidity within their respective investment portfolios in fixed maturity and short-term investments. We believe that the quality of the assets we hold will allow us to realize the long-term economic value of our portfolio, including securities that are currently in an unrealized loss position. We do not anticipate the need to sell these securities to meet our insurance subsidiaries cash requirements since we expect our insurance subsidiaries to generate sufficient operating cash to meet all short-term and long-term cash requirements. However, there can be no assurance that unforeseen business needs or other items will not occur causing us to have to sell those securities in a loss position before their values fully recover, thereby causing us to recognize impairment charges in that time period.

Since October 2007 and through March 2013, our Board of Directors has authorized aggregate repurchases of our common stock of up to \$500 million. Repurchases may be executed using open market purchases, privately negotiated transactions, accelerated repurchase programs or other transactions. We are not required to purchase any specific number of shares or to make purchases by any certain date under this program. During the first three months of 2013, we repurchased 0.5 million shares of our common stock through a privately negotiated transaction and open market purchases at a cost of \$25.2 million. Total repurchases under this program as of March 31, 2013 were 9.6 million shares at a cost of \$410.0 million. During April 2013, we repurchased an additional 0.4 million shares of our common stock through open market purchases at a cost of \$18.5 million. Additionally, from time to time, we may also repurchase our debt.

In January 2013, we repaid \$46.3 million of our FHLBB advances plus prepayment fees of \$7.8 million for a total payment of \$54.1 million. Additional information related to these borrowings is provided in Note 4 Debt in the Notes to Interim Consolidated Financial Statements.

On March 20, 2013, the Company issued \$175 million aggregate principal amount of subordinated unsecured debentures due March 30, 2053. These debentures pay interest quarterly. We may redeem these debentures in whole at any time, or in part from time to time, on or after March 30, 2018, at a redemption price equal to their principal amount plus accrued and unpaid interest. If the debentures are not redeemed in whole, at least \$25.0 million aggregate principal amount of the debentures must remain outstanding. In addition, in certain circumstances, we may redeem the debentures in whole, but not in part, prior to March 30, 2018.

We have a \$200.0 million committed syndicated credit agreement which expires in August 2015, with an option to increase the facility to \$250.0 million assuming no default and satisfaction of certain other conditions. The agreement also includes a \$50 million sub-facility for standby letters of credit that can be used for general corporate purposes. Borrowings, if any, under this agreement are unsecured and incur interest at a rate per annum equal to, at our option, a designated base rate or the three month LIBOR plus applicable margin. The agreement provides covenants, including but not limited to, maintaining at least a certain level of consolidated equity, maximum consolidated leverage ratios, and an RBC ratio at our primary U.S. domiciled property and casualty companies. We had no borrowings under this agreement in 2012 and 2013.

We have a Standby Letter of Credit Facility Agreement (the Facility Agreement) not to exceed \$180.0 million outstanding at any one time, with the option to increase the amount available for issuances of letters of credit to \$270.0 million in the aggregate on one occasion only during the term of the Facility Agreement (subject to the consent of all lenders and assuming no default and satisfaction of other specified conditions). The agreement provides certain covenants including, but not limited to, the syndicates financial condition. The Facility Agreement is used to provide regulatory capital supporting Chaucer's underwriting through two managed syndicates. The Facility Agreement expires on December 31, 2016. A letter of credit commission fee on outstanding letters of credit is payable quarterly, and ranges from 1.50% to 2.125% per annum, depending on our credit ratings for portions that are not cash collateralized, and 0.30% per annum for portions that are cash collateralized. We may, from time to time, collateralize a portion of the outstanding letter of credit. In addition to the commission fee on the uncollateralized outstanding letter of credit, a commitment fee in respect of the unutilized commitments under the Facility Agreement is payable quarterly, and ranges from 0.60% to 0.85% per annum, depending on our credit ratings. Chaucer is also required to pay customary agency fees.

Simultaneous with the Facility Agreement, we entered into a Guaranty Agreement (the Guaranty Agreement) with Lloyds TSB Bank plc, as Facility Agent and Security Agent, pursuant to which, we unconditionally guarantee the obligations of Chaucer under the Facility Agreement. The Guaranty Agreement contains certain financial covenants that require us to maintain a minimum net worth, a minimum risk-based capital ratio at our primary U.S. domiciled property and casualty companies and a maximum leverage ratio, and



**Table of Contents**

certain negative covenants that limit our ability, among other things, to incur or assume certain debt, grant liens on our property, merge or consolidate, dispose of assets, materially change the nature or conduct of our business and make restricted payments (except, in each case, as provided by certain exceptions). The Guaranty Agreement also contains certain customary representations and warranties.

At March 31, 2013, we were in compliance with the covenants of the aforementioned debt agreements.

**Off-Balance Sheet Arrangements**

We currently do not have any material off-balance sheet arrangements that are reasonably likely to have an effect on our financial position, revenues, expenses, results of operations, liquidity, capital expenditures, or capital resources.

**Contingencies and Regulatory Matters**

Information regarding contingencies and regulatory matters appears in Part I Note 12 Commitments and Contingencies in the Notes to Interim Consolidated Financial Statements.

**Risks and Forward-Looking Statements**

Information regarding risk factors and forward-looking information appears in Part II Item 1A of this Quarterly Report on Form 10-Q and in Part I Item 1A of our Annual Report on Form 10-K for the fiscal year ended December 31, 2012. This Management's Discussion and Analysis should be read and interpreted in light of such factors.

**Table of Contents**

**ITEM 3**

**QUANTITATIVE AND QUALITATIVE DISCLOSURES**

**ABOUT MARKET RISK**

Our market risks, the ways we manage them, and sensitivity to changes in interest rates, equity price risk, and foreign currency exchange risk are summarized in Management's Discussion and Analysis of Financial Condition and Results of Operations as of December 31, 2012, included in our Annual Report on Form 10-K for the year ended December 31, 2012. There have been no material changes in the first three months of 2013 to these risks or our management of them.

- 49 -

**Table of Contents**

**ITEM 4**

**CONTROLS AND PROCEDURES**

**Disclosure Controls and Procedures Evaluation**

Under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, we conducted an evaluation of our disclosure controls and procedures, as such term is defined under Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934, as amended (the Exchange Act ).

**Limitations on the Effectiveness of Controls**

Our management, including our Chief Executive Officer and Chief Financial Officer, does not expect that our disclosure controls over financial reporting will prevent all error and all fraud. A control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that the control system's objectives will be met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty and that breakdowns can occur because of simple error or mistake. Controls can also be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the controls. The design of any system of controls is based in part on certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Over time, controls may become inadequate because of changes in conditions or deterioration in the degree of compliance with policies or procedures. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

**Conclusion Regarding the Effectiveness of Disclosure Controls and Procedures**

Based on our controls evaluation, our Chief Executive Officer and Chief Financial Officer concluded that as of the end of the period covered by this quarterly report, our disclosure controls and procedures were effective to provide reasonable assurance that (i) the information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms and (ii) material information 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.

**Internal Control Over Financial Reporting**

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rule 13a-15(f). Under the supervision and with the participation of our management, including our Chief Executive Officer and the Chief Financial Officer, we conducted an evaluation of the internal control over financial reporting, as required by Rule 13a-15(d) of the Exchange Act, to determine whether any changes occurred during the period covered by this quarterly report on Form 10-Q that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that there were no such changes during the quarter ended March 31, 2013, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**Table of Contents**

**PART II OTHER INFORMATION**

**ITEM 1 LEGAL PROCEEDINGS**

Reference is made to the litigation matter captioned Durand Litigation under Commitments and Contingencies Legal Proceedings in Note 12 in the Notes to Interim Consolidated Financial Statements.

**ITEM 1A RISK FACTORS**

This document contains, and management may make, certain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. All statements, other than statements of historical facts, may be forward-looking statements. When used in our Management s Discussion and Analysis, the words: believes , anticipates , expects , projections , outlook , should , could , plan , guided track to , targeted and similar expressions are intended to identify forward-looking statements. We wish to caution readers that accuracy with respect to forward-looking projections is difficult and risks and uncertainties, in some cases, have affected and in the future could affect our actual results and could cause our actual results for the remainder of 2013 and beyond to differ materially from historical results and from those expressed in any of our forward-looking statements. We operate in a business environment that is continually changing, and as such, new risk factors may emerge over time. Additionally, our business is conducted in competitive markets and therefore involves a higher degree of risk. We cannot predict these new risk factors nor can we assess the impact, if any, that they may have on our business in the future. Some of the factors that could cause actual results to differ include, but are not limited to, the following:

changes in the demand for our products;

risks and uncertainties with respect to our ability to retain profitable policies in force and attract profitable policies and to increase rates in excess of loss trends;

changes in our estimates of loss and loss adjustment expense reserves and accident year picks , resulting in lower current year underwriting income or adverse loss development such as we have recently experienced in our Commercial and Personal Lines segments;

changes in frequency and loss trends;

changes in regulation, economic, market and political conditions, particularly with respect to regions where we have geographical concentrations;

volatile and unpredictable developments, including severe weather and other natural physical events, catastrophes and terrorist actions;

changes in weather patterns, whether as a result of global climate change, or otherwise, causing a higher level of losses from weather events to persist;

the availability of sufficient information to accurately estimate a loss at a point in time;



## Edgar Filing: HANOVER INSURANCE GROUP, INC. - Form 10-Q

risks and uncertainties with respect to our ability to collect all amounts due from reinsurers and to maintain current levels of reinsurance in the future at commercially reasonable rates, or at all;

heightened volatility, fluctuations in interest rates (which have a significant impact on the market value of our investment portfolio and thus our book value), inflationary pressures, default rates and other factors that affect investment returns from our investment portfolio;

fluctuations in currencies which affect the values of financial information converted from an originating currency to our reporting currency;

risks and uncertainties associated with our participation in shared market mechanisms, mandatory reinsurance programs and mandatory and voluntary pooling arrangements;

an increase in mandatory assessments by state guaranty funds or by Lloyd's Central Fund;

actions by our competitors, many of which are larger or have greater financial resources than we do;

loss or retirement of key employees;

operating difficulties and other unintended consequences from acquisitions and integration of acquired businesses, the introduction of new products and related technology changes and new operating models;

changes in our claims-paying and financial strength ratings;

negative changes in our level of statutory surplus;

**Table of Contents**

risks and uncertainties with respect to our growth strategies;

our ability to declare and pay dividends;

changes in accounting principles and related financial reporting requirements;

errors or omissions in connection with the administration of any of our products;

risks and uncertainties with technology, data security and/or outsourcing relationships that may negatively impact our ability to conduct business;

an inability to be compliant with new regulations such as Solvency II or existing regulation such as Sarbanes-Oxley;

unfavorable judicial or legislative developments; and

other factors described in such forward-looking statements.

In addition, historical and future reported financial results include estimates with respect to premiums written and earned, reinsurance recoverables, current accident year picks, loss and loss adjustment reserves and development, fair values of certain investments, other assets and liabilities, tax, contingent and other liabilities, and other items. These estimates are subject to change as more information becomes available.

For a more detailed discussion of our risks and uncertainties, see also Item 1A Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2012.

**Table of Contents****ITEM 2 UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS***Issuer Purchases of Equity Securities*

Shares purchased in the first quarter of 2013 are as follows:

<i>Period</i>	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs <sup>(1)</sup>	Approximate Dollar Value of Shares That May Yet be Purchased Under the Plans or Programs <i>(in millions)</i>
January 1 - 31, 2013 <sup>(2)</sup>	3,617	\$ 39.29		\$ 115
February 1 - 28, 2013 <sup>(2)</sup>	75,640	42.48		115
March 1 - 31, 2013 <sup>(3)</sup>	562,055	46.28	544,255	90
Total	641,312	\$ 45.79	544,255	\$ 90

- (1) Since the announcement of our share repurchase program on October 29, 2007, the Board has authorized us to repurchase up to \$500 million in shares of our common stock using open market purchases, privately negotiated transactions, accelerated repurchase programs or other transactions.
- (2) The total number of shares purchased reflects shares withheld to satisfy tax withholding amounts due from employees related to the receipt of stock which resulted from the exercise or vesting of equity awards.
- (3) Includes 17,800 shares withheld to satisfy tax withholding amounts due from employees related to the receipt of stock which resulted from the exercise or vesting of equity awards.

**Table of Contents**

**ITEM 6 EXHIBITS**

- EX 4.1 Indenture, dated as of March 20, 2013, by and between the Registrant and U.S. Bank National Association previously filed as Exhibit 4.1 to the Registrant's Registration Statement No: 333-187373 on Form S-3 as filed with the Commission on March 20, 2013 and incorporated herein by reference.
- EX 4.2 First Supplemental Indenture dated as of March 27, 2013, between U.S. Bank National Association, as trustee, supplementing the Indenture dated as of March 20, 2013 previously filed as Exhibit 4.1 to the Registrant's Current Report on Form 8-K filed with the Commission on March 27, 2013 and incorporated herein by reference.
- EX 4.3 Form of Security Certificate representing the 6.35% Subordinated Debentures due 2053 previously filed as Exhibit 4.2 to the Registrant's Current Report on Form 8-K filed with the Commission on March 27, 2013 and incorporated herein by reference.
- EX 10.1 Description of 2012 Named Executive Officer Short-Term Incentive Compensation Program Awards, 2013 Named Executive Officer Short-Term Incentive Compensation Programs and 2013 Named Executive Officer Long-Term Incentive Compensation Programs previously filed as Item 5.02 to the Registrant's Current Report on Form 8-K filed with the Commission on March 1, 2013 and incorporated herein by reference
- EX 31.1 Certification of the Chief Executive Officer, pursuant to 15 U.S.C. 78m, 78o(d), as adopted pursuant to section 302 of the Sarbanes-Oxley Act of 2002.
- EX 31.2 Certification of the Chief Financial Officer, pursuant to 15 U.S.C. 78m, 78o(d), as adopted pursuant to section 302 of the Sarbanes-Oxley Act of 2002.
- EX 32.1 Certification of the Chief Executive Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002.
- EX 32.2 Certification of the Chief Financial Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002.
- EX 101 The following materials from The Hanover Insurance Group, Inc.'s Quarterly Report on Form 10-Q for the quarter ended March 31, 2013 formatted in eXtensible Business Reporting Language (XBRL): (i) Consolidated Statements of Income for the three months ended March 31, 2013 and 2012; (ii) Consolidated Statements of Comprehensive Income for the three months ended March 31, 2013 and 2012; (iii) Consolidated Balance Sheets at March 31, 2013 and December 31, 2012; (iv) Consolidated Statements of Shareholders' Equity for the three months ended March 31, 2013 and 2012; (v) Consolidated Statements of Cash Flows for the three months ended March 31, 2013 and 2012, and (vi) related notes to these financial statements.

**Table of Contents**

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.

The Hanover Insurance Group, Inc  
Registrant

May 1, 2013  
Date

/s/ Frederick H. Eppinger, Jr.  
Frederick H. Eppinger, Jr.  
President, Chief Executive Officer and Director

May 1, 2013  
Date

/s/ David B. Greenfield  
David B. Greenfield  
Executive Vice President, Chief Financial Officer and Principal  
Accounting Officer

- 55 -