SELECTIVE INSURANCE GROUP INC
Form 10-K
March 01, 2007

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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION**
**WASHINGTON, D.C. 20549**
**FORM 10-K**

***(Mark one)***

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

**For the fiscal year ended December 31, 2006**

***OR***

o **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 0-8641**
**SELECTIVE INSURANCE GROUP, INC.**
(Exact name of registrant as specified in its charter)

| | |
|---|---|
| New Jersey | 22-2168890 |
| (State or Other Jurisdiction of Incorporation or Organization) | (I.R.S. Employer Identification No.) |
| 40 Wantage Avenue, Branchville, New Jersey | 07890 |
| (Address of Principal Executive Office) | (Zip Code) |

Registrant s telephone number, including area code: (973) 948-3000

Securities registered pursuant to Section 12(b) of the Act:

7.5% Junior Subordinated Notes due September 27, 2066
(Title of class)
Common Stock, par value $2 per share
(Title of class)
Preferred Share Purchase Rights
(Title of class)

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

þ Yes o No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.

o Yes þ No

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, and (2) has been subject to such filing requirements for the past 90 days.

þ Yes o No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

o

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

Large accelerated filer þ Accelerated filer o Non-accelerated filer o

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

o Yes þ No

The aggregate market value of the voting Common stock held by non-affiliates of the registrant, based on the closing price on the NASDAQ Global Select Market®, was $1,585,015,215 on June 30, 2006.

As of February 13, 2007, the registrant had outstanding 56,995,648 shares of Common Stock.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant s definitive Proxy Statement for the 2007 Annual Meeting of Stockholders to be held on April 24, 2007 are incorporated by reference into Part III of this report.

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# PART I
## Item 1. Business.
### *Overview*
Selective Insurance Group, Inc. through its subsidiaries, (collectively known as Selective or the Company ) offers property and casualty insurance products and diversified insurance products. Selective was incorporated in New Jersey in 1977. Its principal property and casualty insurance subsidiary was organized in New Jersey in 1926. Its main offices are located in Branchville, New Jersey.

Selective classifies its businesses into three operating segments:

Insurance Operations, which sells property and casualty insurance products and services primarily in 20 states in the Eastern and Midwestern United States, and has at least one company licensed to do business in each of the 50 states;

Investments; and

Diversified Insurance Services, which provides human resource administration outsourcing products and services, and federal flood insurance administrative services.

Financial information about Selective s three operating segments is contained in this report in Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations, and Item 8. Financial Statements and Supplementary Data, Note 12 to the consolidated financial statements, Segment Information.

### *Description of Operating Segment Products and Markets*
### Insurance Operations Segment
Selective s Insurance Operations sell property and casualty insurance policies. Insurance policies are contracts to cover losses for specified risks in exchange for premiums. Property insurance generally covers the financial consequences of accidental loss to the insured s property. Property claims are generally reported and settled in a relatively short period of time. Casualty insurance generally covers the financial consequences of bodily injury and/or property damage to a third party as a result of the insured s negligent acts, omissions, or legal liabilities. Casualty claims often take years to be reported and settled.

Selective s Insurance Operations segment writes its property and casualty insurance products through seven insurance subsidiaries ( Insurance Subsidiaries ), which are listed on the following table together with their respective ratings by A.M. Best Company, Inc. ( A.M. Best ), and state of domicile by which each is primarily regulated:

| Insurance Subsidiaries | A.M. Best Rating [1] | Domiciliary State |
|---|---|---|
| Selective Insurance Company of America (SICA) | A+ (Superior) | New Jersey |
| Selective Way Insurance Company (SWIC) | A+ (Superior) | New Jersey |
| Selective Insurance Company of South Carolina (SICSC) | A+ (Superior) | South Carolina |
| Selective Insurance Company of the Southeast (SICSE) | A+ (Superior) | North Carolina |
| Selective Insurance Company of New York (SICNY) | A+ (Superior) | New York |
| Selective Insurance Company of New England (SICNE) | A+ (Superior) | Maine |
| Selective Auto Insurance Company of New Jersey (SAICNJ) | A+ (Superior) | New Jersey |

[1] With regard to an A+ rating, A.M. Best uses its highest

Financial Strength Rating of Secure, and a descriptor of Superior, which it defines as, Assigned to companies that have, in our opinion, a superior ability to meet their ongoing obligations to policyholders. Only 9% of commercial and personal insurance companies carry an A+ or better rating from A.M. Best.

In 2006, A.M. Best, in its list of Top Property/Casualty Writers, ranked Selective the 47th largest property and casualty group in the United States based on the 2005 combined net premiums written ( NPW ), or premiums for all policies sold, by the Insurance Subsidiaries.

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### *Insurance Operations*

Selective s Insurance Operations segment derives substantially all of its revenues from insurance policy premiums. The Insurance Subsidiaries predominantly write annual policies, of which the associated premiums are defined as net premiums written ( NPW ). NPW is recognized as revenue as net premiums earned ( NPE ) ratably over the life of the insurance policy. Expenses fall into three categories: (i) losses associated with claims and various loss expenses incurred for adjusting claims; (ii) expenses related to the issuance of insurance policies, such as agent commissions, premium taxes, and other underwriting expenses, including employee compensation and benefits; and (iii) policyholder dividends.

Selective s Insurance Subsidiaries are regulated by each of the states in which they do business. Each Insurance Subsidiary is required to file financial statements with such states, prepared in accordance with accounting principles prescribed by, or permitted by, such Insurance Subsidiary s state of domicile ( Statutory Accounting Principles or SAP ). SAP have been promulgated by the National Association of Insurance Commissioners ( NAIC ) and adopted by the various states. Selective evaluates the performance of our Insurance Subsidiaries in accordance with SAP. Incentive-based compensation to independent agents and employees is based on SAP results and our rating agencies use SAP information to evaluate our performance as well as for industry comparative purposes.

The underwriting performance of insurance companies is measured under SAP by four different ratios:

1) Loss and loss expense ratio, which is calculated by dividing incurred loss and loss expenses by NPE;

2) Underwriting expense ratio, which is calculated by dividing all expenses related to the issuance of insurance policies by NPW;

3) Dividend ratio, which is calculated by dividing policyholder dividends by NPE; and

4) Combined ratio, which is the sum of the loss and loss expense ratio, the underwriting expense ratio, and the dividend ratio.

A statutory combined ratio under 100% generally indicates that an insurance company is generating an underwriting profit and a statutory combined ratio over 100% generally indicates that an insurance company is generating an underwriting loss. The statutory combined ratio does not reflect investment income, federal income taxes, or other non-operating income or expense.

SAP differs in many ways from generally accepted accounting principles in the United States of America ( GAAP ), under which Selective is required to report our financial results to the United States Securities and Exchange Commission ( SEC ). The most notable differences impacting our reported net income are as follows:

- Under SAP, underwriting expenses are recognized when incurred; whereas under GAAP, underwriting expenses are deferred and amortized over the life of the policy;

- Under SAP, the underwriting expense ratio is calculated using NPW as the denominator; whereas NPE is used as the denominator under GAAP; and

- Under SAP, the results of Selective s flood line of business are included in the Insurance Operations segment, whereas under GAAP, these results are included within the Diversified Insurance Services segment.

Selective primarily uses SAP information to monitor and manage its results of operations. Selective believes that providing SAP financial information for the Insurance Operations segment helps its investors, agents, and customers better evaluate the underwriting success of Selective s insurance business.

Selective believes that only providing a GAAP presentation of financial information for its Insurance Operations segment would make it more difficult for agents, customers, and investors to evaluate Selective s success or failure in its insurance business.

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The following table shows the statutory results of the Insurance Operations segment for the last three completed fiscal years:

| | Year Ended December 31, | | |
|---|---|---|---|
| (in thousands) | **2006** | 2005 | 2004 |
| **Insurance Operations Results** | | | |
| NPW | $ **1,540,901** | 1,462,914 | 1,368,061 |
| NPE | $ **1,504,632** | 1,421,439 | 1,321,316 |
| Losses and loss expenses incurred | **958,741** | 902,557 | 862,621 |
| Net underwriting expenses incurred | **482,657** | 449,569 | 414,256 |
| Policyholders dividends | **5,927** | 5,688 | 4,275 |
| Underwriting profit (loss) | $ **57,307** | 63,625 | 40,164 |
| **Ratios:** | | | |
| Losses and loss expense ratio | **63.7**% | 63.5 | 65.3 |
| Underwriting expense ratio | **31.3**% | 30.7 | 30.3 |
| Policyholders dividends ratio | **0.4**% | 0.4 | 0.3 |
| Combined ratio | **95.4**% | 94.6 | 95.9 |
| GAAP Combined ratio [1] | **96.1**% | 95.1 | 96.9 |

[1] The GAAP Combined Ratio excludes the flood line of business, which is included in the Diversified Insurance Services segment on a GAAP basis and therefore excluded from the GAAP combined ratio. The total Statutory Combined Ratio excluding flood was 96.1% in

2006, 95.3% in 2005, and 96.5% in 2004.

Selective has consistently produced a lower statutory combined ratio than the property and casualty insurance industry, generally outperforming the industry for the past 10 years by an average of 2.7 points. The table below sets forth a comparison of certain Company and industry statutory ratios:

| | Simple Average of All Periods Presented | **2006** | 2005 | 2004 | 2003 | 2002 | 2001 | 2000 | 1999 | 1998 | 1997 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| **Selective Ratios:** (1) | | | | | | | | | | | |
| Loss and loss expense | 69.8% | **63.7** | 63.5 | 65.3 | 70.3 | 72.3 | 74.3 | 75.7 | 74.4 | 70.2 | 68.2 |
| Underwriting expense | 31.0 | **31.3** | 30.7 | 30.3 | 30.7 | 30.3 | 31.5 | 31.7 | 30.5 | 32.2 | 31.2 |
| Policyholders dividends | 0.6 | **0.4** | 0.4 | 0.3 | 0.5 | 0.6 | 0.9 | 0.9 | 0.8 | 0.7 | 0.7 |
| Statutory combined ratio (2) | 101.5 | **95.4** | 94.6 | 95.9 | 101.5 | 103.2 | 106.7 | 108.2 | 105.7 | 103.2 | 100.1 |
| Growth (decline) in net premiums written | 8.4 | **5.3** | 6.9 | 12.0 | 15.7 | 13.8 | 10.5 | 3.6 | 8.1 | 4.4 | 3.7 |
| **Industry Ratios:** (1) (3) | | | | | | | | | | | |
| Loss and loss expense | 76.9 | **66.9** | 74.8 | 73.1 | 75.1 | 81.5 | 88.4 | 81.5 | 78.8 | 76.2 | 72.8 |
| Underwriting expense | 26.3 | **25.9** | 25.5 | 24.9 | 24.6 | 25.1 | 26.5 | 27.4 | 27.9 | 27.7 | 27.1 |
| Policyholders dividends | 1.0 | **0.5** | 0.5 | 0.5 | 0.5 | 0.6 | 0.8 | 1.4 | 1.3 | 1.7 | 1.7 |
| Statutory combined ratio (2) | 104.2 | **93.3** | 100.8 | 98.5 | 100.2 | 107.3 | 115.7 | 110.4 | 108.1 | 105.6 | 101.6 |
| Growth in net premiums written | 5.1 | **2.6** | (0.2) | 4.4 | 9.6 | 15.1 | 8.5 | 4.7 | 1.9 | 1.8 | 2.9 |
| **Selective Favorable (Unfavorable) to Industry:** | | | | | | | | | | | |
| Statutory combined ratio | 2.7 | **(2.1)** | 6.2 | 2.6 | (1.3) | 4.1 | 9.0 | 2.2 | 2.4 | 2.4 | 1.5 |
| Growth (decline) in net | 3.3 | **2.7** | 7.1 | 7.6 | 6.1 | (1.3) | 2.0 | (1.1) | 6.2 | 2.6 | 0.8 |

premiums written

1. The ratios and percentages are based upon SAP prescribed or permitted by state insurance departments in the states in which each company is domiciled. Effective January 1, 2001, Selective adopted a codified set of statutory accounting principles, as required by the NAIC. These principles were not retroactively applied, but would not have had a material effect on the ratios presented above.

2. A statutory combined ratio under 100% generally indicates an underwriting profit and a statutory combined ratio over 100% generally indicates an underwriting loss. Due to investment income, a company may still be

profitable even though its statutory combined ratio exceeds 100%.

3. Source: A.M. Best. The industry ratios for 2006 have been estimated by A.M. Best.

*Lines of Business and Products*

Selective s Insurance Operations segment includes commercial lines ( Commercial Lines ), which markets primarily to businesses and represents approximately 86% of Selective s NPW; and personal lines ( Personal Lines ), which markets primarily to individuals and represents approximately 14% of NPW.

<u>Commercial Lines</u>

Commercial Lines underwrites general liability, commercial automobile, workers compensation, commercial property, business owners policy, and bond risks through traditional insurance and alternative risk management products.

Personal Lines

Personal Lines underwrites and issues insurance policies for personal automobile, homeowners, and other various risks.

*Regional Geographic Market Focus*

Selective s Insurance Operations segment primarily focuses its marketing efforts and sells its products and services in the Eastern and Midwestern regions of the United States. This large geographic area diversifies Selective s exposure to catastrophic risk. The Insurance Operations segment does not conduct any business outside of the United States. The following table shows the principal states in which Selective writes insurance business and the percentage of Selective s total NPW that such state represents for the last three fiscal years.

| | Year Ended December 31, | | |
|---|---|---|---|
| **Net Premiums Written** | **2006** | 2005 | 2004 |
| New Jersey | **32.6**% | 33.9 | 36.7 |
| Pennsylvania | **14.3** | 14.4 | 13.7 |
| New York | **11.1** | 11.2 | 10.9 |
| Maryland | **7.5** | 7.2 | 7.0 |
| Virginia | **5.9** | 5.6 | 5.4 |
| Illinois | **3.9** | 3.8 | 3.2 |
| North Carolina | **3.8** | 3.8 | 3.7 |
| Georgia | **3.2** | 3.1 | 3.0 |
| Indiana | **3.1** | 2.8 | 2.8 |
| South Carolina | **2.5** | 2.5 | 2.1 |
| Michigan | **1.9** | 1.8 | 1.9 |
| Ohio | **1.6** | 1.5 | 1.6 |
| Connecticut | **1.4** | 1.3 | 1.1 |
| Delaware | **1.3** | 1.4 | 1.4 |
| Rhode Island | **1.3** | 1.2 | 1.1 |
| Minnesota | **1.1** | 1.1 | 1.0 |
| Wisconsin | **1.1** | 1.1 | 1.2 |
| Other states [1] | **2.4** | 2.3 | 2.2 |
| Total | **100.0**% | 100.0 | 100.0 |

[1] Other states include, among others, Washington, D.C., Florida, Iowa, Kentucky, and Missouri.

*Independent Insurance Agent Distribution Model*

According to the Independent Insurance Agents and Brokers of America ( IIABA ), in 2004, independent insurance agents and brokers write approximately 80% of the commercial property and casualty insurance and approximately 35% of the personal lines insurance business in the United States. Independent agents are a significant force in overall insurance industry premium production, in large part because they represent more than one insurance company and, therefore, can provide insureds with a wider choice of commercial and personal property and casualty insurance products. As a result, Selective is committed to the independent agency distribution channel and focuses its primary strategy on building relationships with well-established, independent insurance agents while carefully monitoring each agent s profitability, growth, financial stability, staff, and mix of business against plans that Selective develops annually with the agent. In developing annual plans with its independent insurance agents, Selective s field personnel and management spend considerable time meeting with agencies to: (i) advise them on Company developments; (ii) receive feedback on products and services; (iii) help agents increase market share; and (iv) consolidate more of their business utilizing Selective s technology advantages.

As of December 31, 2006, Selective s Insurance Subsidiaries had entered into agency agreements, pursuant to applicable state laws and regulations, with approximately 770 independent insurance agents having approximately 1,600 storefronts, to allow such agents to sell policies written by the Insurance Subsidiaries. Selective pays its independent agents commissions pursuant to calculations and specific percentages stated in the agency agreement. Under the agency agreement, other than as provided by law, agents are not permitted to receive compensation for the business they place with Selective from any insured or applicant for insurance other than Selective. The agency agreement provides for commissions to be paid based on a percentage of the premium written. Selective and its agents also negotiate other compensation arrangements, including supplemental commissions, based on the underwriting results of the business the agent writes with Selective.

*Technology and Field Model Business Strategy*

Selective uses the trademarks, High-Tech, High-Touch" and 2HT, to describe its business strategy for the Insurance Operations. High-Tech signifies the advanced technology that Selective uses to make it easy for: (i) independent insurance agents to transact and process business with Selective; and (ii) customers to access real-time information, manage their accounts and pay their bills through an on-line customer portal that was established in September 2006. High-Touch

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signifies the close relationships that Selective has with its independent insurance agents and customers as a result of its business model that places underwriters, claims representatives, and safety management representatives in the field near its agents and customers.

Technology

Selective seeks to transact as much of its business as possible through the use of technology and, in recent years, has made significant investments in state-of-the-art information technology platforms, integrated systems, Internet-based applications, and predictive modeling initiatives to: (i) provide its independent agents and customers with access to accurate business information; (ii) provide independent agents the ability to process business transactions from their offices and systems; and (iii) provide underwriters with targeted pricing tools to enhance profitability while growing the business. In 2006, Applied Systems, Inc. presented Selective with the 2006 Interface Leadership and Innovation Award for promoting efficient communication between insurance carriers and independent agents. Applied Systems is the leading provider of automated solutions for the property and casualty insurance industry. The award was granted based on Selective s ability to advance agency-company interface through adoption, support and implementation of initiatives through its xSELerate® agency integration technology. Additionally, Selective received the 2006 E-Fusion Award from A.M. Best Co. for innovative, business-focused agency integration technology. This award was granted to Selective for increasing productivity for its independent insurance agents through its xSELerate® agency integration technology.

Selective manages its information technology projects through a project management office ( PMO ). The PMO is staffed by certified individuals who apply methodologies to: (i) communicate project management standards; (ii) provide project management training and tools; (iii) review project status and cost; and (iv) provide non-technology project management consulting services to the rest of Selective. The PMO meets monthly with Selective s senior management to review all major projects and report on the status of other projects. The PMO is a factor in the success of Selective s technology implementation and in ensuring that Selective has a competitive advantage with independent agents, while reducing overall company expenses and increasing overall employee productivity. Selective s technology operations are located in Branchville, New Jersey; Glastonbury, Connecticut; and Sarasota, Florida.

Field Strategy

To support its independent agents, Selective employs a field underwriting model and a field claims model that are supported by the home office in Branchville, New Jersey, and five regional branch offices ( Region ), which were as follows as of December 31, 2006:

| Region | Office Location |
|---|---|
| Mid-America | Columbus, Ohio |
| New Jersey | Hamilton, New Jersey |
| Northeast | Branchville, New Jersey |
| Pennsylvania | Allentown, Pennsylvania |
| Southern | Charlotte, North Carolina |

Selective also maintains an office in Hunt Valley, Maryland that supports our Selective Risk Managers ( SRM ) operations.

As of December 31, 2006, Selective had:

81 field underwriters within commercial lines, known as agency management specialists ( AMS ). AMSs live and work in the geographic vicinity of Selective s appointed agents and generally work from offices in their homes. As a result of this close proximity, AMSs are able to build strong relationships with agents through direct and regular interaction.

8 territory managers within Personal Lines that work with AMSs and independent agents to advance Personal Lines production. Territory managers build strong relationships with agents through direct and regular interaction, which better positions them to evaluate new business opportunities.

70 safety management specialists ( SMSs ). SMSs are located in the Regions and are responsible for surveying and assessing insured and prospective risks from a risk/safety standpoint, and for providing ongoing safety management services to certain insureds.

136 field claims adjusters, known as claim management specialists ( CMSs ). Like AMSs, CMSs live in the geographic vicinity of Selective s appointed agents and generally work from offices in their homes. CMSs, because of their geographic location, are able to conduct on-site inspections of losses and resolve claims faster, more accurately, and with higher levels of customer satisfaction. As a result, CMSs also obtain knowledge about potential exposures that they can share with AMSs.

Underwriting

Selective seeks to price and underwrite a variety of insurance risks and focuses its efforts on four market segments:

- Small business accounts, representing 9% of Selective s commercial lines premium, can be written through Selective s Internet-based One & Done® system s automated underwriting templates;

- Middle market business accounts with annual premiums up to $250,000, that cannot be underwritten through the One & Done® system, are the primary focus of the AMSs and represent 80% of Selective s commercial lines premium;

- Large business accounts with annual premiums of approximately $250,000 or greater, which represents 11% of Selective s commercial lines premuim, are underwritten by a specialized commercial lines unit, SRM. Approximately 20% of these accounts employ alternative risk transfer mechanisms such as guaranteed costs, retrospective plans, and self-insured group retention programs, or they are self-insured group accounts that retain a portion of the risk.

- Personal Lines.

Selective s underwriting process requires communication and interaction among:

- The independent agents and the AMSs, who identify product and market needs;

- Selective s strategic business units ( SBUs ), located in the home office, which are organized by customer and product type, and develop Selective s pricing and underwriting guidelines in conjunction with regions;

- The Regions, which work with the SBUs to establish annual premium and pricing goals; and

- The Actuarial Department, located in the home office, which assists in the determination of rate and pricing levels while also monitoring pricing and profitability.

A distinct advantage of Selective s field underwriting model is its ability to provide a wide range of front-line safety management services focused on improving the policyholder s safety and risk management programs. Services that Selective offers include: (i) risk evaluation and improvement surveys intended to evaluate potential exposures and provide solutions for mitigation. Risk improvement efforts for existing customers are designed to improve loss experience and retention through valuable ongoing consultative service; (ii) web-based safety management educational resources, including a large library of coverage-specific safety materials, videos and on-line courses; such as defensive driving and employee educational safety courses; (iii) thermographic infrared surveys aimed at identifying electrical hazards; and (iv) OSHA construction and general industry certification training. Selective s Safety Management goal is to partner with policyholders to identify and eliminate potential loss exposures.

Selective also has an underwriting service center ( USC ) located in Richmond, Virginia. The USC assists Selective s agents by servicing small to mid size business customers. During 2006, the USC became available to personal lines business customers of our New Jersey agents with a rollout to Selective s remaining states during 2007. At the USC, Selective employees, who are licensed agents, respond to customer inquiries about insurance coverage, billing transactions, and other matters. The agent, as consideration for these services, receives a commission that is lower than the standard commission by approximately two points. Selective has found that the USC also provides additional opportunities to increase direct premiums written, as larger agencies seek insurance companies that have service center capabilities. Currently, the USC is servicing commercial lines net premiums written of $70 million and personal lines net premiums written of $26 million. The total $96 million serviced represents 6% of total net premiums written.

Selective analyzes its underwriting profitability by line of business, account, product, agency and other bases. Selective s goal is to continue to underwrite the risks that it understands well and that, in aggregate, are profitable.

Field Claims Management

Effective, fair, and timely claims management is one of the most important customer services that Selective provides and one of the critical factors in achieving underwriting profitability. Selective s claims policy emphasizes the maintenance of timely and adequate reserves for claims, and the cost-effective delivery of claims services by controlling losses and loss expenses. CMSs are primarily responsible for investigating and settling claims directly with policyholders and claimants. By promptly and personally investigating claims, CMSs are able to provide personal service and quickly resolve claims. CMSs also provide guidance on the handling of the claim until its final disposition. Selective also believes that by visiting the site of the claim, and meeting face-to-face with the insured or claimant, the settlement will be more accurate. In territories where there is insufficient claim volume to justify the placement of a CMS, or when a particular claim expertise is required, Selective uses independent adjusters to investigate and settle claims.

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Selective has a centralized special investigative unit ( SIU ) that investigates potential insurance fraud and abuse, and supports efforts by regulatory bodies and trade associations to curtail the cost of fraud. The SIU adheres to uniform internal procedures to improve detection and takes action on potentially fraudulent claims. It is Selective s policy to notify the proper authorities of its findings. This policy sends a clear message that Selective will not tolerate fraudulent activity committed against the Company or its customers. The SIU also supervises anti-fraud training for CMSs and other employees, including AMSs.

Selective has a claims service center ( CSC ), co-located with the USC, in Richmond, Virginia. The CSC provides enhanced services to Selective s policyholders, including immediate claim review, 24 hours a day, seven days a week. The CSC is also designed to reduce the loss settlement time on first-party automobile claims and increase the usage of Selective s discounts at body shops, glass repair shops, and car rental agencies.

*Net Loss and Loss Expense Reserves*

Selective establishes loss and loss expense reserves that are estimates of amounts needed to pay claims and related expenses in the future for insured loss events that have already occurred. The process of estimating reserves involves a considerable degree of judgment by management and, as of any given date, is inherently uncertain. See Critical Accounting Policies and Estimates in Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations in this Form 10-K for a full discussion regarding Selective s loss reserving process.

The following information presents: (i) Selective s reserve development over the proceeding ten years; and (ii) a reconciliation of reserves in accordance with SAP to such reserves determined in accordance with GAAP, each as prescribed by Securities Act Industry Guide No. 6.

Section I of the ten-year table shows the estimated liability that was recorded at the end of each of the indicated years for all current and prior accident year unpaid loss and loss expenses. The liability represents the estimated amount of loss and loss expenses for claims that were unpaid at the balance sheet date, including incurred but not reported ( IBNR ) reserves. In accordance with GAAP, the liability for unpaid loss and loss expenses is recorded in the balance sheet gross of the effects of reinsurance with an estimate of reinsurance recoverables arising from reinsurance contracts reported separately as an asset. The net balance represents the estimated amount of unpaid loss and loss expenses outstanding as of the balance sheet date, reduced by estimates of amounts recoverable under reinsurance contracts.

Section II shows the re-estimated amount of the previously recorded net liability as of the end of each succeeding year. Estimates of the liability for unpaid loss and loss expenses are increased or decreased as payments are made and more information regarding individual claims and trends, such as overall frequency and severity patterns, becomes known. Section III shows the cumulative amount of net loss and loss expenses paid relating to recorded liabilities as of the end of each succeeding year. Section IV shows the re-estimated gross liability and re-estimated reinsurance recoverables through December 31, 2006. Section V shows the cumulative net (deficiency)/redundancy representing the aggregate change in the liability from the original balance sheet dates and the re-estimated liability through December 31, 2006.

This table does not present accident or policy year development data, which certain readers may be more accustomed to analyzing. Conditions and trends that have affected development of the reserves in the past may not necessarily occur in the future. Accordingly, it may not be appropriate to extrapolate redundancies or deficiencies based on this table.

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| *($ in millions)* | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | **2006** |
|---|---|---|---|---|---|---|---|---|---|---|---|
| I.Gross reserves for unpaid losses and loss expenses at December 31 | $ 1,189.8 | 1,161.2 | 1,193.3 | 1,273.8 | 1,272.7 | 1,298.3 | 1,403.4 | 1,587.8 | 1,835.2 | 2,084.0 | **2,288.8** |
| Reinsurance recoverable on unpaid losses and loss expenses at December 31 | $ (150.2) | (124.2) | (140.5) | (192.0) | (160.9) | (166.5) | (160.4) | (184.6) | (218.8) | (218.2) | **(199.7)** |
| Net reserves for unpaid losses and loss expenses at December 31 | $ 1,039.6 | 1,037.0 | 1,052.8 | 1,081.8 | 1,111.8 | 1,131.8 | 1,243.1 | 1,403.2 | 1,616.4 | 1,865.8 | **2,089.0** |
| II. Net Reserves estimated as of: | | | | | | | | | | | |
| One year later | $ 1,029.5 | 1,034.5 | 1,044.2 | 1,080.7 | 1,125.5 | 1,151.7 | 1,258.1 | 1,408.1 | 1,621.5 | **1,858.5** | |
| Two years later | 1,028.1 | 1,024.8 | 1,035.9 | 1,088.2 | 1,152.7 | 1,175.8 | 1,276.3 | 1,452.3 | **1,637.3** | | |
| Three years later | 1,020.5 | 1,014.0 | 1,033.3 | 1,115.6 | 1,181.9 | 1,210.7 | 1,344.6 | **1,491.1** | | | |
| Four years later | 1,014.4 | 998.1 | 1,040.3 | 1,134.4 | 1,220.2 | 1,290.2 | **1,371.5** | | | | |
| Five years later | 1,000.9 | 997.9 | 1,049.9 | 1,156.0 | 1,278.3 | **1,306.8** | | | | | |
| Six years later | 1,002.1 | 1,003.6 | 1,058.6 | 1,194.6 | **1,287.5** | | | | | | |
| Seven years later | 1,006.5 | 1,011.6 | 1,090.0 | **1,203.2** | | | | | | | |
| Eight years later | 1,010.9 | 1,038.0 | **1,101.1** | | | | | | | | |
| Nine years later | 1,033.4 | **1,045.2** | | | | | | | | | |
| Ten years later | **1,042.6** | | | | | | | | | | |
| Cumulative net Redundancy (deficiency) | $ **(3.0)** | **(8.2)** | **(48.3)** | **(121.4)** | **(175.7)** | **(174.9)** | **(128.5)** | **(87.8)** | **(20.9)** | **7.3** | |

| | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| III. Cumulative amount of net reserves paid through: | | | | | | | | | | | |
| One year later | $ | 303.6 | 313.7 | 328.1 | 348.2 | 399.2 | 377.1 | 384.0 | 414.5 | 422.4 | **468.6** |
| Two years later | | 519.6 | 531.1 | 537.5 | 600.3 | 649.1 | 627.3 | 653.3 | 691.4 | **729.5** | |
| Three years later | | 674.7 | 665.5 | 703.8 | 767.5 | 815.3 | 807.2 | 836.3 | **903.7** | | |
| Four years later | | 760.8 | 760.8 | 797.1 | 870.8 | 930.9 | 926.9 | **966.2** | | | |
| Five years later | | 820.0 | 812.2 | 856.1 | 933.6 | 1,002.4 | **1,003.3** | | | | |
| Six years later | | 850.9 | 849.7 | 892.2 | 974.6 | **1,046.3** | | | | | |
| Seven years later | | 877.3 | 875.9 | 919.2 | **1,001.1** | | | | | | |
| Eight years later | | 896.0 | 894.7 | **937.1** | | | | | | | |
| Nine years later | | 912.1 | **908.5** | | | | | | | | |
| Ten years later | | **924.2** | | | | | | | | | |
| IV. Re-estimated gross liability | $ | 1,305.9 | 1,294.2 | 1,352.0 | 1,469.3 | 1,519.9 | 1,546.8 | 1,583.3 | 1,716.5 | 1,867.0 | 2,090.5 |
| Re-estimated Reinsurance Recoverable | $ | (263.3) | (249.0) | (250.9) | (266.1) | (232.3) | (240.1) | (211.7) | (225.5) | (229.7) | (232.0) |
| Re-estimated net Liability | $ | 1,042.6 | 1,045.2 | 1,101.1 | 1,203.2 | 1,287.5 | 1,306.8 | 1,371.5 | 1,491.1 | 1,637.3 | 1,858.5 |
| V. Cumulative gross (deficiency) | $ | (116.1) | (133.0) | (158.7) | (195.5) | (247.2) | (248.5) | (179.8) | (128.7) | (31.8) | (6.4) |
| Cumulative net Redundancy (deficiency) | $ | (3.0) | (8.2) | (48.3) | (121.4) | (175.7) | (174.9) | (128.5) | (87.8) | (20.9) | 7.3 |

Note: Some amounts may not foot due to rounding.

The Company experienced favorable development in its loss and loss expense reserves totaling $7.3 million in 2006, which was primarily driven by favorable prior year development in our commercial automobile, workers compensation, and personal automobile lines of business partially offset by adverse development in our general liability line of business. The commercial automobile line of business experienced favorable prior year loss and loss expense reserve development of approximately $15 million, which was primarily driven by lower than expected severity in accident years 2004 and 2005. The workers compensation line of business experienced favorable prior year development of approximately $4 million, which was driven, in part, by savings realized from changing medical and pharmacy networks outside the state of New Jersey and re-contracting our medical bill review services. The personal automobile line of business experienced favorable prior year development of approximately $9 million, due to lower than expected frequency. The general liability line of business experienced adverse prior year loss and loss expense reserve development of approximately $15 million in 2006, which was largely driven by our contractor completed operations business and an increase in reserves for legal expenses. The remaining

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lines of business, which collectively contributed approximately $6 million of adverse development, do not individually reflect significant prior year development.

During the course of 2005, we had analyzed certain negative trends in the workers compensation line of business and certain positive trends in the commercial automobile line of business. In the fourth quarter of 2005, we had sufficient evidence accumulated to change management s best estimate of loss reserves for these lines. Accordingly, workers compensation reserves were increased by approximately $42 million to reflect rising medical cost trends that impacted accident years 2001 and prior. At the same time, commercial automobile reserves were decreased by approximately $48 million, primarily due to ongoing favorable severity trends in the 2002 through 2004 accident years. In addition, the general liability reserves adversely developed by approximately $14 million over the course of the year, which was driven mainly by our contractor completed operations business impacting accident years 2001 and prior, but partially offset by positive development in accident years 2002 through 2004.

In 2005 there was an adverse judicial ruling by the New Jersey Supreme Court, which is discussed in the Personal Automobile section of Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations. This adverse judicial ruling led to an increase in reserves of approximately $10 million, of which $6 million represents adverse development from prior years.

The cumulative net deficiencies seen in the years 1998 through 2003 are reflective of the soft market pricing in the industry during that time frame, which hit the lowest levels in 1999. The industry as a whole underestimated reserves and loss trends leading to intense pricing competition. Additionally, during 1999, Selective significantly increased gross and ceded reserves by $37.5 million for prior accident years related to unlimited medical claims ceded to the Unsatisfied Claim and Judgment Fund in the State of New Jersey. Approximately 24% of the cumulative gross deficiency for years 1998 and prior stems from this increase.

As discussed in the Insurance Operations section of Item 1. Business on this Annual Report on Form 10-K ( Form 10-K ), there are differences between SAP and GAAP accounting. The following table reconciles losses and loss expense reserves under SAP and GAAP at December 31, as follows:

| (in thousands) | **2006** | 2005 |
|---|---|---|
| Statutory losses and loss expense reserves [1] | $ **2,084,012** | 1,862,360 |
| Provision for uncollectible reinsurance | **2,700** | 3,500 |
| Pension adjustment | **2,619** | (59) |
| Other | **(299)** | |
| GAAP losses and loss expense reserve net | **2,089,032** | 1,865,801 |
| Reinsurance recoverable on unpaid losses and loss expenses | **199,738** | 218,248 |
| GAAP losses and loss expense reserves gross | $ **2,288,770** | 2,084,049 |

(1) Statutory losses and loss expense reserves are presented net of reinsurance recoverable on unpaid losses and loss expenses.

Environmental Reserves

Reserves established for liability insurance include exposure to environmental claims, both asbestos and non-asbestos. Selective s exposure to environmental liability is primarily due to: i) policies written prior to the introduction of the absolute pollutions endorsement in the mid-1980 s; and ii) the underground storage tank leaks, mostly from New Jersey homeowners policies in recent years. Selective s asbestos and non-asbestos environmental claims have arisen primarily from insured exposures in municipal government, small commercial risks, and homeowners policies. The emergence of these claims is slow and highly unpredictable.

Asbestos claims are claims presented to us in which bodily injury is alleged to have occurred as a result of exposure to asbestos and/or asbestos-containing products. During the past two decades, the insurance industry has experienced the emergence and development of an increasing number of asbestos claims. At December 31, 2006, asbestos claims constituted 89% of our 2,568 environmental claims compared with 88% of our 2,382 outstanding environmental claims at December 31, 2005.

Non-asbestos claims are pollution and environmental claims alleging bodily injury or property damage presented, or expected to be presented to us, other than asbestos claims. These claims primarily include landfills and leaking underground storage tanks. In past years, landfill claims have accounted for a significant portion of Selective s environmental claim unit s litigation costs. Over the past few years, Selective has been experiencing adverse development in its homeowners line of business as a result of unfavorable trends in claims for groundwater contamination caused by leakage of certain underground heating oil storage tanks in New Jersey.

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Selective refers all environmental claims to its centralized environmental claim unit, which specializes in the claim management of these exposures. Environmental reserves are evaluated on a case-by-case basis. As cases progress, the ability to assess potential liability often improves. Reserves are then adjusted accordingly. In addition, each case is reviewed in light of other factors affecting liability, including judicial interpretation of coverage issues.

IBNR reserve estimation for environmental claims is difficult, because in addition to other factors, there are significant uncertainties associated with critical assumptions in the estimation process, such as average clean-up costs, third-party costs, potentially responsible party shares, allocation of damages, insurer litigation costs, insurer coverage defenses and potential changes to state and federal statutes. Moreover, normal historically-based actuarial approaches are difficult to apply because past environmental claims are not indicative of future potential environmental claims. In addition, while models can be applied, such models can produce significantly different results with small changes in assumptions. As a result, management does not calculate a specific environmental loss range, as it would not be meaningful. Historically, Selective s environmental claims have been significantly less volatile and uncertain than the commercial lines industry. In part, this is due to the fact that Selective is the primary insurance carrier on the majority of its environmental exposures, thus providing more certainty in its reserve position compared to the insurance marketplace.

*Reinsurance*

In the ordinary course of their business, the Insurance Subsidiaries reinsure a portion of the risks that they underwrite in order to control exposure to losses and protect capital resources. Reinsurance also permits the Insurance Subsidiaries additional underwriting capacity by permitting them to accept larger risks and underwrite a greater number of risks without a corresponding increase in capital or surplus. For a premium paid by the Insurance Subsidiaries, reinsurers assume a portion of the losses ceded by the Insurance Subsidiaries. Selective uses traditional forms of reinsurance and does not use finite risk reinsurance. Amounts not reinsured are known as retention. The Insurance Subsidiaries use two types of reinsurance to control exposure to losses:

Treaty reinsurance, in which certain types of policies are automatically reinsured without the need for approval by the reinsurer of the individual risks covered; and

Facultative reinsurance, in which an individual insurance policy or a specific risk is reinsured with the prior approval of the reinsurer. Facultative reinsurance is primarily used for policies with limits greater than the limits available under the reinsurance treaties.

In addition to treaty and facultative reinsurance, the Insurance Subsidiaries are partially protected by the Terrorism Risk Insurance Act of 2002, which was modified and extended through December 31, 2007 via the Terrorism Risk Insurance Extension Act of 2005. For further information regarding this legislation, see Item 1A. Risk Factors of this Form 10-K.

Reinsurance does not legally discharge an insurer from its liability for the full-face amount of its policies, but it does make the reinsurer liable to the insurer to the extent of the reinsurance ceded. Reinsurance carries counterparty credit risk, which may be mitigated in certain cases by collateral such as letters of credit, trust funds, or funds withheld by the Insurance Subsidiaries. Selective attempts to mitigate the credit risk related to reinsurance by pursuing relationships with companies rated A- or higher in most circumstances and/or requiring collateral to secure reinsurance obligations. In addition, Selective employs procedures to continuously review the quality of reinsurance recoverables and reserve for uncollectible reinsurance. Selective also may take actions, such as commutations, in cases of potential reinsurer default. Some of the Insurance Subsidiaries reinsurance contracts include provisions that give Selective a contractual right to terminate and/or commute the reinsurers portion of the liabilities based on deterioration of the reinsurer s rating or financial condition.

Reinsurance recoverable balances tend to fluctuate based on the underlying losses incurred by the Insurance Subsidiaries. If a severe catastrophic event occurs, reinsurance recoverable balances may increase significantly. The reinsurance recoverable balances on paid and unpaid claims were 19% of stockholders equity at December 31, 2006 compared to 23% at December 31, 2005. These balances net of available collateral were 15% of stockholders equity at December 31, 2006 compared to 19% at December 31, 2005. Approximately half of the uncollateralized recoverable on paid and unpaid balances at December 31, 2006 and at December 31, 2005 stem from federal or state sponsored pools, which we believe to have minimal default risk. The following are the five largest individual uncollateralized reinsurance recoverables on paid and unpaid balances based on December 31, 2006 amounts:

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| ($ in thousands) | | As of: 12/31/06 | | As of: 12/31/05 | |
|---|---|---|---|---|---|
| **Reinsurer Name** | **Ratings: A.M. Best** | **Unsecured Recoverable on Paid and Unpaid** | **% of Total** | **Unsecured Recoverable on Paid and Unpaid** | **% of Total** |
| NJ Unsatisfied Claim Judgement Fund | State pool | $ 65,624 | 39% | $ 65,636 | 35% |
| Munich Reinsurance America, Inc. | A | 30,776 | 18% | 30,966 | 17% |
| National Flood Insurance Program | Federal program | 14,823 | 9% | 40,316 | 22% |
| Hannover Ruckversicherungs AG | A | 12,161 | 7% | 8,657 | 5% |
| Swiss Re America Corp. | A+ | 10,740 | 6% | 11,787 | 6% |
| All Other Reinsurers | various | 32,346 | 21% | 28,641 | 15% |
| Total | | $166,470 | | $186,003 | |
| % of Shareholders Equity | | 15% | | 19% | |

The table below summarizes the significant reinsurance treaties covering the Insurance Subsidiaries.

| **Treaty** | **Reinsurance Coverage** | **Terrorism Coverage** |
|---|---|---|
| TRIA, Federal Statutory Program | See above for the description of TRIA. 90% of all TRIA certified losses above the retention. Selective s retention for 2007 is approximately $200 million. Terrorism acts related to the use of nuclear, biological, chemical or radioactive reactions ( NBCR ) weapons are covered by TRIA provided that the Secretary of the Treasury certifies the event. | Current program is set to expire on December 31, 2007. For further information regarding this legislation and our risks concerning terrorism exposure, see Item 1A. Risk Factors of this Form 10-K. |
| Property Excess of Loss | $23 million above a $2 million retention in two layers. Losses other than TRIA certified losses are subject to the following reinstatements and annual aggregate limits:<br>$8 million in excess of $2 million layer provides unlimited reinstatements, no annual aggregate limit;<br>$15 million in excess of $10 million layer provides two reinstatements, $45 million in annual aggregate. | All NBCR losses are excluded regardless of whether or not they are certified under TRIA. For non-NBCR losses, the treaty distinguishes between acts certified under TRIA and those that are not. The treaty provides annual aggregate limits for TRIA certified (other than NBCR) acts of $24 million for the first layer and $22.5 million for the second layer. Non-certified terrorism losses (other than NBCR) are subject to the normal limits under the treaty. |

| | | |
|---|---|---|
| Property Catastrophe | 95% of $285 million above $40 million retention in three layers:<br><br>95% of losses in excess of $40 million up to $100 million;<br>95% of losses in excess of $100 million up to $175 million;<br>95% of losses in excess of $175 million up to $325 million; and<br>The treaty provides one reinstatement per layer, $541.5 million in annual aggregate limit, net of Selective s co-participation. | TRIA losses are excluded from the treaty. In addition, all NBC losses are excluded regardless of whether or not they are certified under TRIA. |

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| Treaty | Reinsurance Coverage | Terrorism Coverage |
| --- | --- | --- |
| Casualty Excess of Loss | Casualty Excess of Loss program is structured in two treaties: Workers Compensation only working layer treaty and all inclusive Casualty treaty, which provides coverage for all casualty lines including Workers Compensation. Workers Compensation losses have per occurrence coverage of \$48 million in excess of \$2 million retention and additional coverage of 75% of \$40 million in excess of \$50 million. All casualty losses have per occurrence coverage of \$45 million in excess of \$5 million retention and additional coverage of 75% of \$40 million in excess of \$50 million. Losses other than TRIA certified losses are subject to the following reinstatements and annual aggregate limits:<br><br>Workers Compensation only working layer of \$3 million in excess of \$2 million layer provides five reinstatements, \$18 million annual aggregate limit;<br><br>Casualty treaty:<br>\$7 million in excess of \$5 million layer provides three reinstatements, \$28 million annual aggregate limit;<br>\$9 million in excess of \$12 million layer provides two reinstatements, \$27 million annual aggregate limit;<br><br>\$9 million in excess of \$21 million layer provides one reinstatement, \$18 million annual aggregate limit; and<br><br>\$20 million in excess of \$30 million layer provides one reinstatement, \$40 million annual aggregate limit. | All NBC losses are excluded regardless of whether or not they are certified under TRIA. For non-NBC losses, the treaty distinguishes between acts certified under TRIA and those that are not.<br><br>TRIA certified losses (other than NBC) are subject to the following reinstatements and annual aggregate limits:<br><br>Workers Compensation only working layer of \$3 million in excess of \$2 million layer provides two reinstatements for TRIA losses, \$9 million annual aggregate limit;<br><br>Casualty treaty:<br><br>\$7 million in excess of \$5 million layer provides two reinstatements for TRIA losses, \$21 million annual aggregate limit;<br><br>\$9 million in excess of \$12 million layer provides two reinstatements for TRIA losses, \$27 million annual aggregate limit;<br>\$9 million in excess of \$21 million layer provides one reinstatement for TRIA losses, \$18 million annual aggregate limit;<br>\$20 million in excess of \$30 million layer provides one reinstatement for TRIA losses, \$40 million annual aggregate limit;<br><br>75% of \$40 million in excess of \$50 million layer provides up to \$30 million of coverage net of co-participation with one reinstatement for TRIA losses, \$60 million in net annual aggregate |

| | | |
|---|---|---|
| | 75% of $40 million in excess of $50 million layer provides up to $30 million of coverage net of co-participation with one reinstatement, $60 million in net annual aggregate limit. | limit; and<br><br>Non-certified terrorism losses (other than NBC) are subject to the normal limits under the treaty. |
| Surety and Fidelity Excess of Loss | The treaty provides per loss/per principal coverage up to $7.2 million in excess of $1.0 million retention and $0.8 million co-participation. The treaty provides the following reinstatements and annual aggregate limits:<br><br>$3 million in excess of $1 million layer provides two reinstatements, $8.1 million annual aggregate limit, net of our co-participation;<br><br>$5 million in excess of $4 million layer provides one reinstatement, $9 million annual aggregate limit, net of our co-participation. | Contract does not provide specific exclusions regarding terrorism losses. |
| Flood | 100% reinsurance by the federal government s National Flood Insurance Program Write Your Own program. | None. |

*Reinsurance Pooling Agreement*

The Insurance Subsidiaries are parties to an inter-company reinsurance pooling agreement ( Pooling Agreement ). The purpose of the Pooling Agreement is to:

Pool or share proportionately the underwriting profit and loss results of property and casualty underwriting operations through reinsurance;

Prevent any Insurance Subsidiary from suffering undue loss;

Reduce administration expenses; and

Permit all of the Insurance Subsidiaries to obtain a uniform rating from A.M. Best.

Under the Pooling Agreement, all of the Insurance Subsidiaries mutually reinsure all insurance risks written by them pursuant to the respective percentage set forth opposite each Insurance Subsidiary s name on the table below:

| **Insurance Subsidiary** | **Respective Percentage** |
|---|---|
| SICA | 49.5% |

| | |
|---|---|
| SWIC | 21.0% |
| SICSC | 9.0% |
| SICSE | 7.0% |
| SICNY | 7.0% |
| SAICNJ | 6.0% |
| SICNE | 0.5% |

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*Insurance Regulation*

General

Insurance companies are subject to supervision and regulation in the states in which they are domiciled and transact business. Such supervision and regulation relates to a variety of aspects of an insurance company s business and financial condition. The primary public purpose of such supervision and regulation is to protect the insurer s policyholders; not the insurer s shareholders. The extent of regulation varies, and generally is derived from state statutes that delegate regulatory, supervisory, and administrative authority to state insurance departments. Although the United States government does not directly regulate the insurance industry, federal initiatives from time to time can have an impact on the industry, such as the federal government s enactment and extension of TRIA.

The Financial Services Modernization Act of 1999, also known as the Gramm-Leach-Bliley Act ( GLB ), and related regulations govern, among other things, the privacy of consumer financial information. GLB limits disclosure by financial institutions of nonpublic personal information about individuals who obtain financial products or services for personal, family, or household purposes. GLB generally applies to disclosures to non-affiliated third parties, but not to disclosures to affiliates. Many states in which Selective operates have adopted laws that are at least as restrictive as GLB. Privacy of consumer financial information is an evolving area of regulation requiring continued monitoring to ensure continued compliance with GLB.

Selective cannot quantify the financial impact it would incur to satisfy revised or additional regulatory requirements that may be imposed in the future.

State Regulation

The regulatory authority of state insurance departments extends to such matters as insurer solvency standards, insurer and agent licensing, investment restrictions, payment of dividends and distributions, provisions for current losses and future liabilities, deposit of securities for the benefit of policyholders, restrictions on policy terminations, unfair trade practices, and approval of premium rates and policy forms. State insurance departments also conduct periodic examinations of the financial and business affairs of insurers and require insurers to file annual and other periodic reports relating to their financial condition. Regulatory agencies require that premium rates not be excessive, inadequate, or unfairly discriminatory. The Insurance Subsidiaries, consequently, must file all rates for commercial and personal insurance with the insurance department of each state in which they operate.

All states have enacted legislation that regulates insurance holding company systems. Each insurance company in a holding company system is required to register with certain insurance supervisory agencies and furnish information concerning the operations of companies within the holding company system that may materially affect the operations, management, or financial condition of the insurers. Pursuant to these laws, the respective departments may:
(i) examine Selective and the Insurance Subsidiaries at any time; (ii) require disclosure or prior approval of material transactions of the Insurance Subsidiaries with any affiliate; and (iii) require prior approval or notice of certain transactions, such as dividends or distributions to Selective Insurance Group, Inc. (the Parent ) from the Insurance Subsidiary domiciled in that state.

National Association of Insurance Commissioners ( NAIC ) Guidelines

The Insurance Subsidiaries are subject to statutory accounting principles and reporting formats established by the NAIC. The NAIC also promulgates model insurance laws and regulations relating to the financial and operational regulations of insurance companies, which includes the Insurance Regulatory Information System ( IRIS ). IRIS identifies 11 industry ratios and specifies usual values for each ratio. Departure from the usual values on four or more of the ratios can lead to inquiries from individual state insurance departments about certain aspects of the insurer s business. The Insurance Subsidiaries have consistently met the majority of the IRIS ratio tests.

NAIC model laws and regulations are not usually applicable unless enacted into law or promulgated into regulation by the individual states. The adoption of certain NAIC model laws and regulations is a key aspect of the NAIC Financial Regulations Standards and Accreditation Program, which also sets forth minimum staffing and resource levels for all state insurance departments. All of the Insurance Subsidiaries states of domicile, except New York, are accredited by the NAIC. Examinations conducted by, or along with, accredited states can be accepted by other states. The NAIC intends to create nationwide regulatory network of accredited states.

The NAIC model laws and regulations are also intended to enhance the regulation of insurer solvency. These model laws and regulations contain certain risk-based capital requirements for property and casualty insurance companies designed to assess capital adequacy and to raise the level of protection that statutory surplus provides for policyholders. Risk-based capital is measured by the four major areas of risk to which property and casualty insurers are exposed: (i) asset risk; (ii) credit risk; (iii) underwriting risk; and (iv) off-balance sheet risk.

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Insurers with total adjusted capital that is less than two times their Authorized Control Level, as calculated pursuant to the NAIC model laws and regulations, are subject to different levels of regulatory intervention and action. Based upon the unaudited 2006 statutory financial statements for the Insurance Subsidiaries, each Insurance Subsidiary s total adjusted capital substantially exceeded two times their Authorized Control Level.

**Investments Segment**

Our investment philosophy includes certain return and risk objectives for our equity and fixed maturity portfolios. The return objective of the equity portfolio is to meet or exceed a weighted-average benchmark of public equity indices. The primary return objective of the fixed maturity portfolio is to maximize after-tax investment yield and income while balancing certain risk objectives, with a secondary objective of meeting or exceeding a weighted-average benchmark of public fixed income indices. The risk objectives for all portfolios are to ensure investments are being structured conservatively, focusing on: (i) asset diversification; (ii) investment quality; (iii) liquidity, particularly to meet the cash obligations of the insurance operations; (iv) consideration of taxes; and (v) preservation of capital. At December 31, 2006, Selective s investment portfolio consisted of $2,946.9 million (82%) of fixed maturity securities, $307.4 million (9%) of equity securities, $197.0 million (5%) of short-term investments, and $144.8 million (4%) of other investments.

Selective s fixed maturity portfolio is comprised primarily of highly rated securities with almost 100% rated investment grade. The average rating of its fixed maturity securities is AA by Standard & Poors ( S&P ), their second highest credit quality rating. Selective expects to continue to invest primarily in high quality, fixed maturity investments. For further information regarding Selective s interest rate sensitivity, see Item 7A. Quantitative and Qualitative Disclosures about Market Risk in this Form 10-K. The average duration of the fixed maturity portfolio, including short-term investments of $197.0 million at December 31, 2006 and $185.1 million at December 31, 2005, was 3.8 years at December 31, 2006 and 4.0 years at December 31, 2005.

Selective s Investments segment operations are primarily based in Parsippany, New Jersey, while certain segments of the portfolio are managed by external money managers. For additional information about investments, see the sections entitled, Investments, in Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations, and Item 8. Financial Statements and Supplementary Data, Note 4 to the consolidated financial statements.

**Diversified Insurance Services Segment**

Selective s Diversified Insurance Services segment provides fee-based revenues that contribute to earnings, increase operating cash flow, and help mitigate potential volatility in insurance operating results. The Diversified Insurance Services segment is complementary to Selective s business model by sharing a common marketing or distribution system and creating new opportunities for independent agents to bring value-added services and products to their customers. In December 2005, Selective divested itself of its 100% ownership interest in CHN Solutions (Alta Services, LLC and Consumer Health Network Plus, LLC), which had historically been reported as part of the Managed Care component of the Diversified Insurance Services segment. For more information concerning the results of the Diversified Insurance Services segment for the last three fiscal years ended December 31, refer to Note 15, Discontinued Operations in Item 8. Financial Statements and Supplementary Data on this Form 10-K. The Diversified Insurance Services operation currently has two major components: (i) human resource administration outsourcing; and (ii) flood insurance.

*Human Resource Administration Outsourcing*

Human resource administration outsourcing ( HR Outsourcing ) products and services are sold by Selective HR Solutions, Inc. and its subsidiaries ( SHRS ), which are headquartered in Sarasota, Florida. SHRS s customers are small business owners who generally have existing relationships with independent insurance agents. SHRS leverages these relationships by using independent insurance agents as its distribution channel for its products and services in the states where it operates. As a Professional Employer Organization ( PEO ), SHRS enters into agreements with clients that establish a three-party relationship under which SHRS and the client are co-employers of the employees who work at the client s location ( worksite employees ). As of December 31, 2006, SHRS had approximately 27,000 worksite employees.

*Flood Insurance*

Selective is a servicing carrier in the Write-Your-Own ( WYO ) Program of the United States government s National Flood Insurance Program ( NFIP ). The WYO Program operates within the context of the NFIP, and is subject to its rules and regulations. The NFIP is administered by the Federal Emergency Management Agency ( FEMA ), which is a component of the Department of Homeland Security. The WYO Program is a cooperative undertaking of the insurance industry and FEMA. The WYO Program allows participating property and casualty insurance companies to write and service the Standard Flood Insurance Policy in their own names, while ceding all of the premiums collected on these policies to the

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federal government. The companies receive an expense allowance, or servicing fee, for policies written and claims processed under the program, while the federal government retains responsibility for all underwriting losses. Selective is servicing approximately 274,000 flood policies under the NFIP through over 6,100 independent agents in 50 states and the District of Columbia.

*Diversified Insurance Services Regulation*

The companies within the Diversified Insurance Services segment are subject to certain laws and regulations. In particular, as a co-employer for some of its clients, SHRS is subject to federal, state, and local laws and regulations relating to labor, tax, employment, employee benefits, and immigration matters. By contracting with its clients and creating a co-employer relationship with the worksite employees, SHRS may be assuming certain contractual and legal obligations and responsibilities of an employer and could incur liability for violations of such laws and regulations, even if it was not actually responsible for the conduct giving rise to such liability. Some states in which SHRS operates have already passed licensing or registration requirements for PEOs. These laws and regulations vary from state to state but generally provide for the monitoring of the fiscal responsibility of PEOs. Currently, many of these laws and regulations do not specifically address the obligations and responsibilities of co-employers. There can be no assurance that SHRS will be able to satisfy new or revised laws and regulations.

Flood insurance is offered through the federal government s NFIP program, which is managed by the Mitigation Division of FEMA under the U.S. Department of Homeland Security. In 2005, the destruction caused by the active hurricane season stressed the NFIP with unprecedented flood losses that have significantly increased the NFIP s deficit.

The NFIP currently covers flooding caused by storm surge, wherein water is pushed toward the shore by the force of the winds swirling around a storm. If this federal program is modified in an unfavorable manner, wherein flooding related to storm surge is no longer covered or is required to be covered by our Insurance Operations Homeowners policies, it could have a material adverse effect on Selective s financial condition, or results of operations, as it relates to Selective s Flood and/or Homeowners results.

Effective October 1, 2006, the fee paid to us by the NFIP decreased 0.6 points to 30.2% of premiums written. Future reductions in this rate could occur through legislative activity.

***Competition***

Selective faces significant competition in both the Insurance Operations and Diversified Insurance Services segments. Property and casualty insurance is highly competitive on the basis of both price and service, and is extensively regulated by state insurance departments. In 2006, Selective was ranked as the 47$^{th}$ largest property and casualty group in the United States based on the 2005 NPW, by A.M. Best in its list, Top Property/Casualty Writers. The Insurance Operations compete with regional insurers, such as Cincinnati Financial, Ohio Casualty, and Harleysville, and national insurance companies, such as Travelers, The Hartford, and Zurich. Selective also competes against direct writers of insurance coverage, primarily in personal lines, such as GEICO and Progressive. Many of these competitors have greater financial, technical, and operating resources than Selective. Purchasers of property and casualty insurance products do not always differentiate between insurance carriers and differences in coverage. The more significant competitive factors for most of Selective s insurance products are financial ratings, safety management, price, coverage terms, claims service, and technology. In addition, Selective also faces competition within each insurance agency that sells its insurance products as most of the agencies represent more than one insurance company.

With regard to the Diversified Insurance Services segment, during 2006, SHRS was ranked as the 11$^{th}$ largest Professional Employer Organization in a Staffing Industry Report published by Staffing Industry Analysts, Inc., based on 2005 gross revenue. Based on 2005 information, Selective s Flood line of business is the 7$^{th}$ largest WYO carrier for the NFIP based on information obtained from Statutory Annual Statements.

Please refer to Item 1A. Risk Factors, for a discussion of the factors that could impact Selective s ability to compete.

***Seasonality***

Selective s insurance business experiences modest seasonality with regard to premiums written. Due to the general timing of commercial policy renewals, premiums written are usually highest in January and July and lowest during the fourth quarter of the year. Although the writing of insurance policies experiences modest seasonality, the premiums related to these policies are earned consistently over the period of coverage. Losses and loss expenses incurred tend to remain consistent throughout the year, unless a catastrophe occurs from man-made or weather-related events such as hail, tornadoes, windstorms, hurricanes, and nor easters.

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***Customers***

No one customer or independent agency accounts for 10% or more of Selective s total revenue or the revenue of any one of its business segments.

***Employees***

At December 31, 2006, Selective had approximately 2,100 employees, of which 1,900 worked in the Insurance Operations and Investments segments and 200 worked in the Diversified Insurance Services segment.

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***Executive Officers of the Registrant***

The following table sets forth biographical information about Selective s Chief Executive Officer, Executive Officers, and senior management, as of March 1, 2007:

| Name, Age, Title | Occupation And Background |
|---|---|
| **Gregory E. Murphy,** 51<br>Chairman, President, and<br>Chief Executive Officer | Chairman, President, and Chief Executive Officer of Selective, present position since May 2000<br>President, Chief Executive Officer, and Director of Selective, May 1999 to May 2000<br>President, Chief Operating Officer, and Director of Selective, 1997 to May 1999<br>Other senior executive, management, and operational positions at Selective, since 1980<br>Director, Newton Memorial Hospital Foundation, Inc., since 1999<br>Director, Insurance Information Institute<br>Director, American Insurance Association (AIA), 2002 to December 2006<br>Trustee, the American Institute for CPCU (AICPCU) and the Insurance Institute of America (IIA), since June 2001<br>Graduate of Boston College (B.S.)<br>Harvard University (Advanced Management Program)<br>Certified Public Accountant (New Jersey) (Inactive) |
| **Jamie Ochiltree III,** 54<br>Senior Executive Vice<br>President, Insurance<br>Operations | Present position since February 2004<br>Variety of executive positions, Selective, 1994  February 2004<br>Miami University (B.A.)<br>Wharton School (Advanced Management Program) |
| **Richard F. Connell,** 61<br>Senior Executive Vice<br><br>President and Chief<br>Information Officer | Present position since January 2006<br>Executive Vice President and Chief Information Officer, August 2000 January 2006<br>Board member, ACORD, an insurance data standards organization<br>Central Connecticut State University (B.S.) |
| **Kerry A. Guthrie,** 49<br>Executive Vice President and<br>Chief Investment Officer | Present position since February 2005<br>Senior Vice President and Chief Investment Officer, Selective, August 2002  February 2005<br>Variety of investment positions, Selective, 1996  2002<br>Chartered Financial Analyst<br>Certified Public Accountant (New Jersey) (Inactive)<br>Member, New York Society of Security Analysts<br>Siena College (B.S. Accounting)<br>Fairleigh Dickinson University (M.B.A. Finance) |
| **Dale A. Thatcher,** 45<br>Executive Vice President,<br>Chief Financial Officer and<br>Treasurer | Present position since February 2003<br>Senior Vice President, Chief Financial Officer and Treasurer, Selective, April 2000  February 2003<br>Certified Public Accountant (Ohio) (Inactive) |

Chartered Property and Casualty Underwriter
Chartered Life Underwriter
Member of the American Institute of Certified Public Accountants
Member of the Ohio Society of Certified Public Accountants
University of Cincinnati (B.B.A. Accounting; M.B.A. Finance)

| Name, Age, Title | Occupation And Background |
|---|---|
| **Ronald J. Zaleski,** 52<br>Executive Vice President and<br><br>Chief Actuary | Present position since February 2003<br>Senior Vice President and Chief Actuary, Selective, February 2000 February 2003<br>Vice President and Chief Actuary, Selective, September 1999 February 2000<br>Fellow of Casualty Actuarial Society<br>Member of the American Academy of Actuaries<br>Loyola College (B.A.) |
| **Victor Daley,** 63<br>Executive Vice President,<br>Human Resources | Present position since September 2005<br>Executive Vice President, Chief Administrative, and Human Resources Officer for AmerUs Group, September 1995 October 2004<br>Providence College (B.S.)<br>Roosevelt University (M.P.A.)<br>Harvard University (Advanced Management Program) |
| **Sharon R. Cooper,** 45<br>Senior Vice President and<br>Director of Communications | Present position since February 2003.<br>Vice President and Director of Communications, Selective, December 2000 February 2003<br>Director of Media Relations, Allstate Insurance, 1996 December 2000<br>Member, Society of Chartered Property and Casualty Underwriters<br>University of Illinois (B.A.) |
| **Michael H. Lanza,** 45<br>Senior Vice President,<br>General Counsel and<br>Corporate Secretary | Present position since July 2004<br>Corporate advisor and legal consultant, April 2003 July 2004<br>Executive Vice President & Corporate Secretary, QuadraMed Corporation, a publicly-traded healthcare technology company, September 2000 March 2003<br>Member, Society of Corporate Secretaries and Corporate Governance Professionals<br>University of Connecticut (B.A.)<br>University of Connecticut School of Law (J.D.) |

Information regarding Selective s directors is included in the definitive Proxy Statement for the 2006 Annual Meeting of Stockholders to be held on April 24, 2007 in Information About Proposal 1, Election of Directors, and is also incorporated by reference into Part III of this
Form 10-K.

***Available Information***

Selective files its annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, proxy statements, and other required information with the SEC. The public may read and copy any materials on file with the SEC at the SEC s Public Reference Room at 100 F Street N.E., Washington, D.C. 20549. The public may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. The SEC also maintains an Internet site, www.sec.gov, that contains reports, proxy and information statements, and other information regarding issuers, including Selective, that file electronically with the SEC.

Selective has a website, www.selective.com, through which its annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Section 13(a) or

15(d) of the Securities Exchange Act of 1934 ( Exchange Act ) are available free of charge as soon as reasonably practicable after they are electronically filed with, or furnished to the SEC.

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## Item 1A. Risk Factors

Certain risk factors exist that can have a significant impact on Selective s business, results of operations, and financial condition. The impact of these risk factors could also impact certain actions that Selective takes as part of its long-term capital strategy including, but not limited to, contributing capital to subsidiaries in its Insurance Operations and Diversified Insurance Services segments, issuing additional debt and/or equity securities, repurchasing shares of the Parent s common stock ( Common Stock ), or increasing stockholders dividends. The following list of risk factors is not exhaustive and others may exist. Selective operates in a continually changing business environment, and new risk factors emerge from time to time. Consequently, Selective can neither predict such new risk factors nor assess the impact, if any, they might have on its business in the future.

***The property and casualty insurance industry is cyclical*.**

Historically, the results of the property and casualty insurance industry have experienced significant fluctuations due to high levels of competition, economic conditions, interest rates, and other factors. We have experienced the following fluctuations in Commercial Lines premium pricing, excluding exposure, over the past several years:

During 2006, pure price on Commercial Lines decreased 1.7%;

During 2005, pure price on Commercial Lines remained flat compared to 2004;

From 2001 2004, pure price on Commercial Lines was increasing in a range from 4.3% to 12.6%; and

For several years prior to 2001, we experienced decreases in pure price in our Commercial Lines operations.

The industry s profitability also is affected by unpredictable developments, including:

Natural and man-made disasters;

Fluctuations in interest rates and other changes in the investment environment that affect investment returns;

Inflationary pressures (medical and economic) that affect the size of losses;

Judicial decisions that affect insurers liabilities;

Changes in the frequency and severity of losses;

Pricing and availability of reinsurance in the marketplace; and

Weather-related impacts due to the effects of global warming trends.

***Catastrophic events***

Results of property and casualty insurers are subject to weather and other conditions. While one year may be relatively free of major weather occurrences or other disasters, another year may have numerous such events, causing results to be materially worse than other years. Selective s Insurance Subsidiaries have experienced catastrophe losses and the Company expects them to experience such losses in the future.

Various natural and man-made events can cause catastrophes, including, but not limited to, hurricanes, tornadoes, windstorms, earthquakes, hail, terrorism, explosions, severe winter weather, and fires. The frequency and severity of these catastrophes are inherently unpredictable. The extent of losses from a catastrophe is determined by the severity of the event and the total amount of insured exposures in the area affected by the event. Although catastrophes can cause losses in a variety of property and casualty lines, most of the catastrophe-related claims of Selective s Insurance Subsidiaries historically have been related to commercial property and homeowners coverages. Selective s property and casualty insurance business is c