

MERCHANTS GROUP INC

Form 10-K

March 28, 2007

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**SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
Form 10-K**

**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

**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 1-9640

MERCHANTS GROUP, INC.

(Exact name of registrant as specified in its charter)

Delaware

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

16-1280763

(I.R.S. Employer Identification No.)

250 Main Street, Buffalo, New York

(Address of principal executive offices)

14202

(Zip Code)

716-849-3333

(Registrant's telephone number, including area code)

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

Title of each class **Common Stock, \$.01 par value per share**

Name of each exchange on which registered **American Stock Exchange, Inc.**

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. Yes 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. Yes No

Note checking the box above will not relieve any registrant required to file reports pursuant to Section 13 or 15(d) of the Exchange Act from their obligations under those Sections.

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 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.

Indicate by checkmark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer.

Large accelerated filer

Accelerated filer

Non-accelerated filer

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

As of March 16, 2007, 2,145,652 shares of common stock were outstanding. The aggregate market value of the common shares held by non-affiliates of Merchants Group, Inc. on March 21, 2007 was \$37,796,000. Solely for purposes of this calculation, the Company deemed every person who beneficially owned 5% or more of its common

stock and all directors and executive officers to be affiliates.

DOCUMENTS INCORPORATED BY REFERENCE: NONE

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DECEMBER 31, 2006

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PART I

Item 1. BUSINESS.

General

Merchants Group, Inc. (the Company), which was incorporated in August 1986 as a Delaware holding company, offers property and casualty insurance generally to preferred risk individuals and small to medium sized businesses in the northeastern United States through its wholly owned subsidiary, Merchants Insurance Company of New Hampshire, Inc. (MNH).

Administration

The Company and MNH operate and manage their business in conjunction with Merchants Mutual Insurance Company (Mutual), a New York domiciled mutual property and casualty insurance company, under a services agreement (the Services Agreement) that became effective January 1, 2003. At December 31, 2006, Mutual owned 11.9% of the Company's issued and outstanding common stock. The Company and MNH do not have any operating assets or employees. In accordance with the Services Agreement, Mutual provides the Company and MNH with the facilities, management and personnel required to operate their day-to-day business. The Services Agreement covers: administrative services, underwriting services, claims services and investment and cash management services.

Effective January 1, 2003, Mutual and MNH agreed to pool, or share, underwriting results on their traditional insurance business (Traditional Business) by means of a reinsurance pooling agreement (the Pooling Agreement). The Pooling Agreement applies to premiums earned and losses incurred after the effective date. It does not apply to any new endeavor of either Mutual or MNH outside of their Traditional Business, unless the companies agree otherwise. Neither Mutual or MNH has entered into any endeavor outside of their Traditional Business.

The Pooling Agreement provides for MNH to cede, or transfer, to Mutual all premiums and risks on its Traditional Business during the term of the agreement, and then to assume from Mutual a percentage of all of Mutual's and MNH's Traditional Business (the Pooled Business). MNH assumed 25% of the Pooled Business in 2006, 30% in 2005 and 35% in 2004. MNH's share of the Pooled Business will be 25% in 2007. Mutual retains a share of the risk in MNH's Traditional Business under Mutual's control pursuant to a profit and loss sharing arrangement in the Pooling Agreement based on the loss and loss adjustment expense (LAE) experience of the Pooled Business. The Company believes the Pooling Agreement and profit (or loss) sharing feature included therein aligns the interests of MNH and Mutual.

On October 31, 2006, the Company entered into an Agreement and Plan of Merger (the Merger Agreement) with American European Group, Inc. (AEG), a Delaware corporation, and American European Financial, Inc., a newly-formed Delaware corporation that is a wholly owned subsidiary of AEG (Merger Sub), pursuant to which Merger Sub will merge with and into the Company (the Merger). Upon completion of the Merger, the Company will be a wholly owned subsidiary of AEG. The Merger is expected to be consummated in the first quarter of 2007. The Company's shareholders approved the Merger on February 1, 2007. The New Hampshire Department of Insurance approved the Merger on March 21, 2007. Upon completion of the Merger, each issued share of the Company's common stock (other than shares held by the Company or by any of its

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subsidiaries, which will be cancelled, and other than shares as to which the holders have validly exercised appraisal rights) will be converted into the right to receive \$33.00 in cash, without interest, plus (subject to certain contingencies) an additional amount per share equal to a pro rated portion of the Company's current regular dividends that have not been paid through the time of the closing.

On December 22, 2006 the Company, Mutual and AEG entered into an agreement (the Renewal Rights Agreement) whereby, contingent upon completion of the Merger, MNH will sell the renewal rights to all of its Traditional Business to Mutual. Substantially all of MNH's business will be renewed by Mutual or one of its subsidiaries. The Renewal Rights Agreement provides that Mutual will continue to provide underwriting and claims services for policies and claims on MNH's Traditional Business. The Renewal Rights Agreement also provides, upon completion of the Merger, for the Pooling Agreement between Mutual and MNH to continue through December 31, 2008 and subject to certain conditions, December 31, 2009.

The Renewal Rights Agreement includes notice by Mutual of the termination of the Administrative Annex of the Services Agreement effective June 30, 2007 unless terminated earlier because the Merger has become effective. In addition, it includes conditional termination by Mutual of the remaining annexes to the Services Agreement and the Reinsurance Pooling Agreement effective December 31, 2007, in the event the Renewal Rights Agreement does not become effective by June 30, 2007.

Marketing

Mutual markets the Traditional Business of the Company and Mutual jointly through approximately 600 independent agents. The primary marketing efforts of the Company and Mutual (collectively referred to as Merchants) are directed to those independent agents who, through their insurance expertise, the broad range of products they offer, and their focus on service, provide value for the insurance consumer.

Mutual and the Company offer the same portfolio of insurance products. The Company's products are generally offered to preferred risks while Mutual's products are generally offered to standard risks. Preferred risks meet more restrictive underwriting criteria than standard risks and generally incur fewer losses. Accordingly, the preferred risks are charged premium rates that are typically 10-15% lower than standard rates.

The Company believes that Merchants, as a regional insurance group, has certain advantages, including a closer relationship with its agents and a better knowledge of its operating territories that enable it to compete effectively against national carriers. The Company believes Merchants distinguishes itself from its competitors by providing its agents and policyholders with superior service and ease of doing business and products that target certain segments of the commercial and personal insurance markets. Merchants also offers an agents' compensation program which, in addition to standard commission rates, includes a profit sharing plan.

Through Mutual, the Company services its agents from six Strategic Business Centers (Buffalo, Albany and Hauppauge, New York; Manchester, New Hampshire; Moorestown, New Jersey; and Columbus, Ohio) and from its home office in Buffalo, New York. The Strategic Business Centers are located in the Company's operating territories and focus primarily on policy sales and underwriting. The Regional Manager of a Strategic Business Center appoints new agents, and agrees upon premium objectives and annual unit sales with the principal(s) of each agency. Regional Managers and Territory Managers, or TMs, develop customized business plans for each agency. These plans identify profitable business

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opportunities and recommend the actions required to achieve the objectives agreed to by the agency and the Company.

TM's meet frequently with targeted agencies' sales staff to review Merchants' renewal policies, as well as to solicit policies new to the agent and/or Merchants. While TM's are capable of providing quotes directly to the agent while in an agent's office, much of that capability has migrated to Merchants' internet website: www.merchantsgroup.com. Through the password protected Agency Gateway of the website agents are able to obtain instant quotes for certain commercial and personal products and to issue from quote, by entering all underwriting information required to issue policies for their customers. This allows for rapid responses to agents' quote requests and reduces expenses associated with quoting and policy issuance.

Each Strategic Business Center has an Agents' Advisory Council that meets at least twice a year. The Advisory Councils provide a forum for Merchants and its agents to discuss issues of mutual interest, and assure that the agents' business needs are being considered by Merchants. Additionally, the Co-chairpersons of the Advisory Councils from each Strategic Business Center meet twice each year with senior officers of Merchants.

In addition to standard commissions paid as a percentage of premiums written, the Company's agents are eligible to participate in the Agents' Profit Sharing Plan. This plan rewards agents based on total premiums written and the loss and allocated loss adjustment expenses (LAE) ratio on business placed during each year by the agent with the Company and Mutual. The Company believes the terms of the Agents' Profit Sharing Plan encourage its agents to increase the volume of profitable Traditional Business they place with Merchants. The Company's share of payments for the Agents' Profit Sharing Plan for 2006 assumed under the Pooling Agreement totaled \$1,263,000, or 2.5%, and \$1,404,000, or 2.4%, of the Company's share of group-wide direct premiums written for 2006 and 2005, respectively.

Insurance Underwriting

The Company is licensed to issue insurance policies in 13 states, primarily in the northeastern United States. In 2006, net premiums written totaled \$37,740,000, with 80% of the net premiums written derived from commercial insurance and 20% from personal insurance.

The following table sets forth the distribution of the combined Company and Mutual Traditional Business direct premiums written by state for the years indicated. See the Administration section of this Item for further discussion.

| | 2004 | As of December 31, 2005 | 2006 |
|---------------|------|----------------------------|------|
| New York | 63% | 63% | 61% |
| New Jersey | 14 | 13 | 14 |
| New Hampshire | 8 | 8 | 7 |
| Pennsylvania | 7 | 7 | 7 |
| Massachusetts | 3 | 4 | 4 |
| Rhode Island | 3 | 3 | 2 |
| Other | 2 | 2 | 5 |
| Total | 100% | 100% | 100% |

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The Company and Mutual are licensed to underwrite most major lines of property and casualty insurance. They issue policies primarily to individuals and small to medium sized commercial businesses. The types of risks insured include:

Personal automobile full coverage of standard performance automobiles, generally requiring drivers with good driving records during the past three years at the time of first issuance by Merchants.

Homeowners properties generally with no losses in the last three years that are less than 30 years old and valued between \$125,000 and \$500,000.

Commercial automobile primarily light and medium duty vehicles operating in a limited radius, with complete background information required of all drivers.

Commercial multi-peril properties with medium to high construction quality and low to moderate fire exposure, and occupancies with low to moderate exposure to hazardous materials and processes.

General liability low hazard service, mercantile and light processing businesses, generally with at least three years of business experience and with no losses in the last three years.

Workers compensation risks with low loss frequency and severity, low to moderate exposure to hazardous materials and processes, and favorable experience modification factors. Generally, workers compensation insurance is written in conjunction with other commercial insurance.

The Company and Mutual use automated underwriting processes for personal automobile, homeowners and certain commercial products, which perform an initial review of policy applications based upon established underwriting guidelines. Applications that do not meet the guidelines for automated acceptance are either referred to underwriters who review the applications and assess exposure, or rejected if the risk characteristics are such that neither the Company nor Mutual would insure the applicant.

Merchants establishes premium rates for most of its products based on its loss experience, in some cases after considering prospective loss costs provided by the Insurance Services Office, Inc., an industry advisory group, for the individual and commercial classes of business that it insures. Merchants establishes rates independently for its personal automobile and homeowners insurance policies and its specialty products, such as its Contractors Coverall Plus and businessowners policies.

The following table shows, for each of the years in the three year period ended December 31, 2006 (i) the amount of the Company's net premiums written attributable to various personal and commercial products and (ii) underwriting results attributable to each such product as measured by the calendar year loss and allocated loss adjustment expense (LALAE) ratio for such product. The LALAE ratio is the ratio of incurred losses and allocated LAE to net premiums earned for a given period.

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| | Year ended December 31, | | | | | | | | |
|--|-------------------------------|---------------|----------------|-------------------------------|---------------|----------------|-------------------------------|---------------|----------------|
| | 2004 | | | 2005 | | | 2006 | | |
| | Premiums Written Amount | % | LALAE Ratio | Premiums Written Amount | % | LALAE Ratio | Premiums Written Amount | % | LALAE Ratio |
| | (dollars in thousands) | | | | | | | | |
| Personal | | | | | | | | | |
| Auto Liability | \$ 7,467 | 14.1% | 59.5% | \$ 4,395 | 9.7% | 21.0% | \$ 2,496 | 6.6% | 24.7% |
| Auto Physical Damage | 3,873 | 7.3 | 42.8 | 2,254 | 5.0 | 36.0 | 1,693 | 4.5 | 40.8 |
| Homeowners Multi-Peril | 5,080 | 9.6 | 59.4 | 4,266 | 9.5 | 50.3 | 3,405 | 9.0 | 69.1 |
| Total | 16,420 | 31.0 | 55.1 | 10,915 | 24.2 | 34.5 | 7,594 | 20.1 | 46.5 |
| Commercial | | | | | | | | | |
| Auto Liability | 12,542 | 23.6 | 51.2 | 11,074 | 24.5 | 32.0 | 9,697 | 25.7 | 40.9 |
| Auto Physical Damage | 2,734 | 5.1 | 38.1 | 2,235 | 5.0 | 37.9 | 2,094 | 5.5 | 42.9 |
| Commercial Multi-Peril | 15,701 | 29.6 | 76.6 | 14,926 | 33.1 | 63.9 | 13,084 | 34.7 | 35.8 |
| Workers Compensation | 4,536 | 8.5 | 72.8 | 4,461 | 9.9 | 9.1 | 4,235 | 11.3 | 117.1 |
| Other | 1,169 | 2.2 | 75.5 | 1,524 | 3.3 | 189.1 | 1,036 | 2.7 | 18.1 |
| Total | 36,682 | 69.0 | 64.6 | 34,220 | 75.8 | 50.2 | 30,146 | 79.9 | 48.3 |
| Total Personal & Commercial | \$ 53,102 | 100.0% | 61.2 | \$ 45,135 | 100.0% | 45.9 | \$ 37,740 | 100.0% | 47.9 |

Calendar year LALAE ratios set forth in the preceding table include an estimate of LALAE for that accident year, as well as increases or decreases in estimates made in that year for prior accident years' LALAE. Depending on the size of the increase or decrease in prior accident years' LALAE, calendar year LALAE ratios may not be as indicative of the profitability of policies in force in a particular year as accident year LALAE ratios, which do not take into account increases or decreases in estimates of reserves for prior accident years' LALAE.

The following table sets forth the composition of voluntary direct premiums written for 2002 through 2006:

| | For the Year Ended December 31, | | | | |
|--------------|---------------------------------|-------------|-------------|-------------|-------------|
| | 2002 | 2003 | 2004(1) | 2005(1) | 2006 (1) |
| Commercial | 40% | 63% | 73% | 79% | 82% |
| Personal | 60 | 37 | 27 | 21 | 18 |
| Total | 100% | 100% | 100% | 100% | 100% |

- (1) Shown on a group-wide basis for the Pooled Business. See the Administration section of this Item for further discussion.

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Commercial Business

Merchants' commercial business is primarily retail and mercantile in nature and generally consists of small to medium sized, low hazard commercial risks which as a group have relatively stable loss ratios. Merchants' underwriting criteria attempt to exclude classes of risks that are considered to be high hazard or volatile, or which involve substantial risk of latent injury or other long-tail liability exposures. The Company and Mutual offer specialized products within the commercial multi-peril line such as the Contractors Coverall Plus policy for artisan and trade contractors.

The Company believes that it and Mutual can insure commercial business profitably by selecting those classes of risks that offer better than average profit potential and charging rates commensurate with the quality of the risk insured. Merchants competes for commercial business based upon the service it provides to agents and policyholders, the compensation it pays to its agents and the price of its products. Merchants establishes prices after considering its costs, the exposures inherent in a particular class of risk, estimated investment income, projected future trends in loss frequency and severity, the degree of competition within a specific territory and a provision for profit. Accordingly, the prices of Merchants' commercial products may vary considerably from competitors' prices.

Personal Business

Merchants generally targets experienced drivers with no accidents or moving violations in the last three years for personal automobile insurance, and medium to high value homes with systems (e.g. heating, plumbing, electrical) that are less than thirty years old in fire protected areas for homeowners' insurance. Personal automobile premium rates attempt to cover costs associated with required participation in involuntary personal automobile programs, in addition to the costs directly associated with the policies written voluntarily. Due to volatility in the size of the New York Automobile Insurance Plan (NYAIP) and the poor loss experience associated with that business in most years, the Company historically had been unable to fully recover costs of the NYAIP business with premium rates charged for its voluntary personal automobile business. In 2002 the Company implemented a moratorium on writing new voluntary personal automobile business in New York which remains in effect. Further, in order to minimize the adverse impact of assignments from the NYAIP, in 2003 the Company began to purchase territorial credits from an unaffiliated company. The credits against NYAIP assignments were generated by another insurance company for writing private passenger automobile business in localities in New York with private passenger automobile availability problems. The other insurance company, by nature of its concentration in private passenger automobile business in credit territories, generated more credits than it required to offset its NYAIP assignments.

Involuntary Business

As a condition to writing voluntary business in most states in which it operates, the Company and Mutual must participate in state-mandated programs that provide insurance for individuals and businesses unable to obtain insurance voluntarily, primarily for personal automobile insurance. The legislation creating these programs usually allocates a pro rata portion of the risks attributable to such insureds to each company writing voluntary business in the state on the basis of its historical voluntary premiums written or the number of automobiles which it historically insures voluntarily. Due to changing market conditions the Company cannot predict the size of the NYAIP for 2007 or future years.

The Company's gross (direct and assumed) premiums written attributable to involuntary policies were \$1,183,000, \$2,518,000 and \$3,259,000 in 2006, 2005 and 2004, respectively, mostly in New York.

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These amounts represent the Company's pro-forma share of the applicable amount of pooled direct and assumed premiums written.

Pooling Agreement

The Company believes pooling of risks is advantageous for the following reasons: (1) Mutual's risk selection, pricing, marketing and claims philosophies and practices are consistent with and complementary to the Company's; (2) as market conditions change, management can adjust eligibility criteria to permit Merchants as a group to participate in a changing rate environment without concern for any conflict of interest; (3) pooling, especially with Mutual subject to profit and loss sharing, more closely aligns the interests of the Company and Mutual; and (4) by reducing its share of participation in the pool, the Company is able to create more capacity to pursue other endeavors, which it might not otherwise be able to do as a result of regulatory constraints on non-renewal of business, particularly for personal business.

Claims

Insurance claims on policies written by the Company and by Mutual are investigated and settled by claims adjusters employed by Mutual pursuant to the Services Agreement. Mutual maintains three claims offices within its operating territories. In areas where there is insufficient claim volume to justify the cost of internal claims staff, Mutual uses independent appraisers and adjusters to investigate claims. Merchants' claims policy emphasizes timely investigation of claims, settlement of valid claims for equitable amounts, maintenance of adequate reserves for claims and control of external claims adjustment expenses. In order to support its claims policy, Merchants maintains a process designed to ensure that as soon as practical, claims are assigned an accurate reserve value based on available information. The process includes the centralization of certain branch claims operations and an emphasis on the training of claims adjusters and supervisors by senior claims staff. Merchants' claims policy is designed to provide agents and policyholders with prompt service and support.

Claims settlement authority levels are established for each adjuster, supervisor and manager based on their expertise and experience. When Merchants receives notice of a claim, it is assigned to an adjuster based upon its type and severity. The claims staff then reviews the claim, obtains appropriate information and establishes a loss reserve. Claims that exceed certain dollar amounts or that cannot be readily settled are assigned to more experienced claims staff.

Loss and Loss Adjustment Expense Reserves

The Company, like other insurance companies, establishes reserves for losses and LAE. These reserves are estimates intended to cover the probable ultimate cost of settling all losses incurred and unpaid, including those losses not yet reported to the Company. An insurer's ultimate liability is likely to differ from its interim estimates because during the life of a claim, which may be many years, additional facts affecting the amount of damages and an insurer's liability may become known. The reserves of an insurer are frequently adjusted based on monitoring by the insurer and are periodically reviewed by state insurance departments. The Company retains an independent actuarial firm to satisfy state insurance departments' requirements for the certification of reserves for losses and LAE.

Loss reserves are established for known claims based on the type and circumstance of the loss and the results of similar losses. For claims not yet reported to the Company, loss reserves are based on statistical information from previous experience periods adjusted for inflation, trends in court decisions and economic conditions. LAE reserves are intended to cover the ultimate cost of investigating all losses that

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have occurred and defending lawsuits, if any, arising from these losses. LAE reserves are evaluated periodically using statistical techniques which compare current costs with historical data. Inflation is implicitly reflected in the reserving process through analysis of cost trends and review of historical reserve results. With the exception of workers compensation claims, loss reserves are not discounted for financial statement purposes.

The Company's reserving process is based on the assumption that past experiences, adjusted for the effect of current developments and trends, are relevant in predicting future events. In the absence of specific developments, the process also assumes that the legal climate affecting the claims process and underlying liabilities remains constant. Other assumptions employed by the Company or its actuarial firm may change from time to time as circumstances change. In estimating loss and LAE reserves, the Company employs a number of actuarial methods, depending on their applicability to each product, in order to balance the advantages and disadvantages of each method. Typically, several estimates are developed for each product using different methods. However, the Company does not believe it is appropriate to sum the high and low values developed using different actuarial methods for each product to determine a range for the Company's total loss and LAE reserves. Instead, the Company's actuary and its consulting actuary provide the Company with their respective best estimates of total loss and LAE reserves by summing their best estimate for each product. The Company's small size, the presence or absence of a limited number of moderate losses, and the timing of the reporting of such losses to the Company by claimants could result in changes in actuarial estimates that are significant to the Company's net income for a quarter or a year.

Due to uncertainties inherent in the estimation of incurred losses and LAE, the Company has recorded changes in reserves for prior accident years' losses and LAE. In 2006 the Company decreased reserves for prior years by \$4,170,000 primarily due to favorable loss development related to private passenger auto liability and commercial package policies, somewhat offset by unfavorable development on workers' compensation policies. In 2005 and 2004, the Company decreased reserves for prior years by \$3,303,000 and \$843,000, respectively, primarily due to favorable loss development related to private passenger auto liability and workers' compensation policies, somewhat offset by unfavorable development on commercial package policies.

The following table sets forth the changes in the reserve for losses and LAE for 2006, 2005 and 2004.

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| | Year Ended December 31, | | |
|---|-------------------------|----------------|------------|
| | 2006 | 2005 | 2004 |
| | | (in thousands) | |
| Reserve for losses and LAE at beginning of year | \$ 115,191 | \$ 128,415 | \$ 146,474 |
| Less reinsurance recoverables | (13,807) | (15,630) | (22,715) |
| Net balance at beginning of year | 101,384 | 112,785 | 123,759 |
| Provision for losses and LAE for claims occurring in: | | | |
| Current year | 26,317 | 29,711 | 38,524 |
| Prior years | (4,170) | (3,303) | (843) |
| | 22,147 | 26,408 | 37,681 |
| Losses and LAE payments for claims occurring in: | | | |
| Current year | (9,382) | (10,359) | (13,647) |
| Prior years | (20,810) | (27,450) | (35,008) |
| | (30,192) | (37,809) | (48,655) |
| Reserve for losses and LAE at end of year, net | 93,339 | 101,384 | 112,785 |
| Plus reinsurance recoverables | 11,575 | 13,807 | 15,630 |
| Balance at end of year | \$ 104,914 | \$ 115,191 | \$ 128,415 |

The first line of the following table presents, as of the end of the year at the top of each column, the estimated amount of unpaid losses and LAE, net of reinsurance, for claims arising in that year and in all prior years, including claims that had occurred but were not yet reported to the Company. For each column, the rows of the table present, for the same group of claims, the amount of unpaid losses and LAE, net of reinsurance, as re-estimated as of the end of each succeeding year. The estimate is modified as more information becomes known about the number and severity of claims for each year. The cumulative redundancy (deficiency) represents the change in the estimated amount of unpaid losses and LAE, net of reinsurance, from the end of the year at the top of each column through the end of 2006.

For each column in the table, the change from the liability for losses and LAE shown on the first line to the liability as re-estimated as of the end of the following year was included in operating results for the following year. That change includes the change in the previous year's column from the liability as re-estimated one year later to the liability as re-estimated two years later which, in turn, includes the change in the second preceding column from the liability as re-estimated two years later to the liability as re-estimated three years later, and so forth.

The rows of the table appearing under the caption Net paid (cumulative) as of: present, as of the end of each succeeding year, the amount of paid losses and LAE for claims unpaid at the end of the year at the top of each column:

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| | 1996 | 1997 | 1998 | 1999 | As of December 31, | | 2002 | 2003 | 2004 | 2005 |
|---|----------------------|---------------|--------------|------------------|--------------------|------------------|---------------|--------------|--------------|--------------|
| | | | | | 2000 | 2001 | | | | |
| | | | | | (in thousands) | | | | | |
| Net liability for losses and LAE: | \$ 126,260 | \$ 130,781 | \$ 126,820 | \$ 127,458 | \$ 131,178 | \$ 132,113 | \$ 127,756 | \$ 123,759 | \$ 112,785 | \$ 101,384 |
| Liability re-estimated as of: | | | | | | | | | | |
| One year later | 130,768 | 128,636 | 123,071 | 128,886 | 129,704 | 128,328 | 127,666 | 122,916 | 109,482 | 97,214 |
| Two years later | 133,029 | 130,498 | 120,345 | 123,299 | 129,621 | 132,674 | 129,722 | 122,071 | 106,843 | |
| Three years later | 132,948 | 127,893 | 113,661 | 124,944 | 133,769 | 135,865 | 129,254 | 120,827 | | |
| Four years later | 129,210 | 122,508 | 114,068 | 128,121 | 138,538 | 137,813 | 128,492 | | | |
| Five years later | 124,238 | 122,347 | 117,678 | 131,977 | 140,804 | 137,990 | | | | |
| Six years later | 124,319 | 125,741 | 120,958 | 133,913 | 142,403 | | | | | |
| Seven years later | 127,659 | 128,998 | 123,359 | 134,697 | | | | | | |
| Eight years later | 130,280 | 130,907 | 123,310 | | | | | | | |
| Nine years later | 131,887 | 130,995 | | | | | | | | |
| Ten years later | 131,334 | | | | | | | | | |
| Net cumulative redundancy (deficiency): | \$ (5,074) %(4.0) | (214) (.2) | 3,510 2.8 | (7,239) (5.7) | (11,225) (8.6) | (5,877) (4.4) | (736) (.6) | 2,932 2.4 | 5,942 5.3 | 4,170 4.1 |
| Net paid (cumulative) as of: | | | | | | | | | | |
| One year later | 40,954 | 42,433 | 37,125 | 40,970 | 45,461 | 40,843 | 35,168 | 35,008 | 27,450 | 20,810 |
| Two years later | 69,035 | 66,477 | 63,325 | 69,393 | 70,075 | 64,959 | 61,031 | 56,290 | 43,250 | |
| Three years later | 86,364 | 86,313 | 80,142 | 86,670 | 85,772 | 83,552 | 78,109 | 68,677 | | |
| Four years later | 98,300 | 97,770 | 89,383 | 96,222 | 98,053 | 96,986 | 86,588 | | | |
| Five years later | 105,787 | 104,282 | 94,809 | 102,892 | 107,913 | 103,268 | | | | |
| Six years later | 109,639 | 107,431 | 99,131 | 108,438 | 112,706 | | | | | |
| Seven years later | 111,822 | 110,193 | 103,180 | 111,091 | | | | | | |
| Eight years later | 114,246 | 113,200 | 105,167 | | | | | | | |
| Nine years later | 116,279 | 115,174 | | | | | | | | |
| Ten years later | 117,446 | | | | | | | | | |
| Gross/net liability for losses and | | | | | | | | | | |

LAE:

| | | | | | | | | | | |
|---|----------------------|--------------|--------------|--------------------|--------------------|--------------------|-------------------|-------------|--------------|--------------|
| Initial gross liability for losses and LAE: | \$ 133,859 | \$ 141,154 | \$ 136,636 | \$ 133,483 | \$ 145,004 | \$ 151,355 | \$ 147,136 | \$ 146,474 | \$ 132,112 | \$ 122,401 |
| Initial ceded liability for losses and LAE: | 7,599 | 10,373 | 9,816 | 6,025 | 13,826 | 19,242 | 19,380 | 22,715 | 19,327 | 21,017 |
| Initial net liability | \$ 126,260 | \$ 130,781 | \$ 126,820 | \$ 127,458 | \$ 131,178 | \$ 132,113 | \$ 127,756 | \$ 123,759 | \$ 112,785 | \$ 101,384 |
| Gross liability as currently re-estimated | 139,584 | 139,691 | 132,125 | 148,358 | 172,782 | 168,823 | 157,855 | 145,203 | 128,619 | 116,223 |
| Ceded liability as currently re-estimated | 8,250 | 8,696 | 8,815 | 13,661 | 30,379 | 30,833 | 29,363 | 24,376 | 21,776 | 19,009 |
| Net liability as currently re-estimated | \$ 131,334 | \$ 130,995 | \$ 123,310 | \$ 134,697 | \$ 142,403 | \$ 137,990 | \$ 128,492 | \$ 120,827 | \$ 106,843 | \$ 97,214 |
| Gross cumulative redundancy (deficiency): | \$ (5,725) %(4.3) | 1,463 1.0 | 4,511 3.3 | (14,875) (11.1) | (27,778) (19.2) | (17,468) (11.5) | (10,719) (7.3) | 1,271 .9 | 3,493 2.6 | 6,178 5.0 |

The loss and LAE reserves reported in the Company's consolidated financial statements prepared in accordance with generally accepted accounting principles (GAAP) differ from those reported in the statements filed by MNH with the New Hampshire Insurance Department in accordance with statutory accounting principles (SAP) as follows:

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| | 2006 | As of December 31, 2005 (in thousands) | 2004 |
|--|------------|--|------------|
| Loss and LAE reserves on a SAP basis | \$ 93,339 | \$ 101,384 | \$ 112,785 |
| Adjustments: | | | |
| Ceded reinsurance balances recoverable | 11,575 | 13,807 | 15,630 |
| Loss and LAE reserves on a GAAP basis | \$ 104,914 | \$ 115,191 | \$ 128,415 |

Reinsurance

The Company follows the customary industry practice of reinsuring a portion of the exposure under its policies and as consideration pays to its reinsurers a portion of the premium received on its policies. Insurance is ceded principally to reduce an insurer's liability on individual risks and to protect against catastrophic losses. Although reinsurance does not legally discharge an insurer from its primary liability for the full amount of coverage provided by its policies, it does make the assuming reinsurer liable to the insurer to the extent of the reinsurance ceded.

The Company is a party to reinsurance contracts under which certain types of policies are automatically reinsured without the need for approval by the reinsurer with respect to the individual risks that are covered (treaty reinsurance). The Company also is a party to reinsurance contracts which are handled on an individual policy or per risk basis and require the specific agreement of the reinsurer as to each risk insured (facultative reinsurance). Occasionally, the Company may secure facultative reinsurance to supplement its coverage under treaty reinsurance.

Prior to January 1, 1998, the Company's excess of loss reinsurance agreements for automobile liability, general liability and workers' compensation insurance provided for recovery of losses over \$500,000 up to a maximum of \$5,000,000 per occurrence. For claims occurring from 1987 through 1992, the \$500,000 threshold was indexed for inflation for casualty lines other than workers' compensation and New York State no-fault, and applied retroactively to all occurrences until they are settled. There was no index provision for casualty claims occurring after 1992. This coverage was supplemented by additional treaty reinsurance covering losses up to \$5,000,000 in excess of the first \$5,000,000. Prior to January 1, 1998, property reinsurance agreements provided for recovery of property losses over \$500,000 up to \$2,000,000 per occurrence without any index provision.

Beginning January 1, 1998, the Company's property and casualty excess of loss reinsurance agreement provided for recovery of casualty losses over \$500,000 up to \$10,000,000 per occurrence and property losses over \$500,000 up to \$10,000,000 per risk. This coverage is supplemented by a contingent casualty layer of reinsurance for workers' compensation claims of \$5,000,000 in excess of the first \$10,000,000 subject to a calendar year limit of \$10,000,000. For 2007 the supplemental reinsurance for workers' compensation claims is \$15,000,000 in excess of the first \$10,000,000, subject to a calendar year limit of \$30,000,000. Effective January 1, 2002, the Company increased its retention on casualty losses to \$750,000. Effective January 1, 2004, the Company adjusted the property loss occurrence limit to \$5,000,000 per risk. Individual property facultative reinsurance was purchased for all exposures greater than \$5,000,000. Effective January 1, 2005, the Company adjusted the property loss occurrence limit to \$7,000,000 per risk, with individual property facultative reinsurance purchased for exposures exceeding that amount.

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Prior to 2007, property catastrophe coverage provided for recovery of 47.5% of the first \$5,000,000 and of 95% of the next \$55,000,000 above aggregate retained losses of \$5,000,000 per occurrence. For 2007 property catastrophe coverage provides for recovery of 90% of \$75,000,000 above aggregate retained losses of \$10,000,000 per occurrence. The property catastrophe reinsurance coverage is shared by the Company and Mutual in accordance with the Pooling Agreement (see Administration above) for a covered event.

Under the terms of the Pooling Agreement (see Administration in Item 1.) effective as of January 1, 2003 Mutual and MNH pool, or share, underwriting results on their Traditional Business. The Pooling Agreement does not apply to any new endeavor of either Mutual or MNH outside of their Traditional Business, unless the companies agree otherwise.

The Pooling Agreement provides for MNH to cede, or transfer, to Mutual all of its premiums and risks on its Traditional Business during the term of the agreement, and then to assume from Mutual a percentage of all of Mutual's and MNH's Traditional Business (the Pooled Business). MNH assumed 25% of the Pooled Business in 2006, 30% of the Pooled Business in 2005 and 35% of the Pooled Business in 2004. MNH's share of the Pooled Business will be 25% in 2007. Mutual retains a share of the risk in MNH's Traditional Business under Mutual's control pursuant to a profit and loss sharing arrangement in the Pooling Agreement based on the loss and LAE experience of the Pooled Business. The Company believes the Pooling Agreement and profit (or loss) sharing feature included therein align the interests of MNH and Mutual.

Investments

The primary source of funds for investment by the Company is premiums collected. Although premiums, net of commissions and other underwriting costs, are taken into income ratably over the terms of the policies, they provide funds for investment from the date cash is received. Similarly, although establishment of and changes in reserves for losses and LAE are included in results of operations immediately, the amounts so set aside are available to be invested until the Company pays those claims.

The investments of the Company are regulated by New Hampshire insurance law and are reviewed by the Board of Directors. Other than certain short-term investments held to maintain liquidity, the Company primarily invests in corporate bonds, mortgage-backed and other asset-backed securities, including collateralized mortgage obligations and tax-exempt securities with expected maturities of 10 years or less. The mortgage-backed securities held by the Company are typically purchased at expected yields which are greater than comparable maturity Treasury securities and are AAA or AA rated.

At December 31, 2006 the Company had \$17,017,000 of short-term investments with maturities less than 30 days and \$2,925,000 of non-investment grade securities. These non-investment grade securities represented 2% of the investment portfolio as compared to \$6,123,000, or 3%, of the investment portfolio at December 31, 2005.

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The table below provides information regarding the Company's investments as of the dates indicated.

| | 2006 | | As of December 31, 2005 | | 2004 | |
|--------------------------------------|------------|--------|----------------------------------|--------|------------|--------|
| | Amount | % | Amount (dollars in thousands) | % | Amount | % |
| Fixed Maturities (1): | | | | | | |
| U.S. Government and Agencies | \$ 10,139 | 5.7% | \$ 7,145 | 3.9% | \$ 5,028 | 2.5% |
| Corporate Securities | 26,448 | 14.9 | 17,147 | 9.4 | 28,003 | 14.2 |
| Mortgage and Asset Backed Securities | 80,518 | 45.4 | 97,044 | 53.2 | 110,082 | 55.7 |
| Tax-Exempt Bonds | 39,759 | 22.4 | 45,257 | 24.8 | 40,979 | 20.7 |
| Total Bonds | 156,864 | 88.4 | 166,593 | 91.3 | 184,092 | 93.1 |
| Preferred Stocks (1) | 3,563 | 2.0 | 4,312 | 2.4 | 3,509 | 1.8 |
| Short-Term Investments (2) | 17,017 | 9.6 | 10,650 | 5.9 | 7,412 | 3.7 |
| Other (3) | 84 | | 734 | .4 | 2,696 | 1.4 |
| Total Invested Assets | \$ 177,528 | 100.0% | \$ 182,289 | 100.0% | \$ 197,709 | 100.0% |

- (1) Shown at fair value.
- (2) Shown at cost, which approximates fair value.
- (3) Shown at estimated fair value or unpaid principal balance, which approximates estimated fair value.

The table below sets forth the Company's net investment income and net realized gains and losses, excluding the effect of income taxes, for the periods shown:

| | Year Ended December 31, | | |
|-----------------------|-------------------------|-----------|-----------|
| | 2006 | 2005 | 2004 |
| | (dollars in thousands) | | |
| Average investments | \$180,589 | \$185,925 | \$196,148 |
| Net investment income | 7,938 | 7,733 | 7,881 |

| | | | |
|--|---------|------|----------|
| Net investment income as a percentage of average investments (1) | 4.4% | 4.2% | 4.0% |
| Net gains (losses) on investments | \$ (60) | \$ | \$ (221) |

(1) The taxable equivalent yield for the years ended December 31, 2006, 2005 and 2004 was 4.7%, 4.5% and 4.3%, respectively, assuming an effective tax rate of 34%.

The table below sets forth the carrying value of bonds and percentage distribution of various maturities at the dates indicated. Fixed maturities are included at fair value. Mortgage and asset backed securities are presented based upon their projected cash flows.

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| | 2006 | | As of December 31, 2005 | | 2004 | |
|--------------------------|------------|--------|----------------------------|--------|------------|--------|
| | Amount | % | Amount | % | Amount | % |
| | | | (dollars in thousands) | | | |
| 1 year or less | \$ 27,027 | 17.2% | \$ 35,259 | 21.2% | \$ 49,275 | 26.8% |
| 1 year through 5 years | 103,081 | 65.7 | 104,957 | 63.0 | 112,476 | 61.1 |
| 5 years through 10 years | 16,590 | 10.6 | 18,978 | 11.4 | 18,870 | 10.2 |
| More than 10 years | 10,166 | 6.5 | 7,399 | 4.4 | 3,471 | 1.9 |
| Total | \$ 156,864 | 100.0% | \$ 166,593 | 100.0% | \$ 184,092 | 100.0% |

Competition

The property and casualty insurance business is highly competitive. The Company is in direct competition with many national and regional multiple-line insurers, many of which are substantially larger than the Company and have considerably greater financial resources. Competition is further intensified by the independent agency system because each independent agent who sells the Company's policies also represents one or more other insurers. Also, the Company's agents compete with direct writing insurers and this indirectly affects the Company.

Historically, the property and casualty industry has tended to be cyclical in nature. During the up cycle, or hard market, the industry is characterized by price increases, strengthening of loss and LAE reserves, surplus growth and improved underwriting results. Near the end of the up cycle, an increase in capacity causes insurance companies to begin to compete for market share on the basis of price. This price competition causes the emergence of the down cycle, or soft market, characterized by a reduction in the premium growth rate and a general decline in profitability. Often times, the down cycle is accompanied by a decline in the adequacy of loss and LAE reserves and a decrease in premium writing capacity. The property and casualty insurance industry experienced a cyclical downturn for most of the 1990's through 2001 due primarily to intense premium rate competition and an excess capacity to write premiums. From 2002 to 2004 the property casualty industry experienced price firming primarily within the commercial lines segment. However, some of the circumstances which typically lead to a cyclical downturn in the property and casualty insurance industry have become evident, and the Company believes that this price firming or hard market has ended. Generally, since mid-2004 premium rates have been decreasing due to excess capacity in the industry. The Company anticipates that price-based competition will continue to intensify in its markets in 2007.

Regulation**General**

MNH is subject to regulation under applicable insurance statutes, including insurance holding company statutes, of the various states in which it writes insurance. Insurance regulation is intended to provide safeguards for policyholders rather than to protect stockholders of insurance companies or their holding companies. Insurance laws of the various states establish regulatory agencies with broad administrative powers including, but not limited to, the power to grant or revoke licenses to transact insurance business and to regulate trade practices, investments, premium rates, the deposit of securities, the form and content of financial statements and insurance policies, accounting practices, the maintenance of specified reserves and capital, and insurers' consumer privacy policies. The regulatory agencies of each

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state have statutory authority to enforce their laws and regulations through various administrative orders, civil and criminal enforcement proceedings, and the suspension or revocation of certificates of authority. In extreme cases, including insolvency, impending insolvency and other matters, a regulatory authority may take over the management and operation of an insurer's business and assets.

Under insolvency or guaranty laws in the states in which MNH operates, insurers doing business in those states can be assessed up to prescribed limits for policyholder losses caused by other insurance companies that become insolvent. The extent of any requirement for MNH to make any further payment under these laws is not determinable. Most laws do provide, however, that an assessment may be excused or deferred if it would threaten a solvent insurer's financial strength. In addition, MNH is required to participate in various mandatory pools or underwriting associations in certain states in which it operates.

The property and casualty insurance industry has been the subject of regulations and legislative activity in various states attempting to address the affordability and availability of different lines of insurance. The regulations and legislation generally restrict the discretion an insurance company has in operating its business. It is not possible to predict the effect, if any, that new regulations and legislation would have on the Company and MNH.

The Company depends on cash dividends from MNH to pay cash dividends to its stockholders and to meet its expenses. MNH is subject to New Hampshire state insurance laws which restrict its ability to pay dividends without the prior approval of state regulatory authorities. These restrictions limit dividends to those that, when added to all other dividends paid within the preceding twelve months, would not exceed 10% of the insurer's policyholders' surplus as of the preceding December 31st. The maximum amount of dividends that MNH could pay during any twelve-month period ending in 2007 without the prior approval of the New Hampshire Insurance Commissioner is \$7,167,000. MNH paid \$1,000,000, \$2,000,000 and \$750,000 of dividends to the Company in August 2006, January 2007 and March 2007, respectively.

In certain states in which it operates, MNH is required to maintain deposits with the appropriate regulatory authority to secure its obligations under certain insurance policies written in the jurisdiction. At December 31, 2006, investments of MNH having a par value of \$850,000 were on deposit with regulatory authorities.

MNH is required to file detailed annual reports with the appropriate regulatory agency in each of the states in which it does business. Its business and accounts are subject to examination by such agencies at any time, and the laws of many states require periodic examination. The State of New Hampshire Insurance Department most recently examined the accounts of MNH as of December 31, 2003. MNH's annual report as of that date was accepted as submitted, without adjustment.

The National Association of Insurance Commissioners (NAIC) applies a risk-based capital measurement formula to all property and casualty insurance companies. The formula calculates a minimum required statutory net worth based on the underwriting, investment, credit, loss reserve and other business risks inherent in an individual company's operations. Any insurance company that does not meet threshold risk-based capital measurement standards could be forced to reduce the scope of its operations and ultimately could become subject to statutory receivership proceedings. MNH's capital substantially exceeded the statutory minimum as determined by the risk-based capital measurement formula as of December 31, 2006 and 2005.

The NAIC has established eleven financial ratios (the Insurance Regulatory Information System, or IRIS) to assist state insurance departments in their oversight of the financial condition of insurance

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companies operating in their respective states. The NAIC calculates these ratios based on statutory information submitted by insurers on an annual basis and shares the information with the applicable state insurance departments. The ratios relate to leverage, profitability, liquidity and loss reserve development. Each of MNH's ratios for 2006 and 2005 was within the usual or acceptable range as published by the NAIC.

Rates

Premium rate regulations vary greatly among states and lines of insurance, but generally require either approval of the regulatory authority or review by the authority prior to changes in rates. Rate filings are based upon an actuarial analysis of historical results and competition in the market. However, in certain states, insurers writing in designated product lines may periodically revise rates within the limits of applicable flexibility bands (flex-bands) on a file and use basis, but must obtain the state insurance department's prior approval in order to implement rate increases or decreases outside these flex-bands.

Renewal of Policies

Many states restrict the ability of insurers to non-renew insurance policies or to exit a line of business. In particular, New York substantially limits the ability of insurers to non-renew personal automobile insurance. This restricts the Company's ability to mitigate its exposure to the NYAIP.

Insurance Holding Companies

The Company is subject to statutes governing insurance holding company systems. Typically, these statutes require the Company to file information periodically concerning its capital structure, ownership, financial condition, general business operations and material inter-company transactions not in the ordinary course of business. Under the terms of applicable New Hampshire statutes, any person or entity desiring to purchase shares which would result in such person beneficially owning 10% or more of the Company's outstanding voting securities would be required to obtain regulatory approval prior to the purchase.

Involuntary Business

As a condition to writing voluntary insurance in most of the states in which it operates, the Company must participate in programs that provide insurance for persons or businesses unable to obtain insurance voluntarily. Uncertainties as to the size of the involuntary market population make it difficult to predict the amount of involuntary business in a given year.

Employees

The Company and MNH have no employees. At December 31, 2006, Mutual had 302 full-time equivalent employees. The Company believes that Mutual's relationship with its employees is satisfactory.

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Item 1.A. RISK FACTORS.

The following factors may affect the Company's business.

Factors Affecting the Property and Casualty Industry Generally:

If our estimates of loss and LAE reserves prove inaccurate and if we have to make even a relatively small adjustment to our reserves, the adjustment may have a significant impact on our income.

As discussed in Item 1. BUSINESS, the Company establishes reserves for its estimate of losses and LAE associated with reported and unreported claims for each accounting period. The Company frequently evaluates the adequacy of its reserves and its reserving techniques. Due to uncertainties inherent in the estimation of incurred losses and LAE, the Company is likely to record increases or decreases to its reserves in current periods for losses and LAE that occurred in prior periods. If an increase in reserves is warranted, the Company would record an increase to its incurred losses and LAE and a reduction to its net income in the period in which the deficiency in reserves is identified. Accordingly, an increase in reserves for losses and LAE could have a material adverse effect on the Company's results of operations, liquidity and financial condition.

The demand for property and casualty insurance is cyclical, which may adversely affect our operating results for extended periods.

The property and casualty industry has historically been cyclical in nature. The industry has experienced periods of intense price competition that at times of overcapacity in the industry can result in reduced premium rates. The demand for property and casualty insurance, particularly for commercial products, can vary with the overall level of economic activity.

If catastrophic events affect many of our policyholders at the same time, we may experience significant extraordinary losses.

The financial results of the Company and those of the property and casualty industry have historically been subject to fluctuations due to unpredictable developments such as natural disasters. Weather-related events such as hurricanes, as well as other natural and unnatural events such as terrorism, may adversely affect the financial results of the Company. The frequency and severity of these catastrophes are unpredictable. Although any one year may be free of major weather or other disasters or catastrophes, another year may have several such events, causing results to be materially worse than for other years. The extent of losses resulting from a catastrophe is a function of both the total amount of insured exposures in the affected area and the severity of the event.

The Company seeks to mitigate the potential impact of such catastrophes through geographic diversification and through the purchase of reinsurance. Reinsurance recoveries may prove inadequate if a catastrophe were to occur and the cost of the catastrophe were to exceed the amount of reinsurance purchased.

Adequate reinsurance may not be available at acceptable prices so that we may not be able to adequately protect the Company against extraordinary losses.

As discussed in Item 1. BUSINESS, the Company transfers a portion of the risk associated with the insurance that it sells to reinsurance companies through reinsurance contracts. The availability, amount and

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cost of such arrangements may vary significantly from year to year depending on market conditions, which include the number and severity of recent natural disasters. Any decrease in the amount of reinsurance purchased by the Company would increase its risk of loss. Furthermore, the Company is exposed to credit risk related to amounts recoverable from reinsurers.

Our investment income is very sensitive to prevailing interest rates, and general decreases in interest rates will adversely affect both our investment income and our net income.

The Company, like other property and casualty insurance companies, depends upon income from its investment portfolio for a significant portion of its revenues and its net income. Most of the Company's investment portfolio is invested in interest bearing securities. Accordingly, a decrease in the general level of interest rates would likely have an adverse effect on the Company's investment income and on its net income.

Government regulation affecting property and casualty insurance companies could restrict our operations in ways that would adversely affect our business.

The Company is subject to regulation under applicable insurance statutes, including insurance holding company statutes, of the various states in which MNH writes insurance. Insurance regulation is intended to provide safeguards for policyholders rather than to protect stockholders of insurance companies or their holding companies. Insurance laws of the various states establish regulatory agencies with broad administrative powers, including the power to grant or revoke licenses to transact insurance business and to regulate trade practices, investments, premium rates and the maintenance of specific levels of capital.

The Company's business can be affected adversely by insurance regulations and other regulations affecting property and casualty insurance companies. For example, laws and regulations can set rates at levels that the Company does not believe are sufficient to recover the costs of the risks that it insures. Other laws and regulations can limit the Company's ability to cancel or refuse to renew policies or require the Company to offer coverage to all policy applicants. Federal initiatives such as federal terrorism backstop legislation may also impact the insurance industry.

Factors Affecting the Company Specifically:

The Company's and MNH's current operations are heavily dependent on their relationships with Mutual, and any disruption of those relationships could adversely affect our business.

The Company's and MNH's business and day-to-day operations are closely aligned with those of Mutual. This is the result of a combination of factors. Mutual has had a historical ownership interest in the Company and MNH. At December 31, 2006 Mutual owned 11.9% of the Company's common stock. Under the Services Agreement (see Item 1. **BUSINESS**), Mutual provides the Company and MNH with all facilities and with personnel to operate their business. The officers of the Company or MNH are employees of Mutual whose services are provided to, and paid for by, the Company and MNH through the Services Agreement. Further, since 2003 the Company and Mutual share underwriting results by means of a reinsurance pooling agreement.

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We compete with other regional and national property and casualty insurance companies, many of which have greater resources than we do.

The Company competes with many other regional and national property casualty insurance companies, many of which are larger and have greater financial, technical and operating resources. Further, the Company competes with other insurance companies within each agency because each independent agency represents more than one insurance company. If competitors offer better coverage or lower prices, the Company's ability to sell new policies or to renew existing policies may be adversely impacted.

Our operations are relatively concentrated in one geographic region, and a large disaster in the states that we serve could adversely affect our business.

The Company writes property and casualty insurance business in the northeast and portions of the Midwest United States. Unusually severe storms or natural or man-made disasters that destroy property in these states could have an adverse impact on the Company's financial condition. The Company's revenues and profitability are subject to the prevailing economic conditions in the states in which it writes insurance.

New Hampshire state regulations limit our ability to pay dividends even when we have sufficient cash to pay them.

As a holding Company, the Company is dependent on cash dividends from MNH to meet its obligations and pay any cash dividends. MNH is subject to New Hampshire insurance laws, which place certain restrictions on its ability to pay dividends without the prior approval of state regulatory authorities. These restrictions limit dividends to those that, when added to all other dividends paid within the preceding twelve months, would not exceed 10% of the insurer's policyholders' surplus as of the preceding December³¹. Further, if the New Hampshire Insurance Department were to determine that an MNH dividend to the Company was detrimental to MNH's policyholders, the Department may limit or prohibit dividends that would otherwise be permitted without prior approval.

Although the Company has a history of paying dividends to its shareholders, future cash dividends will depend on the Company's results of operations, its financial condition, its cash requirements and other factors including MNH's ability to pay dividends to the Company as discussed in the previous paragraph. There can be no assurance that the Company will continue to pay dividends to its shareholders even if it has sufficient cash to do so.

Item 2. PROPERTIES.

Although the Company has no facilities, it benefits from the facilities of Mutual pursuant to the Services Agreement, under which the Company is charged a fee for a portion of the costs of such facilities.

The Company's corporate headquarters are located in Buffalo, New York in a building owned by a subsidiary of Mutual that contains approximately 113,000 square feet of office space. Mutual also has regional underwriting and/or claims office facilities in Buffalo, Albany and Hauppauge, New York; Manchester, New Hampshire; Moorestown, New Jersey and Columbus, Ohio. All of the offices except the Buffalo office are leased.

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Item 3. LEGAL PROCEEDINGS.

MNH, like many other property and casualty insurance companies, is subject to environmental damage claims asserted by or against its insureds. Management of the Company is of the opinion that based on various court decisions throughout the country certain of these claims should not be recoverable under the terms of MNH's insurance policies because of either specific or general coverage exclusions contained in the policies. However, there is no assurance that the courts will agree with MNH's position in every case, nor can there be assurance that material claims will not be asserted under policies which a court will find do not explicitly or implicitly exclude claims for environmental damages. Management, however, is not aware of any pending claim or group of claims which would result in a liability that would have a material adverse effect on the financial condition of the Company or MNH.

In addition to the foregoing matters, MNH is a defendant in a number of other legal proceedings in the ordinary course of its business. Management of the Company is of the opinion that the ultimate aggregate liability, if any, resulting from such proceedings will not materially affect the financial condition of the Company or MNH.

Item 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS.

On February 1, 2007 the Company held a special meeting of stockholders to consider and adopt a merger agreement entered into with American European Group, Inc. and American European Financial, Inc. on October 31, 2006 and a proposal to transact other business that may have been properly brought before the meeting, including procedural matters such as a motion to adjourn the special meeting, if necessary or appropriate, to solicit additional proxies for the approval of the merger agreement.

A summary of stockholder voting with respect to these items follows:

- (1) To adopt the Agreement and Plan of Merger, dated as of October 31, 2006, by and among Merchants Group, Inc., a Delaware corporation, American European Group, Inc., a Delaware corporation, and, American European Financial, Inc., a Delaware corporation (the Merger Agreement), and to approve the merger and related transactions contemplated by the Merger Agreement.

| | |
|---------|-----------|
| For | 1,651,644 |
| Against | 7,802 |
| Abstain | |

- (2) To adjourn or postpone the special meeting, if necessary, in order to solicit additional proxies in favor if there are not sufficient favorable votes at the time of the meeting to adopt the Merger Agreement and approve the merger and related transactions.

| | |
|---------|-----------|
| For | 1,631,749 |
| Against | 26,697 |
| Abstain | |

PART II

Table of Contents**Item 5. MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES.**

The Company's common stock is traded on the American Stock Exchange (AMEX symbol: MGP). The following table sets forth the high and low closing prices of the common stock for the periods indicated as reported on the American Stock Exchange.

| 2006: | High | Low | Dividend |
|----------------|---------|---------|----------|
| Fourth Quarter | \$32.44 | \$29.51 | \$.25 |
| Third Quarter | 31.30 | 29.69 | .25 |
| Second Quarter | 31.50 | 28.98 | .25 |
| First Quarter | 30.65 | 27.85 | .25 |
| 2005: | High | Low | Dividend |
| Fourth Quarter | \$31.60 | \$26.65 | \$.25 |
| Third Quarter | 27.10 | 24.10 | .10 |
| Second Quarter | 26.60 | 24.00 | .10 |
| First Quarter | 26.15 | 23.60 | .10 |

The number of stockholders of record of the Company's Common Stock as of February 15, 2007 was 72. Securities held by nominees are counted as one stockholder of record.

The Company has paid a quarterly cash dividend to its common stockholders since 1993. Continued payment of this dividend and its amount will depend upon the Company's operating results, financial condition, capital requirements and other relevant factors, including legal restrictions applicable to the payment of dividends by its insurance subsidiary, MNH.

As a holding company, the Company depends on dividends from its subsidiary, MNH, to pay cash dividends to its stockholders. MNH is subject to New Hampshire state insurance laws which restrict its ability to pay dividends without the prior approval of state regulatory authorities. These restrictions limit dividends to those that, when added to all other dividends paid within the preceding twelve months, would not exceed 10% of the insurer's policyholders surplus as of the preceding December 31. The maximum amount of dividends that MNH could pay during any twelve-month period ending in 2007 without prior approval of the New Hampshire Insurance Commissioner is \$7,167,000.

During the fourth quarter of its fiscal year, neither the Company nor any affiliated purchaser (as defined in SEC Rule 10b-18(a)(3)) made any purchases of any of its equity securities on its behalf.

Equity Compensation Plan Information

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| Plan Category | Number of Securities to be Issued Upon Exercise Of Outstanding Options, Warrants and Rights (a) | Weighted-Average Exercise Price of Outstanding Options, Warrants and Rights (b) | Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans (Excluding Securities) Reflected in Column (a) (c) |
|--|--|--|--|
| Equity Compensation Plans Approved by Security Holders | 0 | N/A | 0 |
| Equity Compensation Plans Not Approved by Security Holders | 0 | N/A | 0 |
| Total | 0 | N/A | 0 |

The company did not sell any unregistered equity securities during the 2006 fiscal year.

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Item 6. SELECTED FINANCIAL DATA.

The selected financial data set forth in the following table for each of the five years in the period ended December 31, 2006 have been derived from the audited consolidated financial statements of the Company.

| | 2002 | As of December 31, | | | 2006 |
|---|------------|--|------------|------------|------------|
| | | 2003 | 2004 | 2005 | |
| | | (in thousands, except per share amounts) | | | |
| Net premiums written | \$ 70,528 | \$ 64,179 | \$ 53,102 | \$ 45,135 | \$ 37,740 |
| Net premiums earned | \$ 83,120 | \$ 65,097 | \$ 57,123 | \$ 49,121 | \$ 41,173 |
| Net investment income | 10,403 | 8,815 | 7,881 | 7,733 | 7,938 |
| Net investment gains (losses) | 953 | 2,500 | (221) | | (60) |
| Other revenues | 635 | 560 | 722 | 571 | 489 |
| Total revenues | 95,111 | 76,972 | 65,505 | 57,425 | 49,540 |
| Net losses and loss adjustment expenses | 62,873 | 49,612 | 37,681 | 26,408 | 22,147 |
| Amortization of deferred policy acquisition costs | 22,227 | 16,925 | 14,852 | 12,771 | 10,705 |
| Other underwriting expenses | 5,744 | 5,031 | 8,291 | 8,811 | 8,324 |
| Total expenses | 90,844 | 71,568 | 60,824 | 47,990 | 41,176 |
| Income before income taxes | 4,267 | 5,404 | 4,681 | 9,435 | 8,364 |
| Provision for income taxes | 1,729 | 1,039 | 919 | 2,736 | 2,427 |
| Net income | \$ 2,538 | \$ 4,365 | \$ 3,762 | \$ 6,699 | \$ 5,937 |
| Earnings per share | | | | | |
| Basic | \$ 1.19 | \$ 2.07 | \$ 1.78 | \$ 3.17 | \$ 2.77 |
| Diluted | \$ 1.19 | \$ 2.07 | \$ 1.78 | \$ 3.16 | \$ 2.77 |
| Weighted average number of shares outstanding: | | | | | |
| Basic | 2,125 | 2,110 | 2,114 | 2,115 | 2,145 |
| Diluted | 2,129 | 2,111 | 2,118 | 2,118 | 2,145 |
| <u>Balance Sheet Data: (at year end)</u> | | | | | |
| Total investments | \$ 209,397 | \$ 202,887 | \$ 197,709 | \$ 182,289 | \$ 177,528 |
| Total assets | 265,900 | 268,678 | 255,704 | 233,978 | 222,795 |
| Reserve for losses and loss adjustment expenses | 147,136 | 146,474 | 128,415 | 115,191 | 104,914 |
| Unearned premiums | 35,119 | 36,176 | 33,685 | 29,662 | 25,371 |
| Stockholders equity | 67,924 | 70,259 | 71,974 | 75,894 | 80,221 |

Dividend Data:

| | | | | | | | | | | |
|--------------------------------|----|-----|----|-----|----|-----|----|-----|----|------|
| Cash dividend per common share | \$ | .40 | \$ | .40 | \$ | .40 | \$ | .55 | \$ | 1.00 |
|--------------------------------|----|-----|----|-----|----|-----|----|-----|----|------|

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The following discussion should be considered in light of the statements under the heading "Safe Harbor Statement" under the Private Securities Litigation Reform Act of 1995, at the end of this Item. All capitalized terms used in this Item that are not defined in this Item have the meanings given to them in the Notes to Consolidated Statements contained in Item 15 (a) (1) of this Form 10-K.

Important Subsequent Events

Upon completion of the Merger, each issued share of the Company's common stock (other than shares held by the Company or by any of its subsidiaries, which will be cancelled, and other than shares as to which the holders have validly exercised appraisal rights) will be converted into the right to receive \$33.00 in cash, without interest, plus (subject to certain contingencies) an additional amount per share equal to a pro-rated portion of the Company's current regular dividends that have not been paid through the time of the closing.

2006 Compared to 2005

Results of operations for 2006 and 2005 reflect the effects of the Services Agreement and the Reinsurance Pooling Agreement among the Company, its wholly-owned insurance subsidiary, MNH, and Mutual, effective January 1, 2003. The Services Agreement calls for Mutual to provide underwriting, administrative, claims and investment services to the Company and MNH. The Reinsurance Pooling Agreement provides for the pooling, or sharing, of insurance business traditionally written by Mutual and MNH on or after the effective date. MNH's share of pooled (combined Mutual and MNH) premiums earned and losses and loss adjustment expenses (LAE) for 2006 and 2005 in accordance with the Reinsurance Pooling Agreement was 25% and 30%, respectively. The Reinsurance Pooling Agreement pertains to premiums earned and incurred losses and LAE. Direct premiums written by MNH or Mutual are not pooled. MNH's share of pooled premiums will be 25% in 2007.

Total combined Mutual and MNH or group-wide direct premiums written (DWP) for the year ended December 31, 2006 were \$198,258,000, an increase of \$3,030,000, or 2%, from \$195,228,000 in 2005. The Company's pro-forma share of combined DWP in 2006, in accordance with the Reinsurance Pooling Agreement, was \$49,565,000 compared to \$58,569,000 in 2005. The table below shows a comparison of DWP by major category in 2006 and 2005:

| | Group-wide DWP | | | MNH | | |
|--|----------------------------|-------------------|-----------|---|------------------|--------------|
| | Year ended December 31, | | | Pro Forma Share Year ended December 31, | | |
| | 2006 | 2005 | Variance | 2006 | 2005 | Variance |
| | (000's omitted) | | | (000's omitted) | | |
| | | | | (25%) | (30%) | |
| Voluntary Personal | \$ 36,154 | \$ 40,842 | (11%) | \$ 9,038 | \$ 12,253 | (26%) |
| Voluntary Commercial | 145,838 | 131,789 | 11% | 36,460 | 39,537 | (8%) |
| Umbrella Program | 15,060 | 19,688 | (24%) | 3,765 | 5,906 | (36%) |
| Involuntary | 1,206 | 2,909 | (59%) | 302 | 873 | (65%) |
| Total Direct Written Premiums | \$ 198,258 | \$ 195,228 | 2% | \$ 49,565 | \$ 58,569 | (15%) |

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The 11% (or \$4,688,000) decrease in group-wide voluntary personal DWP resulted from a 20% decrease in private passenger automobile (PPA) DWP and a 1% decrease in homeowners DWP. The decrease in PPA DWP is the result of the companies' decision, implemented in 2001, not to write new policies in certain jurisdictions and to increased availability of this product from other competitors. As a result, voluntary PPA policies in force at December 31, 2006 were 12,173, a decrease of 2,467 or 17%, from 14,640 at December 31, 2005.

Group-wide voluntary commercial DWP were \$145,838,000, an increase of \$14,049,000, or 11%, from \$131,789,000 in 2005. This increase resulted from period to period increases in every significant group-wide commercial product. The average premium per group-wide, non-Umbrella Program commercial policy increased 2% from the year earlier period. Total non-Umbrella Program commercial policies in force at December 31, 2006 were 38,737, an increase of 7% from 36,050 at December 31, 2005.

The monoline commercial umbrella program (the Umbrella Program) resulted in \$15,060,000 of DWP in 2006 compared to \$19,688,000 in 2005. This decrease of \$4,628,000 or 24% resulted from increased competition from property casualty companies that have expanded their underwriting appetite to include commercial umbrella policies written in conjunction with the underlying property and liability policies. The Umbrella Program is marketed exclusively through one independent agent and approximately 95% of the premiums from Umbrella Program Policies are reinsured with an A rated national reinsurer through a quota share reinsurance treaty.

The 59% decrease in group-wide involuntary DWP resulted primarily from a decrease in assignments from the New York Automobile Insurance Plan (NYAIP). DWP related to policies assigned from the NYAIP decreased 67% to \$764,000 from \$2,329,000 for 2005. The NYAIP provides coverage for individuals who are unable to obtain auto insurance in the voluntary market. Assignments from the NYAIP vary depending upon a company's PPA market share and the size of the NYAIP. The Company is unable to predict the volume of future assignments from the NYAIP.

In order to minimize the adverse impact of assignments from the NYAIP, the Company purchased territorial credits from an unaffiliated company pursuant to Section 6.A.7. of the NYAIP Manual. The credits against NYAIP assignments were generated by the other insurance company for writing PPA business in certain localities in New York with PPA market availability problems. The other insurance company, by nature of its concentration in PPA business in credit territories, generated more credits than it required to offset its NYAIP assignments. The purchased credits reduced the Company's share of the NYAIP. The purchased credits decreased direct premiums written related to NYAIP assignments during 2006 and 2005 by approximately \$971,000 and \$1,200,000, respectively.

Group-wide pooled net premiums written for 2006 were \$167,697,000, an increase of \$3,395,000, or 2%, from \$164,302,000 for 2005. This increase resulted from the 2% increase in group-wide DWP. The Company's share of pooled net premiums written in 2006 in accordance with the Reinsurance Pooling Agreement was \$37,740,000, a decrease of \$7,395,000, or 16%, from \$45,135,000 in 2005. This decrease resulted primarily from the 5 percentage point decrease in the Company's participation in the Reinsurance Pooling Agreement.

Total revenues for 2006 were \$49,540,000, a decrease of \$7,885,000 or 14%, from \$57,425,000 in 2005.

The Company's share of pooled net premiums earned in accordance with the Reinsurance Pooling Agreement for 2006 was \$41,173,000. The Company's share of net premiums earned in 2005 was

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\$49,121,000. This \$7,948,000, or 16%, decrease in net premiums earned primarily resulted from the 5 percentage point decrease in the Company's participation in the Reinsurance Pooling Agreement.

Net investment income was \$7,938,000, an increase of \$205,000, or 3%, from \$7,733,000 in 2005 primarily due to a 19 basis point (5%) increase in average portfolio yield somewhat offset by a 3% decrease in average portfolio assets.

The Company recorded \$60,000 of net investment losses in 2006. There were no net investment gains or losses in 2005. The 2006 amount included an aggregate \$118,000 of investment losses related to other-than-temporary impairments.

Other revenues were \$489,000 in 2006, a decrease of \$82,000, or 14%, from \$571,000 in 2005, primarily due to the 5 percentage point decrease in the Company's participation in the Reinsurance Pooling Agreement.

Net losses and LAE were \$22,147,000 for 2006, a decrease of \$4,261,000, or 16%, from \$26,408,000 for 2005. The decrease in net losses and LAE was due to the 16% decrease in net premiums earned. The calendar year loss and LAE ratio was 53.8% in 2006 and in 2005. The loss and LAE ratio for the current accident year was 63.9% in 2006 compared to 60.5% in 2005, an increase of 3.4 percentage points. This increase resulted from increased costs of reinsurance and market pricing pressure as well as a snow and ice storm in Western New York State during October 2006 that added approximately .9 percentage points to the 2006 accident year loss and LAE ratio. There were no similar storms in 2005.

The Company recorded decreases to its estimate of losses and LAE related to prior accident years of \$4,170,000 and \$3,303,000 in 2006 and 2005, respectively, a difference of \$867,000. These decreases in losses and LAE relating to prior accident years reduced the loss and LAE ratio in 2006 and 2005 by 10.1 and 6.7 percentage points, respectively. The reserve development for each product and for each accident year during 2006 was within the range of reasonably likely reserves by product as of December 31, 2005. It is not appropriate to predict future increases or decreases in the estimate of losses and LAE for prior accident years from past experience. See "Critical Accounting Policies and Estimates" for a further discussion of the Company's Reserves for Losses and LAE. The following table documents the changes in the estimate of losses and LAE related to prior accident years recorded in 2006 for the Company's primary products.

| Accident Year | Home-owners | PPA Liability | Commercial | | | | All Other | Total |
|--------------------------------------|-------------|---------------|----------------|----------------------|--------------------|-------------------|-----------|------------|
| | | | Auto Liability | Workers Compensation | Commercial Package | General Liability | | |
| Increases (decreases) (in thousands) | | | | | | | | |
| Prior to | | | | | | | | |
| 2003 | \$ 266 | \$ (408) | \$ (135) | \$ 2,240 | \$ (2,045) | \$ (632) | \$ (50) | \$ (764) |
| 2003 | 15 | (322) | 181 | 385 | (758) | (11) | 32 | (478) |
| 2004 | (84) | (245) | (149) | (532) | (586) | 194 | 8 | (1,394) |
| 2005 | 120 | (361) | (412) | (335) | (312) | (266) | 32 | (1,534) |
| Total | \$ 317 | \$ (1,336) | \$ (515) | \$ 1,758 | \$ (3,701) | \$ (715) | \$ 22 | \$ (4,170) |

The Company experienced favorable development during 2006 in its PPA liability product of \$1,336,000, primarily due to lower claims frequency and lower estimated severity on voluntary business. These changes are consistent with increased fraud prevention, detection and prosecution efforts stemming from certain legislative changes in New York State.

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The Company experienced unfavorable development during 2006 in its workers' compensation product of \$1,758,000. The Company made no significant changes to its procedures for processing or reserving for workers' compensation claims during 2006. The unfavorable loss development on the workers' compensation product stems from inherent uncertainty in estimating ultimate costs in circumstances that involve the complex and changing medical condition of claimants.

During 2006, the Company experienced favorable development in its commercial package and general liability products amounting to \$3,701,000 related to accident years prior to 2002, due to lower than anticipated incurred loss development. The Company has made no changes to its procedures for processing or reserving for commercial package and general liability claims and is not aware of any changes to its business that might have caused a change in loss development patterns.

The Company's reduction in its estimate of losses and LAE related to prior accident years represented less than 4% of the recorded reserve for losses and LAE at December 31, 2005 and is within a reasonable range of loss reserve volatility for the products being underwritten.

The Company made no changes to the key assumptions used in evaluating the adequacy of its reserves for losses and LAE during 2006. A reasonable possibility exists in any year that relatively minor fluctuations in the estimate of reserves for losses and LAE may have a significant impact on the Company's net income. This is due primarily to the size of the Company's reserves for losses and LAE (\$104,914,000 at December 31, 2006) relative to its net income.

The ratio of amortization of deferred policy acquisition costs and other underwriting expenses to net premiums earned was 46.2% for 2006 compared to 43.9% for 2005. Amortization of deferred policy acquisition costs decreased \$2,066,000 or 16% compared to the year earlier period, consistent with the 16% decrease in net premiums earned. Other underwriting expenses as a percentage of net premiums earned increased by 2.3 percentage points to 20.2% in 2006 from 17.9% in 2005 primarily due to an increase in expenses associated with the efforts to sell the Company to \$1,463,000 in 2006, compared to \$303,000 in 2005. Other underwriting expenses include retrospective commissions related to the Reinsurance Pooling Agreement, which provides for retrospective commission income or expense due from or to Mutual based on the estimated experience compared to a targeted loss and LAE ratio. Retrospective commission expense totaled \$2,765,000 (6.7 percentage points of the expense ratio for 2006) compared to \$3,320,000 (6.8 percentage points of the expense ratio) for 2005. Commissions (other than retrospective commissions under the Reinsurance Pooling Agreement), premium taxes and other state assessments that vary directly with the Company's premium volume represented 20.9% and 19.7% of net premiums earned in 2006 and in 2005, respectively.

Tax exempt income reduced the Company's effective income tax rate by 5 percentage points for the years ended December 31, 2006 and 2005.

2005 Compared to 2004

MNH's share of pooled (combined Mutual and MNH) premiums earned and losses and LAE for 2005 and 2004 in accordance with the Reinsurance Pooling Agreement was 30% and 35%, respectively. The Reinsurance Pooling Agreement pertains to premiums earned and incurred losses and LAE.

Total combined Mutual and MNH or group-wide DWP for the year ended December 31, 2005 were \$195,228,000, an increase of \$4,090,000, or 2%, from \$191,138,000 in 2004. The Company's pro-forma share of combined DWP in 2005, in accordance with the Reinsurance Pooling Agreement, was

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\$58,569,000 compared to \$66,900,000 in 2004. The table below shows a comparison of DWP by major category in 2005 and 2004:

| | Group-wide DWP | | | MNH Pro Forma Share | | |
|--|----------------------------|-------------------|-----------|----------------------------|------------------|--------------|
| | Year ended December 31, | | Variance | Year ended December 31, | | Variance |
| | 2005 | 2004 | | 2005 | 2004 | |
| | (000 s omitted) | | | (000 s omitted) | | |
| | | | | (30%) | (35%) | |
| Voluntary Personal | \$ 40,842 | \$ 50,879 | (20%) | \$ 12,253 | \$ 17,808 | (31%) |
| Voluntary Commercial | 131,789 | 119,113 | 11% | 39,537 | 41,690 | (5%) |
| Umbrella Program | 19,688 | 17,536 | 12% | 5,906 | 6,138 | (4%) |
| Involuntary | 2,909 | 3,610 | (19%) | 873 | 1,264 | (31%) |
| Total Direct Written Premiums | \$ 195,228 | \$ 191,138 | 2% | \$ 58,569 | \$ 66,900 | (12%) |

The 20% (or \$10,037,000) decrease in group-wide voluntary personal DWP resulted from a 30% decrease in private passenger automobile DWP and a 1% decrease in homeowners DWP. The decrease in PPA DWP is the result of the companies' decision, implemented in 2001, not to write new policies in certain jurisdictions and from the approval of the companies' plan to withdraw from the New Jersey PPA market by the New Jersey Department of Banking and Insurance, which was effective in June 2003 and was completed in May 2005. As a result, voluntary PPA policies in force at December 31, 2005 were 14,640, a decrease of 5,291 or 27%, from 19,931 at December 31, 2004.

Group-wide voluntary commercial DWP were \$131,789,000, an increase of \$12,676,000, or 11%, from \$119,113,000 in 2004. This increase resulted from period to period increases in every significant group-wide commercial product. The average premium per group-wide, non-Umbrella Program commercial policy increased 2% from the year earlier period. Total non-Umbrella Program commercial policies in force at December 31, 2005 were 36,050, an increase of 8% from 33,415 at December 31, 2004.

The 19% decrease in group-wide involuntary DWP resulted primarily from a decrease in assignments from the NYAIP. DWP related to policies assigned from the NYAIP decreased 16% to \$2,329,000 from \$2,783,000 for 2004. The NYAIP provides coverage for individuals who are unable to obtain auto insurance in the voluntary market. Assignments from the NYAIP vary depending upon a company's PPA market share and the size of the NYAIP.

In order to minimize the adverse impact of assignments from the NYAIP, the Company purchased territorial credits from an unaffiliated company pursuant to Section 6.A.7. of the NYAIP Manual. The purchased credits decreased DWP related to NYAIP assignments during 2005 and 2004 by approximately \$1,200,000 and \$2,351,000, respectively.

Group-wide pooled net premiums written for 2005 were \$164,302,000, an increase of \$756,000, or less than 1%, from \$163,546,000 for 2004. This increase resulted from the 2% increase in group-wide direct premiums written, somewhat offset by an increase in 2005 as compared to 2004 of reinsurance premiums ceded to third parties. The Company's share of pooled net premiums written in 2005 in accordance with the Reinsurance Pooling Agreement was \$45,135,000, a decrease of \$7,967,000, or 15%, from \$53,102,000 in 2004. This decrease resulted primarily from the 5 percentage point decrease in the Company's participation in the Reinsurance Pooling Agreement.

Total revenues for 2005 were \$57,425,000, a decrease of \$8,080,000 or 12%, from \$65,505,000 in 2004.

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The Company's share of pooled net premiums earned in accordance with the Reinsurance Pooling Agreement for 2005 was \$49,121,000. The Company's share of net premiums earned in 2004 was \$57,123,000. This \$8,002,000, or 14%, decrease in net premiums earned primarily resulted from the 5 percentage point decrease in the Company's participation in the Reinsurance Pooling Agreement.

Net investment income was \$7,733,000, a decrease of \$148,000, or 2%, from \$7,881,000 in 2004. The average pre-tax yield on the investment portfolio increased 6 basis points to 4.2% in 2005 compared to 2004. Average invested assets for 2005 decreased 5% from the year earlier period.

There were no net investment gains or losses in 2005 compared to \$221,000 (\$.07 per fully diluted share after taxes) of net investment losses in 2004. The 2004 amount included an aggregate \$700,000 of investment losses related to an other-than-temporary impairment in the value of two investment securities owned by the Company at December 31, 2004.

Other revenues were \$571,000 in 2005, a decrease of \$151,000, or 21%, from \$722,000 in 2004, primarily due to the 5 percentage point decrease in the Company's participation in the Reinsurance Pooling Agreement.

Net losses and LAE were \$26,408,000 for 2005, a decrease of \$11,273,000, or 30%, from \$37,681,000 for 2004. The decrease in net losses and LAE was due to the 14% decrease in net premiums earned and a 12.2 percentage point decrease in the loss and LAE ratio to 53.8% in 2005 from 66.0% in 2004. This 12.2 percentage point decrease in the loss and LAE ratio was due to a 6.9 percentage point decrease in the loss and LAE ratio for the current accident year to 60.5% in 2005 from 67.4% in 2004 and a \$2,460,000 increase in the amount of favorable development of the Company's estimates of losses incurred related to prior accident years.

The 6.9 percentage point decrease in the loss and LAE ratio for the current accident year primarily resulted from: An improvement in the accident year direct loss and LAE ratio for each of the Company's primary products, the most significant of which was an improvement from 64.4% to 54.1% in the accident year direct loss and LAE ratio in the Company's PPA product. This improvement was due to increased fraud prevention, detection and prosecution efforts resulting from certain legislative changes in New York State. PPA is one of the Company's larger products and represents approximately 23% of the Company's net earned premiums. The decrease in the PPA loss and LAE ratio decreased the Company's overall loss and LAE ratio by approximately 1.6 percentage points.

Mild weather in the Company's operating territory during 2005 contributed to significant decreases in claim frequency (reported claims per earned policy) in the Company's homeowners and commercial property products.

The Company recorded decreases to its estimate of losses and LAE related to prior accident years of \$3,303,000 and \$843,000 in 2005 and 2004, respectively, a difference of \$2,460,000. These decreases in losses and LAE relating to prior accident years reduced the loss and LAE ratio in 2005 and 2004 by 6.7 and 1.5 percentage points, respectively. The reserve development for each product and for each accident year during 2005 was within the range of reasonably likely reserves by product as of December 31, 2004. It is not appropriate to predict future increases or decreases in the estimate of losses and LAE for prior accident years from past experience. See Critical Accounting Policies and Estimates for a further discussion of the

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Company's Reserves for Losses and LAE. The following table documents the changes in the estimate of losses and LAE related to prior accident years recorded in 2005 for the Company's primary products.

| Accident Year | Home-owners | PPA Liability | Commercial | | | | General Liability | All Other | Total |
|---------------|-------------|---------------|----------------|----------------------|--------------------|--------------------------------------|-------------------|------------|-------|
| | | | Auto Liability | Workers Compensation | Commercial Package | Increases (decreases) (in thousands) | | | |
| Prior to 2002 | \$ 126 | \$ (172) | \$ (43) | \$ (1,856) | \$ 2,054 | \$ 1,540 | \$ 300 | \$ 1,949 | |
| 2002 | 79 | (568) | (132) | (501) | (1,216) | (99) | 21 | (2,416) | |
| 2003 | 211 | (333) | (323) | (36) | 91 | 117 | (104) | (377) | |
| 2004 | (361) | (926) | (731) | (166) | 4 | 223 | (502) | (2,459) | |
| Total | \$ 55 | \$ (1,999) | \$ (1,229) | \$ (2,559) | \$ 933 | \$ 1,781 | \$ (285) | \$ (3,303) | |

The Company experienced favorable development during 2005 in its PPA liability product of \$1,999,000 of which \$926,000 related to accident year 2004, primarily due to lower claims frequency and lower estimated severity on voluntary business. These changes are consistent with increased fraud prevention, detection and prosecution efforts stemming from certain legislative changes in New York State.

The Company experienced favorable development during 2005 in its workers' compensation product of \$1,856,000 relating to accident years prior to 2002. The development for accident years prior to 2002 primarily resulted from lower than expected emergence of paid losses and incurred losses during 2005, and a resulting reduction in the expected loss per claim. The Company made no significant changes to its procedures for processing or reserving for workers' compensation claims during 2005. In addition to the comments above related to accident years prior to 2002, the favorable loss development on the workers' compensation product stems from inherent uncertainty in estimating ultimate costs in circumstances that involve the complex and changing medical condition of claimants.

During 2005, the Company experienced unfavorable development in its commercial package and general liability products amounting to \$3,594,000 related to accident years prior to 2002, due to greater than anticipated incurred loss development. The Company has made no changes to its procedures for processing or reserving for commercial package and general liability claims and is not aware of any changes to its business that might have caused a change in loss development patterns.

The Company's reduction in its estimate of losses and LAE related to prior accident years represented less than 3% of the recorded reserve for losses and LAE at December 31, 2004 and is within a reasonable range of loss reserve volatility for the products being underwritten.

The Company made no changes to the key assumptions used in evaluating the adequacy of its reserves for losses and LAE during 2005. A reasonable possibility exists in any year that relatively minor fluctuations in the estimate of reserves for losses and LAE may have a significant impact on the Company's net income. This is due primarily to the size of the Company's reserves for losses and LAE (\$115,191,000 at December 31, 2005) relative to its net income.

The ratio of amortized deferred policy acquisition costs and other underwriting expenses to net premiums earned increased to 43.9% for 2005 from 40.5% for 2004. A \$2,081,000 or 14% decrease in the amortization of deferred acquisition costs was partly offset by a \$520,000 or 6% increase in other underwriting expenses. Other underwriting expenses included \$3,320,000 (6.8 percentage points of the expense ratio) of retrospective commission expense related to the Reinsurance Pooling Agreement, which provides for retrospective commission income or expense based on actual experience compared to a targeted loss and LAE ratio. The commission is owed to Mutual based on a decrease during 2005 in the estimated

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cumulative loss and LAE ratio on the pooled business since the inception of the Reinsurance Pooling Agreement. During 2004 the Company recorded \$1,543,000 of retrospective commission expense related to the Reinsurance Pooling Agreement, which increased the 2004 ratio of amortized deferred policy acquisition costs and other underwriting expenses to net premiums earned by 2.7 percentage points. Other underwriting expenses in 2004 also included \$266,000 related to the November 2004 resignation of the Company's President and \$486,000 of consulting and due diligence expenses pertaining to the investigation of business opportunities. Other underwriting expenses also included \$329,000 and \$462,000 in 2005 and 2004, respectively, related to the purchase of territorial credits against NYAIP assignments discussed earlier in this item. Commissions (other than retrospective commissions under the Reinsurance Pooling Agreement), premium taxes and other state assessments that vary directly with the Company's premium volume represented 19.7% and 19.9% of net premiums earned in 2005 and in 2004, respectively.

Tax exempt income reduced the Company's effective income tax rate by 5 and 8 percentage points, respectively, for the years ended December 31, 2005 and 2004. In addition, the Company reversed excess tax reserves related to uncertain tax positions which reduced the Company's effective income tax rate by 4 percentage points for the year ended December 31, 2004.

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Critical Accounting Policies

Reserve for Losses and LAE

The Reserve for Losses and LAE is an estimate of the ultimate cost of settling all losses incurred and unpaid, including those losses not yet reported to the Company, and is stated net of reinsurance. The amount of loss reserves for reported claims is based upon a case-by-case evaluation of the circumstances and policy provisions pertaining to the claim (case reserves) relating to the loss. Reserves for claims that have occurred but have not been reported (IBNR) to the Company and for the costs of settling or adjusting claims are determined using commonly accepted actuarial techniques based on historical information for each of the Company's products, adjusted for current conditions.

The Company's primary assumption when determining its reserves is that past experience, adjusted for the effect of current developments and trends, is relevant in predicting future events. When establishing its loss reserves, the Company analyzes historical data and estimates the impact of various loss development factors such as the historical loss experience of the Company and of the industry, the mix of products sold, trends in claim frequency and severity, the Company's claim processing procedures, changes in legislation, judicial decisions, legal developments, including the prevalence of litigation in the areas served by the Company, and changes in general economic conditions including inflation.

Management determines the amount of reserves for losses and LAE to be recorded based upon analyses prepared by the Company's internal and external actuaries and management's assessment of a reasonable amount of reserves. The reasonable estimate is determined after considering the estimates produced using a variety of actuarial techniques for each of the Company's products. The following is a summary of the methods used:

Paid Loss Development

The paid loss development method is based on the assumption that past rates of claims payments are indicative of future rates of claims payments. An advantage of this method is that paid losses contain no case reserve estimates. Additionally, paid losses are not as greatly influenced by changes in claims reserving practices as are incurred losses. Estimates can be distorted if changes in claims handling practices or procedures cause an acceleration or deceleration in claims payments. Furthermore, paid loss development may produce biased estimates for long-tailed products where paid loss development factors are large at early evaluation points.

Incurred Loss Development

The incurred loss development method is based on the assumption that the past relative adequacy of case reserves is consistent with the current relative adequacy of case reserves. Because incurred losses include payments and case reserves, a larger volume of data is considered in the estimate of ultimate losses. As a result, incurred loss data patterns may be less erratic than paid loss data patterns, particularly for coverages on which claims are reported relatively quickly but have a long payout pattern. Because this method assumes that the relative adequacy of case reserves has been consistent, changes in claims handling procedures or the occurrence or absence of large losses may cause estimates to be erratic.

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Bornhuetter-Ferguson with Premium and Paid Loss

The Bornhuetter-Ferguson (BF) with premium and paid loss method is a combination of the paid loss development method and an expected loss ratio assumption. The expected loss ratios are modified to the extent actual loss payments differ from payments expected based on the selected paid loss development pattern. This method avoids possible distortions resulting from a large development factor being applied to a small base of paid losses in order to estimate ultimate losses. This method will react slowly if actual ultimate losses differ substantially from losses inherent in the expected loss ratio.

Bornhuetter-Ferguson with Premium and Incurred Loss

The Bornhuetter-Ferguson (BF) with premium and incurred loss method is a combination of the incurred loss development method and an expected loss ratio assumption. The expected loss ratios are modified to the extent actual incurred losses differ from expected incurred losses based on the selected incurred loss development pattern. This method avoids possible distortions resulting from a large development factor being applied to a small base of incurred losses in order to estimate ultimate losses. This method will react slowly if actual ultimate losses differ substantially from losses inherent in the expected loss ratio.

Ultimate Claims and Average Loss

This method multiplies the estimated number of ultimate claims by a selected ultimate average loss for each accident year to produce ultimate loss estimates. If loss development methods produce erratic or unreliable estimates, this method can provide more stable estimates, consistent with recent loss history. This method may produce erratic results if there has been a change in the way claims are counted or in the mix of types of loss. The occurrence or absence of large losses can also distort the average loss estimate.

Allocated loss adjustment expenses (ALAE) are estimated separately from losses because ALAE payment patterns differ from loss payment patterns. The company employs the following methods to estimate ALAE reserves.

Paid ALAE Development

This method is analogous to the paid loss development method except paid ALAE is developed instead of paid losses. Paid ALAE patterns often are more stable than paid loss patterns. However, paid ALAE typically develop more slowly than paid losses, resulting in a large leveraging impact on less mature accident years.

Bornhuetter-Ferguson with Ultimate Loss and Paid ALAE

The Bornhuetter-Ferguson (BF) with ultimate loss and paid ALAE method is a combination of the paid ALAE development method and an expected ratio of ultimate ALAE to ultimate loss. The expected ALAE to loss ratios are modified to the extent paid ALAE differ from expected based on the selected paid ALAE development pattern. This method avoids possible distortions resulting from a large development factor being applied to a small base of paid ALAE in order to estimate ultimate ALAE. This is a useful method for estimating ultimate ALAE for less mature accident years.

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Estimated ultimate losses and LAE and the resulting reserve for losses and LAE are determined based on the results of the methods described above along with the following considerations:

How results of methods based on paid losses compare to methods based on incurred losses.

How results of paid and incurred development methods compare to results of paid and incurred BF methods.

Whether diagnostic tests cause management to favor the results of one or more methods over the results of other methods. Such tests include:

closed claim to reported claim ratios

average case reserves per open claim

paid loss per closed claim

paid loss to incurred loss ratios

the reasonableness of ultimate loss & ALAE ratios and ultimate severities

management's consideration of other factors such as premium and loss trends, large loss experience, legislative and judicial changes and changes in underwriting guidelines and practices.

To the extent these considerations result in changes to the Company's estimates of reserves for losses and LAE related to prior accident years, the Company recognizes such changes in the accounting period in which the change becomes known.

As stated previously, the above methods assume that past experience adjusted for the effects of current developments and trends is an appropriate basis for predicting future events. A range of reasonably likely reserves by product as of December 31, 2006, net of reinsurance, developed by the Company's actuaries are shown in the table below. Generally the low and the high values in the range represent reasonable minimum and maximum amounts of these actuarial indications using the methods described above.

| Products* | Range of Net Loss & LAE Reserves (\$000's) | | |
|------------------------------|--|----------|-----------|
| | Low | Recorded | High |
| Personal Auto | \$ 7,357 | \$ 8,673 | \$ 10,147 |
| Homeowners | \$ 1,669 | \$ 2,256 | \$ 2,943 |
| Commercial Auto | \$ 8,896 | \$12,377 | \$ 16,036 |
| Workers Compensation | \$21,227 | \$26,029 | \$ 31,093 |
| Commercial General Liability | \$30,621 | \$39,923 | \$ 51,578 |
| Commercial Property | \$ 3,262 | \$ 4,078 | \$ 4,893 |
| Other | \$ 3 | \$ 3 | \$ 4 |
| All Products | \$79,596 | \$93,339 | \$108,565 |

* The product categories shown in this table are those used by the Company in its loss reserving process. The Company's reserve for unpaid losses

and LAE in the table that follows are segregated by product type as defined in the Company's Annual Statement filed with insurance department regulators.

Because the reserve estimates by product are independent of each other it is highly unlikely that the actual results for each of the products will be consistent with all of the high estimates, or with all of the low estimates, at the same time. Accordingly, the low and the high estimates for All Products shown above

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are greater than the sum of the low estimates and less than the sum of the high estimates, resulting in a narrower range.

Despite the many factors considered in the reserving process, it is reasonably probable that actual payments for losses and LAE will differ from those contemplated in the Company's reserves. Such fluctuations could have a significant impact on the Company's net income. This is primarily due to the size of the Company's reserves for losses and LAE (\$104,914,000 at December 31, 2006) relative to its net income.

The following table presents the liability for the reserve for unpaid losses and LAE separated into case reserves, reserves for IBNR losses and reserves for LAE by major product:

| | December 31, | |
|---------------------------|--------------|----------|
| | 2006 | 2005 |
| | (000 s) | |
| Case reserves: | | |
| PPA liability | \$ 5,203 | \$ 6,072 |
| Homeowners | 1,353 | 1,899 |
| Commercial auto liability | 4,336 | 5,384 |
| Workers' compensation | 13,136 | 14,531 |
| Commercial package | 10,302 | 12,739 |
| General liability | 618 | 505 |
| Other | 147 | 308 |
| Total case reserves | 35,095 | 41,438 |
| IBNR: | | |
| PPA liability | 2,092 | 4,372 |
| Homeowners | 381 | 228 |
| Commercial auto liability | 6,484 | 6,396 |
| Workers' compensation | 10,531 | 8,074 |
| Commercial package | 16,964 | 16,965 |
| General liability | 2,608 | 2,581 |
| Other | (228) | (407) |
| Total IBNR | 38,832 | 38,209 |
| Reserve for LAE: | | |
| PPA liability | 1,342 | 2,004 |
| Homeowners | 522 | 604 |
| Commercial auto liability | 1,523 | 1,622 |
| Workers' compensation | 2,364 | 2,104 |
| Commercial package | 10,174 | 11,493 |
| General liability | 3,322 | 3,668 |
| Other | 165 | 242 |
| Total reserve for LAE | 19,412 | 21,737 |
| Subtotal | 93,339 | 101,384 |
| Reinsurance recoverables | 11,575 | 13,807 |

| | | |
|----------------------------|------------|------------|
| Reserve for losses and LAE | \$ 104,914 | \$ 115,191 |
|----------------------------|------------|------------|

Deferred Policy Acquisition Costs

Policy acquisition costs, such as commissions (net of reinsurance commissions), premiums taxes and certain other underwriting expenses which vary directly with premium volume, are deferred and amortized over the terms of the related insurance policies. Deferred policy acquisition costs are evaluated on an aggregate basis at least quarterly to determine if recorded amounts exceed estimated recoverable amounts

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after allowing for anticipated investment income. Premium deficiencies, if any, are recorded as amortization of deferred policy acquisition costs. Actual amounts may vary from the Company's estimates.

Investments

Fixed maturity investments are classified as available for sale and are carried at fair value. Net unrealized holding gains or losses, net of taxes, are shown as accumulated other comprehensive income. Investment income is recognized when earned, and gains and losses are recognized when investments are sold and in instances when a decline in the fair value of a security is determined to be other-than-temporary.

The Company's investment committee, comprised of the Chief Operating Officer, the Chief Investment Officer and the Chief Financial Officer, meets monthly and monitors the Company's investment portfolio for declines in value that are other-than-temporary. This assessment requires significant judgment. The investment committee considers the nature of the investment, the severity and length of the decline in fair value, events specific to the issuer including valuation modeling, overall market conditions, and the Company's intent and ability to retain the investment for a period of time sufficient to allow for any anticipated recovery in market value. When a decline in the fair value of a security is determined to be other-than-temporary, the Company adjusts the cost basis of that security to fair value and records a charge to earnings. Future increases in fair value, and future decreases in fair value if not other-than-temporary, are included in other comprehensive income.

Liquidity and Capital Resources

In developing its investment strategy the Company determines a level of cash and short-term investments which, when combined with expected cash flow, is estimated to be adequate to meet expected cash obligations. Due to declining written premiums however, the Company's operating activities have resulted in a use of cash each year since 2001. Net cash used in operations was \$4,350,000 in 2006.

The Company's objectives with respect to its investment portfolio include maximizing total return within investment guidelines while protecting policyholders' surplus and maintaining flexibility. The Company relies on premiums as a major source of cash, and therefore liquidity. Cash flows from the Company's investment portfolio, in the form of interest or principal payments, are an additional source of liquidity.

At December 31, 2006, the Company owned 124 investment securities, of which 105 were in an unrealized loss position. As of December 31, 2006 all of the Company's fixed maturity investments were exchange traded or are readily marketable and are supported by the broker/dealer community. The total potential impact on the Company's future earnings if the unrealized losses associated with its investment portfolio at December 31, 2006 were to become other-than-temporary would be \$2,991,000, or \$1,974,000 after taxes.

Included in net investment losses for the year ended December 31, 2006 are write-downs on investment securities held in the Company's investment portfolio at December 31, 2006 determined to have had an other-than-temporary impairment in market value. The total amount of other-than-temporary impairments recorded as losses amounted to \$118,000 in 2006. No other-than-temporary impairments were recorded in 2005. There were \$700,000 of such impairments recorded in 2004.

At December 31, 2006, \$2,925,000 or 2% of the Company's investment portfolio was invested in non-investment grade securities, compared to \$6,123,000 or 3% at December 31, 2005.

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The Company designates newly acquired fixed maturity investments as available for sale and carries these investments at fair value. Unrealized gains and losses related to these investments are recorded as accumulated other comprehensive income within stockholders' equity.

At December 31, 2006 the Company's portfolio of fixed maturity investments represented 88.4% of invested assets. Management believes that this level of fixed maturity investments is consistent with the Company's liquidity needs because it anticipates that cash receipts from net premiums written, investment income and maturing securities will enable the Company to satisfy its cash obligations. Furthermore, a portion of the Company's fixed maturity investments are invested in mortgage-backed and other asset-backed securities which, in addition to interest income, provide monthly paydowns of bond principal.

At December 31, 2006, \$80,518,000, or 51.3%, of the Company's fixed maturity portfolio was invested in mortgage-backed and other asset-backed securities. The Company invests in a variety of collateralized mortgage obligation (CMO) products but has not invested in the derivative type of CMO products such as interest only, principal only or inverse floating rate securities. All of the Company's CMO investments have a secondary market and their effect on the Company's liquidity does not differ significantly from that of other fixed maturity investments.

At December 31, 2006, the Company owed \$1,915,000 of retrospective commissions to Mutual in accordance with the Reinsurance Pooling Agreement (see the 2006 compared to 2005 section of this Item for a discussion of retrospective commissions). The Reinsurance Pooling Agreement requires the amount of retrospective commissions to be calculated and paid annually, six months after the end of each calendar year.

The Company did not repurchase any shares of its common stock during 2006. At December 31, 2006 the Company was holding 1,139,700 shares in treasury.

During 2006 stock options for 13,000 shares of the Company's stock were exercised. Proceeds to the Company from the exercise of these options amounted to \$273,000.

The Company has arranged for a \$2,000,000 unsecured credit facility from a bank. Any borrowings under this facility are payable on demand and carry an interest rate which can be fixed or variable and is negotiated at the time of each advance. This facility is available for general working capital purposes and for repurchases of the Company's common stock. No amounts were outstanding related to this facility at December 31, 2006.

As a holding company, the Company is dependent upon cash dividends from MNH to meet its obligations and to pay any cash dividends. MNH is subject to New Hampshire insurance laws which place certain restrictions on its ability to pay dividends without the prior approval of state regulatory authorities. These restrictions limit dividends to those that, when added to all other dividends paid within the preceding twelve months, would not exceed 10% of the insurer's policyholders' surplus as of the preceding December 31st. The maximum amount of dividends that MNH could pay during any twelve month period ending in 2007 without the prior approval of the New Hampshire Insurance Commissioner is \$7,167,000. MNH paid \$1,000,000, \$2,000,000 and \$750,000 of dividends to the Company in August 2006, January 2007 and March 2007, respectively. The Company paid aggregate quarterly cash dividends to its common stockholders of \$1.00 per share in 2006, which amounted to \$2,147,000.

Regulatory guidelines suggest that the ratio of a property and casualty insurer's annual net premiums written to its statutory surplus should not exceed 3 to 1. The Company has consistently followed a business

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strategy that would allow MNH to meet this 3 to 1 regulatory guideline. MNH's ratio of net premiums written to statutory surplus for 2006 was .5 to 1.

Off-Balance Sheet Arrangements

The Company does not have any off-balance sheet arrangements.

Contractual Obligations

At December 31, 2006, the Company had no contractual obligations related to long-term debt, capital leases, operating leases, purchase obligations or other long-term liabilities reflected on its balance sheet.

A summary of the Company's non-cancelable contractual obligations follows:

| | Total | Less than 1 Year | 1 - 3 Years | 3 - 5 Years | More than 5 Years |
|---|------------|---------------------|----------------|----------------|----------------------|
| Reserve for losses and loss adjustment expenses | \$ 104,914 | \$ 27,278 | \$ 36,720 | \$ 18,885 | \$ 22,031 |

Unlike most other contractual obligations, reserves for losses and LAE do not have specified due dates. The amounts shown in the preceding table are the Company's estimates of these amounts.

Recently Issued Accounting Standards

The following accounting pronouncements were issued by the Financial Accounting Standards Board during 2006 and are effective for fiscal years ending after December 31, 2006:

SFAS No. 155 Accounting for Certain Hybrid Instruments.

SFAS No. 156 Accounting for Servicing Assets and Liabilities.

SFAS No. 157 Fair Value Measurements.

SFAS No. 158 Employers' Accounting For Defined Benefit Pension and Other Post Retirement Plans.

SFAS No. 159 The Fair Value Option for Financial Assets and Financial Liabilities.

FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes.

The Company does not expect these pronouncements to have any material impact on its financial statements.

Federal Legislation

The Terrorism Risk Insurance Act of 2002 (TRIA), signed into law on November 26, 2002, provides a federal backstop for losses related to the writing of the terrorism peril in property and casualty insurance policies. In December 2005, TRIA was extended through December 31, 2007. The Company has complied with TRIA requirements to notify commercial policyholders about requirements of the law, that the Company is required to offer terrorism coverage and how the coverage is priced. Currently, the Company is issuing terrorism exclusions on its commercial lines policies in states other than New York, where terrorism exclusions have not been approved by the New York Insurance Department. These exclusions will be effective if TRIA expires at December 31, 2007.

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Environmental Claims

MNH, like many other property and casualty insurance companies, is subject to environmental damage claims asserted by or against its insureds. Management of the Company is of the opinion that based on various court decisions throughout the country, certain of these claims should not be recoverable under the terms of MNH's insurance policies because of either specific or general coverage exclusions contained in the policies. However, there is no assurance that the courts will agree with MNH's position in every case, nor can there be assurance that material claims will not be asserted under policies which a court will find do not explicitly or implicitly exclude claims for environmental damages. Management, however, is not aware of any pending claim or group of claims which would result in a liability that would have a material adverse effect on the financial condition of the Company or MNH.

Inflation

Inflation affects the Company, like other companies in the property and casualty insurance industry, by contributing to higher losses, LAE and operating costs, as well as greater investment income resulting from the higher interest rates which can prevail in an inflationary period. Premium rates, however, may not keep pace with inflation since competitive forces may limit the Company's ability to increase premium rates. The Company considers inflationary trends in estimating its reserves for reported and IBNR claims.

Relationship with Mutual

The Company's and MNH's business and day-to-day operations are closely aligned with those of Mutual. This is the result of a combination of factors. Mutual has had a historical ownership interest in the Company and MNH. Prior to November 1986 MNH was a wholly-owned subsidiary of Mutual. Following the Company's initial public offering in November 1986 and until a secondary stock offering in July 1993 the Company was a majority-owned subsidiary of Mutual. At December 31, 2006 Mutual owned 11.9% of the Company's common stock. Under the Services Agreement, Mutual provides the Company and MNH with all facilities and personnel to operate their business. The officers of the Company and MNH are employees of Mutual whose services are provided to, and paid for by, the Company and MNH through the Services Agreement. Also, the operation of MNH's insurance business, which offers substantially the same products as Mutual through the same independent insurance agents, creates a very close relationship among the companies.

Safe Harbor Statement under the Private Securities Litigation Reform Act of 1995:

With the exception of historical information, the matters and statements discussed, made or incorporated by reference in this Annual Report on Form 10-K constitute forward-looking statements and are discussed, made or incorporated by reference, as the case may be, pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Forward-looking statements include, without limitation, statements relating to the Company's plans, strategies, objectives, expectations and intentions. Words such as believes, forecasts, intends, possible, expects, anticipates, estimates, or plans, and similar expressions are intended to identify forward-looking statements. Such forward-looking statements involve certain assumptions, risks and uncertainties that include, but are not limited to, those associated with factors affecting the property-casualty insurance industry generally, including price competition, the Company's dependence on state insurance departments for approval of rate increases, size and frequency of claims, escalating damage awards, natural disasters, fluctuations in interest rates and general business conditions; the Company's dependence on investment income; the geographic

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concentration of the Company's business in the northeastern United States and in particular in New York, New Hampshire, New Jersey, Rhode Island, Pennsylvania and Massachusetts; the adequacy of the Company's loss reserves; the Company's dependence on the general reinsurance market; government regulation of the insurance industry; exposure to environmental claims; dependence of the Company on its relationship with Merchants Mutual Insurance Company; and the other risks and uncertainties discussed or indicated in all documents filed by the Company with the Securities and Exchange Commission. Forward-looking statements are not guarantees of future performance and involve known and unknown risks, uncertainties and other factors that may cause the Company's actual results, performance, achievements or financial condition to be materially different from any future results, performance, achievements, or financial condition expressed or implied by the forward-looking statements. The Company expressly disclaims any obligation to update any forward-looking statements as a result of developments occurring after the filing of this report.

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Item 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Market Risk

Market risk represents the potential for loss due to changes in the fair value of financial instruments. The market risk related to the Company's financial instruments primarily relates to its investment portfolio. The value of the Company's investment portfolio of \$177,528,000 at December 31, 2006 is subject to changes in interest rates and to a lesser extent on credit quality. Further, certain mortgage-backed and asset-backed securities are exposed to prepayment or extension risk generally caused by interest rate movements. If interest rates decline, mortgage holders would be more likely to refinance existing mortgages at lower rates. Acceleration of future repayments could adversely affect future investment income, if the accelerated receipts were invested in lower yielding securities.

The table below provides information related to the Company's fixed maturity investments at December 31, 2006. The table presents cash flows of principal amounts and related weighted average interest rates by expected maturity dates. The cash flows are based upon the maturity date or, in the case of mortgage-backed and asset-backed securities, expected payment patterns. Actual cash flows could differ from those shown in the table.

Expected Cash Flows of Principal Amounts (\$ in 000's):

| | 2006 | 2007 | 2008 | 2009 | 2010 | There- after | TOTAL Amortized Cost | TOTAL Estimated Market Value |
|---|-----------|-----------|-----------|-----------|-----------|-----------------|----------------------------|---------------------------------------|
| Available for Sale | | | | | | | | |
| U.S. Treasury securities and obligations of U.S. Government corporations and agencies | \$ 0 | \$ 3,002 | \$ 2,998 | \$ 4,245 | \$ 0 | \$ 0 | \$ 10,245 | \$ 10,139 |
| Average interest rate | 0.0% | 3.2% | 4.9% | 4.8% | 0.0% | 0.0% | | |
| Obligations of states and political subdivisions | 5,807 | 15,862 | 5,946 | 7,445 | 0 | 5,247 | 40,307 | 39,759 |
| Average interest rate | 4.6% | 3.9% | 4.5% | 5.0% | 0.0% | 4.9% | | |
| Corporate securities | 0 | 3,247 | 7,750 | 5,151 | 8,488 | 2,145 | 26,781 | 26,448 |
| Average interest rate | 0.0% | 3.7% | 4.5% | 5.0% | 5.5% | 6.3% | | |
| Mortgage & asset backed securities | 21,518 | 14,085 | 12,595 | 10,367 | 6,794 | 17,095 | 82,454 | 80,518 |
| Average interest rate | 4.8% | 4.8% | 4.8% | 4.9% | 4.9% | 5.0% | | |
| Total | \$ 27,325 | \$ 36,196 | \$ 29,289 | \$ 27,208 | \$ 15,282 | \$ 24,487 | \$ 159,787 | \$ 156,864 |

The discussion and the estimated amounts referred to above include forward-looking statements of market risk which involve certain assumptions as to market interest rates and the credit quality of the fixed maturity investments. Actual future market conditions may differ materially from such assumptions. Accordingly, the forward-looking statements should not be considered projections of future events by the Company.

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Item 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA.

The consolidated financial statements required in response to this Item are submitted as part of Item 14 (a) of this report, and are incorporated in this item by reference.

Quarterly data for the two most recent fiscal years is set forth below:

| | 3/31 | Three months ended | | 12/31 |
|-------------------------------|--|--------------------|------------------|------------------|
| | | 6/30 | 9/30 | |
| | (in thousands, except per share amounts) | | | |
| 2006 | | | | |
| Net premiums earned | \$ 10,026 | \$ 10,019 | \$ 10,699 | \$ 10,429 |
| Net investment income | 1,944 | 2,002 | 1,923 | 2,069 |
| Net investment gains (losses) | (110) | 42 | | 8 |
| Other revenues | 133 | 77 | 112 | 167 |
| Total revenues | \$ 11,993 | \$ 12,140 | \$ 12,734 | \$ 12,673 |
| Income before income taxes | \$ 3,295 | \$ 2,172 | \$ 1,652 | \$ 1,245 |
| Net income | \$ 2,338 | \$ 1,534 | \$ 1,159 | \$ 906 |
| Net income per diluted share | \$ 1.09 | \$.71 | \$.54 | \$.43 |
| 2005 | | | | |
| Net premiums earned | \$ 11,977 | \$ 12,767 | \$ 12,155 | \$ 12,222 |
| Net investment income | 1,936 | 1,908 | 1,890 | 1,999 |
| Net investment gains | | | | |
| Other revenues | 136 | 114 | 163 | 158 |
| Total revenues | \$ 14,049 | \$ 14,789 | \$ 14,208 | \$ 14,379 |
| Income before income taxes | \$ 1,599 | \$ 4,532 | \$ 2,484 | \$ 820 |
| Net income | \$ 1,188 | \$ 3,178 | \$ 1,721 | \$ 612 |
| Net income per diluted share | \$.56 | \$ 1.50 | \$.81 | \$.29 |

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Item 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE.

None.

Item 9A. CONTROLS AND PROCEDURES.

After evaluating the effectiveness of the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934 (the Exchange Act)) as of the end of the period covered by this Annual Report on Form 10-K, the Company's Chief Operating Officer and Chief Financial Officer, who are, respectively, its principal executive officer and principal financial officer, concluded that the Company's disclosure controls and procedures were effective in reaching a reasonable level of assurance that information required to be disclosed by the Company in reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time period specified in the SEC's rules and forms.

The Company's Chief Operating Officer and Chief Financial Officer also evaluated the Company's internal controls over financial reporting (as defined in Exchange Act Rule 13a-15(f)) and determined that no changes in internal control over financial reporting occurred during the quarter ended December 31, 2006 that have materially affected, or which are reasonably likely to material affect, the Company's internal controls over financial reporting.

Item 9.B. OTHER INFORMATION.

None.

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PART III

Item 10. DIRECTORS AND EXECUTIVE OFFICERS

Information Concerning Directors

The Company's Certificate of Incorporation provides that the number of directors of the Company shall be not less than five and not more than fifteen and that the directors shall be divided into three classes, each class containing as nearly equal a number of directors as possible, with one class standing for election each year. Directors for each class are elected for three year terms at the annual meeting in which the term of their class expires.

The Board of Directors has determined that all members of the Company's Board of Directors are independent directors under the American Stock Exchange Listing Qualifications.

The Board of Directors of the Company has determined that Thomas E. Kahn is an audit committee financial expert as defined by Item 401(h) of Regulation S-K of the Securities Exchange Act of 1934, as amended (the Exchange Act) and is independent within the meaning of Item 7(d) (3) (iv) of Schedule 14A of the Exchange Act.

The Company has a separately designated Audit Committee established in accordance with Section 3(a) (58) (A) of the Exchange Act. The members of the Audit Committee are: Frank J. Colantuono, Thomas E. Kahn and Henry P. Semmelhack (Chair).

The Company's Board of Directors has adopted a Code of Conduct and Ethics and a Code of Business Conduct, which governs business decisions made and actions taken by the Company's directors, officers and employees. A copy of this code is available in print, without charge, to any shareholder upon written request to:

Investor Relations
Merchants Group, Inc.
250 Main Street
Buffalo, NY 14202

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Directors

The following table sets forth information regarding directors:

| Name, Position and Tenure with the Company | Age Principal Occupation and Business Experience For Past Five Years |
|--|--|
| Director Whose Terms Expire In 2009 | |
| Henry P. Semmelhack Director since 1987 | 70 Chairman, President and Chief Executive Officer from 1982 to 2002 of Barrister Global Services Network, Inc., a public computer software and services company. Private investor since 2002. |
| Directors Whose Terms Expire In 2008 | |
| Andrew A. Alberti Director since 1998 | 61 President of Cross River International, Inc., an insurance management consulting firm, since 1993; President of Hanover Management Services Inc., an insurance management consulting firm, from 1989 to 1993. Positions in the New York Insurance Department Liquidation Bureau from 1973 to 1988. |
| Frank J. Colantuono Director since 1994 | 58 President and Chief Executive Officer of Independent Health Association, Inc., a health maintenance organization, from 1984 to 2004. President Emeritus from 2004 to present. |
| Directors Whose Terms Expire in 2007 | |
| Brent D. Baird Director since 1995 | 68 President and Chief Executive Officer of the Company from 1995 to 2003; private investor since 1991; limited partner of Trubee Collins & Co. (member firm of New York Stock Exchange, Inc.) from 1983 to 1991. |
| Thomas E. Kahn Director since 2000 and Chairman of the Board since May, 2004 | 54 Vice President and Secretary of Clayton Management Company, an investment management company, since 1993. |

Table of Contents**Executive Officers**

The following is a listing of the Company's executive officers.

| Name, Position and Tenure with the Company | Age | Principal Occupation and Business Experience for Past Five Years |
|--|------------|---|
| Robert M. Zak Senior Vice President and Chief Operating Officer | 49 | President and Chief Executive Officer of MNH and Mutual since November 1, 1995; Director of MNH since 1990; Director of the Company from 1994 to 2006; Sr. Vice President of MNH and Mutual from 1992 to 1995; Chief Financial Officer of the Company, MNH and Mutual from 1991 through 1996; Vice President Financial Services of MNH and Mutual from 1989 through 1996; Secretary of MNH and Mutual from 1990 through November 1, 1995. |
| Edward M. Murphy Vice President, Chief Investment Officer and Assistant Secretary since 1991 | 56 | Vice President and Chief Investment Officer of the Company, Mutual and MNH since 1991; Assistant Vice President of Mutual and MNH from 1989 to 1991. |
| Kenneth J. Wilson Vice President, Treasurer, and Chief Financial Officer since 1996 and Secretary since 1999 | 59 | Vice President, Treasurer and Chief Financial Officer of the Company, Mutual and MNH since 1996; President and Chief Executive Officer of Carbadon Corp. and its operating subsidiary, Empire of America Realty Credit Corp., from December 1995 to December 1996 and Chief Financial Officer from November 1992 to December 1996. |

There are no family relationships between any of the directors or executive officers of the Company.

Section 16(a) Beneficial Ownership Reporting Compliance

Section 16(a) of the Securities Exchange Act of 1934, as amended, requires directors, executive officers and holders of more than 10% of the Company's common stock (collectively "Insiders") to file with the Securities and Exchange Commission reports regarding their ownership and changes in ownership of the Company's securities. The Company believes that during 2006 its directors, executive officers and 10% shareowners complied with all Section 16(a) filing requirements. In making this statement, the Company has relied upon examination of the copies of Forms 3, 4 and 5, and amendments thereto, provided to the Company by, and the written representations of, its directors, executive officers and 10% shareowners.

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Item 11. COMPENSATION OF EXECUTIVE OFFICERS AND DIRECTORS

Compensation Discussion and Analysis:

The Company and its wholly-owned operating subsidiary, MNH, have no employees and do not compensate their executive officers, including the executive officers named in the Summary Compensation Table (the NEOs). Mutual operates and manages the Company's business under the terms of a Services Agreement. The NEOs are employees of Mutual, and Mutual compensates them for their services to it, including both services they provide to Mutual for managing Mutual and services they provide in managing the Company and MNH under the terms of the Services Agreement.

Although Mutual may use a portion of the fees that the Company and MNH pay to Mutual under the Services Agreement to compensate the NEOs for providing services to the Company and MNH, the Company has not negotiated with Mutual the levels or types of compensation that Mutual pays to the NEOs. Accordingly, the Company does not have a compensation program with respect to the NEOs.

Compensation Committee Report:

The Compensation Committee of the Board of Directors consists of Andrew A. Alberti, Frank J. Colantuono and Thomas E. Kahn. The Compensation Committee has reviewed and discussed the Compensation Discussion and Analysis required by Regulation S-K, Item 402(b) (section 222.402(b)) with management, and based upon that review and discussion the Compensation Committee has recommended to the Board of Directors that the Compensation Discussion and Analysis be included in the Company's annual report on Form 10-K.

Submitted by the Compensation Committee:

Frank J. Colantuono, Chairman
Andrew A. Alberti
Thomas E. Kahn

The Compensation Committee Report shall not be deemed to be soliciting material or to be filed with the SEC, or subject to Regulation 14A or Regulation 14C of the SEC, or to be subject to the liabilities of Section 18 of the Securities Exchange Act, except if, in the future, the Company specifically requests that the information be treated as soliciting material or specifically incorporates it by reference into a document filed under the Securities Act or the Securities Exchange Act.

Summary Compensation Table:

The following table contains information covering the compensation awarded to, earned by, or paid to, the principal executive officer, principal financial officer, and any other executive officers of Merchants Group, Inc. whose total compensation exceeded \$100,000, by any person for services provided to Merchants Group, Inc. in the fiscal year ended December 31, 2006.

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| Name and Principal Position | Year | Salary | Total |
|---|------|--------------|--------------|
| Robert M. Zak (1) Chief Operating Officer | 2006 | \$(2) \$0 | \$(2) \$0 |
| Kenneth J. Wilson Chief Financial Officer | 2006 | \$0 | \$0 |

(1) Since November 30, 2004, Mr. Zak has assumed the duties of the principal executive officer of the Company.

(2) Under the Services Agreement, effective January 1, 2003, salaries for officers who are employees of Mutual are allocated by Mutual to the various services (administrative, underwriting, claims and investments) provided by Mutual pursuant to the Services Agreement and, where applicable, Mutual used the allocations to determine the fees it charged to MNH. As such, the exact portion of their compensation

that Mutual charged to MNH for the services of Mr. Zak and Mr. Wilson is not determinable. Based on information provided by Mutual, the Company estimates that the portion of Mr. Zak's and Mr. Wilson's salaries for 2006 included in the fees charged to MNH pursuant to the Services Agreement was \$96,000 and \$51,000, respectively.

Grants of Plan-Based Awards:

The Company's Option Plan expired in 1996. No plan based awards were made to the NEOs for services provided to the Company.

Outstanding Equity Awards at Fiscal Year-End:

There were no outstanding Equity Awards for NEOs as of the fiscal year-end. All equity options previously awarded to NEOs expired as of February 22, 2006.

Option Exercises and Stock Vested:

The following table sets forth information concerning any exercises of stock options, SARs, and similar instruments, and any vesting of stock, including restricted stock, restricted stock units and similar instruments, during 2006 for each of the NEOs on an aggregated basis.

OPTIONS EXERCISED AND STOCK VESTED

| Name | Option Awards | | Stock Awards | |
|---------------|---|---------------------------------|--|--------------------------------|
| | Number of Shares Acquired on Exercise (#) | Value Realized on Exercise (\$) | Number of Shares Acquired on Vesting (#) | Value Realized on Vesting (\$) |
| Robert M. Zak | 7,500 | 66,750 | 0 | 0 |

(1) Based upon the difference

between the closing price of the common stock on the American Stock Exchange on the date of exercise and exercise price of the stock option.

Pension Benefits:

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The Company does not provide pension benefits to the NEOs under any plan that provides payments or other benefits following or in connection with their retirement.

Non-Qualified Deferred Compensation:

The Company does not maintain any defined contribution or other plan that provides for the deferral of compensation for the benefit of the NEOs.

Directors Compensation:

The following table contains information concerning the total compensation earned by each individual who served as a director of the Company during 2006 other than directors who are also NEOs.

| Name | Fees Earned Or Paid In Cash (\$) | Total (\$) |
|---------------------|--|---------------|
| Andrew A. Alberti | \$ 38,500 | \$ 38,500 |
| Brent D. Baird | 37,000 | 37,000 |
| Frank J. Colantuono | 48,000 | 48,000 |
| Thomas E. Kahn (1) | 141,500 | 141,500 |
| Henry P. Semmelhack | 42,500 | 42,500 |

(1) Mr. Kahn received additional director fees for his participation in meetings, conferences, interviews and negotiations with third parties as a representative of the Board, which resulted in the Merger Agreement with AEG.

Compensation Committee Interlocks and Insider Participation:

With respect to members serving on the Company's Compensation Committee during 2006, there are no compensation committee interlocks which the SEC regulations would require to be disclosed in this report, and there was no insider participation which the SEC regulations would require to be disclosed.

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Item 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT.

Security Ownership of Certain Beneficial Owners

Merchants Group, Inc. believes that the following persons and groups were the beneficial owners of more than 5% of the outstanding shares as of March 20, 2007.

| Name and Address of Beneficial Owner | Number of Shares Beneficially Owned (1) | Percent of Class |
|--|--|---------------------|
| John D. Weil 200 N. Broadway St. Louis, Missouri 63102 | 256,155(2) | 11.9% |
| Merchants Mutual Insurance Company 250 Main Street Buffalo, New York 14202 | 255,000(3) | 11.9% |
| Brent D. Baird and others 1350 One M&T Plaza Buffalo, New York 14203 | 232,400(4) | 10.8% |
| Franklin Resources, Inc. 777 Mariners Island Blvd. San Mateo, California 94404 | 155,800(5) | 7.3% |
| Kahn Brothers & Co., Inc. 555 Madison Avenue New York, New York 10022 | 112,186(6) | 5.2% |
| Dimensional Fund Advisors, Inc. 1299 Ocean Avenue, 11 th Floor Santa Monica, California 90401 | 112,424(7) | 5.2% |

(1) The beneficial ownership information presented is based upon information furnished by each person or contained in filings made with the Securities and Exchange Commission. Except as

otherwise indicated, each person has sole voting and investment power with respect to the Shares indicated.

- (2) These shares are owned by Woodbourne Partners, LP, an investment partnership of which Clayton Management Company is the sole general partner. Clayton Management has sole voting and investment power over these shares. John D. Weil owns 100% of the outstanding stock of Clayton Management. Includes 4,995 shares held in six individual retirement accounts maintained for the benefit of certain persons holding limited partnership interests in Woodbourne Partners, LP. Mr. Weil disclaims beneficial ownership of such shares.

(3)

Mutual operates
its business in
conjunction
with Merchants
Group, Inc. and
Merchants
Insurance

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Company of
New Hampshire,
Inc., Merchants
Group Inc. s
wholly-owned
subsidiary.

- (4) Mr. Baird has sole voting and dispositive powers with respect to 13,600 shares and Mr. Baird, members of the Baird family, and entities owned or controlled by the Baird family have shared voting and dispositive power with respect to 218,800 shares.
- (5) Franklin Resources, Inc. through its advisory subsidiary, Franklin Advisory Services, LLC, has sole voting and dispositive power with respect to the 155,800 shares.
- (6) Based on a Schedule 13G/A dated February 2, 2005, which indicated Kahn Brothers & Co., Inc. shares

dispositive power but no voting power with respect to these shares.

- (7) Dimensional Fund Advisors has sole voting and dispositive power with respect to the 112,424 shares.

Merchants Group, Inc. is subject to statutes governing insurance holding company systems. Under the terms of the applicable New Hampshire statute, any person or entity desiring to effect an acquisition of the Company's securities that would result in that person or entity owning 10% or more of the Company's outstanding voting securities would be required to obtain the approval of the New Hampshire Insurance Department prior to the acquisition.

Security Ownership of Management

The following table sets forth the number of Merchants Group, Inc. shares beneficially owned as of March 20, 2007 (unless otherwise indicated) by each director and each one of the executive officers who would be a named executive officer listed in the Summary Compensation Table. Unless otherwise stated, each person has sole voting and investment power with respect to the Shares set forth in the table.

| Name | Number of Shares Beneficially Owned (1) | Percent of Class (2) |
|---|---|----------------------------|
| Andrew A. Alberti | 0 | |
| Brent D. Baird | 232,400(3) | 10.8% |
| Frank J. Colantuono | 1,000 | * |
| Thomas E. Kahn | 0(4) | |
| Henry P. Semmelhack | 1,500 | * |
| Robert M. Zak | 22,410(5) | 1.0% |
| Kenneth J. Wilson | 1,000 | * |
| Directors and officers as a group (7 persons) | 258,310 | 12.0% |

* Less than 1% of the amount outstanding.

- (1) The beneficial ownership information presented is based upon information furnished by each person

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or contained in filings made with the Securities and Exchange Commission. Unless as otherwise indicated, each person has sole voting and investment power with respect to the Shares indicated.

(2) Percentage calculations for each individual and group in the table are based on 2,145,652 shares outstanding.

(3) See note 4 to table under Security Ownership of Certain Beneficial Owners.

(4) See note 2 to table under Security Ownership of Certain Beneficial Owners. Mr. Kahn is a Vice President and the Secretary of Clayton Management.

(5)

Includes 2,800 shares that Mr. Zak owns jointly with his spouse, and 1,110 Shares held by the Merchants Mutual Supplemental Executive Retirement Plan for the benefit of Mr. Zak. Does not include 255,000 Shares owned by Mutual as to which Mr. Zak disclaims beneficial ownership. Mr. Zak is President and Chief Executive Officer of Mutual.

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Item 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS.

The Company and MNH operate and manage their business in conjunction with Merchants Mutual Insurance Company (Mutual), a New York domiciled mutual property and casualty insurance company, under a services agreement (the Services Agreement) that became effective January 1, 2003. At December 31, 2006, Mutual owned 11.9% of the Company's issued and outstanding common stock. The Company and MNH do not have any operating assets or employees. In accordance with the Services Agreement, Mutual provides the Company and MNH with the facilities, management and personnel required to operate their day-to-day business. The Services Agreement covers: administrative services, underwriting services, claims services and investment and cash management services.

Effective January 1, 2003, Mutual and MNH agreed to pool, or share, underwriting results on their traditional insurance business (Traditional Business) by means of a reinsurance pooling agreement (the Pooling Agreement). The Pooling Agreement applies to premiums earned and losses incurred after the effective date. It does not apply to any new endeavor of either Mutual or MNH outside of their Traditional Business, unless the companies agree otherwise. Neither Mutual or MNH has entered into any endeavor outside of their Traditional Business.

The Pooling Agreement provides for MNH to cede, or transfer, to Mutual all premiums and risks on its Traditional Business during the term of the agreement, and then to assume from Mutual a percentage of all of Mutual's and MNH's Traditional Business (the Pooled Business). MNH assumed 25% of the Pooled Business in 2006, 30% in 2005 and 35% in 2004. MNH's share of the Pooled Business will be 25% in 2007. Mutual retains a share of the risk in MNH's Traditional Business under Mutual's control pursuant to a profit and loss sharing arrangement in the Pooling Agreement based on the loss and loss adjustment expense (LAE) experience of the Pooled Business. The Company believes the Pooling Agreement and profit (or loss) sharing feature included therein aligns the interests of MNH and Mutual.

On October 31, 2006, the Company entered into an Agreement and Plan of Merger (the Merger Agreement) with American European Group, Inc. (AEG), a Delaware corporation, and American European Financial, Inc., a newly-formed Delaware corporation that is a wholly owned subsidiary of AEG (Merger Sub), pursuant to which Merger Sub will merge with and into the Company (the Merger). Upon completion of the Merger, the Company will be a wholly owned subsidiary of AEG. The Merger is expected to be consummated in the first quarter of 2007. The Company's shareholders approved the Merger on February 1, 2007. The New Hampshire Department of Insurance approved the Merger on March 21, 2007.

On December 27, 2006 the Company, Mutual and AEG entered into an agreement (the Renewal Rights Agreement) whereby, contingent upon completion of the Merger, MNH will sell the renewal rights to all of its Traditional Business to Mutual. Substantially all of MNH's business will be renewed by Mutual or one of its subsidiaries. The Renewal Rights Agreement provides that Mutual will continue to provide underwriting and claims services for policies and claims on MNH's Traditional Business. The Renewal Rights Agreement also provides, upon completion of the Merger, for the Pooling Agreement between Mutual and MNH to continue through December 31, 2009 and subject to certain conditions, December 31, 2009.

The Renewal Rights Agreement includes notice by Mutual of the termination of the

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Administrative Annex of the Services Agreement effective June 30, 2007 unless terminated earlier because the Merger has become effective. In addition, it includes conditional termination of the remaining annexes to the Services Agreement and the Reinsurance Pooling Agreement effective December 31, 2007 by Mutual, in the event the Renewal Rights Agreement does not become effective by June 30, 2007.

Mutual controls (as that term is used in the New Hampshire Insurance Law) the Company by reason of the combination of Mutual's ownership of Shares of the Company, and the management of the day-to-day business of the Company and MNH under the Services Agreement by officers who are also officers of Mutual.

During the fiscal year ended December 31, 2006, the law firm of Hodgson Russ LLP served as principal corporate counsel to the Company and billed the Company an aggregate of \$115,596 for its legal services, which included services provided by one of its partners, David M. Stark. Mr. Stark is the son-in-law of Brent D. Baird, a Director of the Company.

The following individuals are members of the Company's Board of Directors: Andrew A. Alberti, Brent D. Baird, Frank J. Colantuono, Thomas E. Kahn, Henry P. Semmelhack.

The Board of Directors has determined that all of its members are independent directors under the American Stock Exchange Listing Qualifications.

Item 14. PRINCIPAL ACCOUNTANTS FEES AND SERVICES

PricewaterhouseCoopers LLP (PwC) has served as the Company's independent auditor since 1981. Services provided to the Company and its subsidiaries by PwC in 2006 included the examination of the Company's consolidated financial statements, limited reviews of quarterly reports, statutory audits of subsidiaries, services related to filings with the Securities and Exchange Commission, and consultations on various tax and accounting matters.

Audit Fees

The following table sets forth the fees for professional services rendered by PwC for the audit of the Company's annual financial statements for the years ended December 31, 2006 and 2005, and for tax fees billed in 2006 and 2005.

| | 2006 | 2005 |
|--------------------|------------|------------|
| Audit Fees | \$ 294,300 | \$ 176,050 |
| Audit Related Fees | 18,000(b) | 6,285(a) |
| Tax Fees (c) | 3,000 | 2,500 |
| All Other Fees | | |
| | \$ 315,300 | \$ 184,835 |

(a) Audit related fees consist primarily of consulting fees related to internal controls in connection with planning for compliance with Section 404 of the Sarbanes Oxley Act of 2002.

(b)

Audit related fees consist primarily of fees related to the Company's investigation of strategic alternatives and the preparation of audit workpapers for due diligence activities by potential acquirers of the company.

- (c) Principally tax compliance services.

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The Audit Committee has considered and determined that the provision of services by PwC other than professional services rendered for the audit of the Company's annual financial statements and reviews of financial statements for quarterly reports is compatible with maintaining the independence of PwC.

PART IV

Item 15. EXHIBITS AND FINANCIAL STATEMENTS SCHEDULES.

(a)(1) The following financial statements of Merchants Group, Inc. are included on pages F-1 to F-25:

| | |
|---|-----|
| <u>Report of Independent Registered Public Accounting Firm</u> | F-1 |
| <u>Consolidated Balance Sheet December 31, 2006 and 2005.</u> | F-2 |
| <u>Consolidated Statement of Operations Years ended December 31, 2006, 2005 and 2004.</u> | F-4 |
| <u>Consolidated Statement of Changes in Stockholders Equity Years ended December 31, 2006, 2005 and 2004.</u> | F-6 |
| <u>Consolidated Statement of Cash Flows Years ended December 31, 2006, 2005 and 2004.</u> | F-7 |
| <u>Notes to Consolidated Financial Statements.</u> | F-9 |

(a)(2) The following financial statement schedules of Merchants Group, Inc. are filed herewith pursuant to Item 8:

Schedule I

Summary of Investments Other Than Investments in Related Parties.

Schedule II

Amounts Receivable From/Payable to Related Parties, and Underwriters, Promoters and Employees Other Than Related Parties.

Schedule III

Condensed Financial Information of Registrant.

Schedule IV Reinsurance

Schedule V

Supplemental Insurance Information (see Schedule VI).

Schedule VI

Supplemental Insurance Information Concerning Property Casualty Subsidiaries

(a)(3) Exhibits required by Item 601 of Regulation S-K:

- (3) (a) Restated Certificate of Incorporation (incorporated by reference to Exhibit No. 3C to Amendment No. 1 to the Company's Registration Statement (No. 33-9188) on Form S-1 filed on November 7, 1986).
- (b) Restated By-laws (incorporated by reference to Exhibit No. 3D to Amendment No. 1 to the Company's Registration Statement (No. 33-9188) on Form S-1 filed on November 7, 1986).
- (10) (a) Management Agreement dated as of September 29, 1986 by and among Merchants Mutual Insurance Company, Registrant and Merchants Insurance Company of

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New Hampshire, Inc. (incorporated by reference to Exhibit No. 10A to the Company's Registration Statement (No. 33-9188) on Form S-1 filed on September 30, 1986).

- (b) Services Agreement Among Merchants Mutual Insurance Company, Merchants Insurance Company of New Hampshire, Inc. and Merchants Group, Inc. dated January 1, 2003 (incorporated by reference to Exhibit No. 10b to the Company's 2003 Quarterly Report on Form 10-Q filed on May 14, 2003).
- (c) Reinsurance Pooling Agreement between Merchants Insurance Company of New Hampshire, Inc. and Merchants Mutual Insurance Company effective January 1, 2003 (incorporated by reference to Exhibit No. 10c to the Company's 2003 Quarterly Report on Form 10-Q filed on May 14, 2003).
- (d) Endorsement to the Casualty Excess of Loss Reinsurance agreement between Merchants Mutual Insurance Company, Merchants Insurance Company of New Hampshire, Inc. and American Reinsurance Company dated February 23, 2004 (incorporated by reference to Exhibit 10(e) to the Company's 2004 Quarterly Report on Form 10-Q filed on November 10, 2004).
- (e) Property Per Risk Excess of Loss Reinsurance Agreement between Merchants Mutual Insurance Company, Merchants Insurance Company of New Hampshire, Inc. and American Reinsurance Company dated April 16, 2004 (incorporated by reference to Exhibit 10(f) to the Company's 2004 Quarterly Report on Form 10-Q filed on November 10, 2004).
- (f) Property Catastrophe Excess of Loss Reinsurance Agreement between Merchants Mutual Insurance Company, Merchants Insurance Company of New Hampshire, Inc. and the various reinsurers as identified by the Interest and Liabilities Agreements attaching to and forming part of this Agreement (filed herewith).
- (g) Quota Share Reinsurance Treaty Agreement between Merchants Insurance Company of New Hampshire, Inc. and The Subscribing Underwriting Members of Lloyd's, London specifically identified on the schedules attached to this agreement dated January 1, 2000 (incorporated by reference to Exhibit 10(h) to the Company's 2000 Annual Report on Form 10-K filed on March 28, 2001).
- * (h) Form of Amended Indemnification Agreement entered into by Registrant with each director and executive officer of Registrant (incorporated by reference to Exhibit No. 10N to Amendment No. 1 to the Company's Registration Statement on (No. 33-9188) Form S-1 filed on November 7, 1986).
- * (i) Merchants Mutual Insurance Company Adjusted Return on Equity Incentive Compensation Plan January 1, 2000 (incorporated by reference to Exhibit 10p to the Company's 2000 Annual Report on Form 10-K filed on March 28, 2001).
- * (j) Amendment No. 1 to Employee Retention Agreement between Robert M. Zak and Merchants Mutual Insurance Company originally dated as of May 31, 1999, dated February 6, 2002 (incorporated by reference to Exhibit 10(s) to the Company's 2002 Annual Report on Form 10-K filed on March 31, 2003).

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- * (k) Amendment No. 1 to Employee Retention Agreement between Edward M. Murphy and Merchants Mutual Insurance Company originally dated as of March 1, 1999 dated February 6, 2002 (incorporated by reference to Exhibit 10(t) to the Company's 10-K filed on March 31, 2003).
- * (l) Amendment No. 1 to Employee Retention Agreement between Kenneth J. Wilson and Merchants Mutual Insurance Company originally dated as of March 1, 1999 dated February 6, 2002 (incorporated by reference to Exhibit 10(u) to the Company's Annual Report on Form 10-K filed on March 31, 2003).
- (m) Amendment to Services Agreement, dated June 12, 2006, among Merchants Group, Inc., Merchants Insurance Company of New Hampshire, Inc., and Merchants Mutual Insurance Company (incorporated by reference to Exhibit 99.1 to the Company's Form 8-K Report dated June 12, 2006).
- (n) Amendment to Services Agreement, dated September 28, 2006 among Merchants Group, Inc., Merchants Insurance Company of New Hampshire, Inc., and Merchants Mutual Insurance Company (incorporated by reference to Exhibit 99.1 to the Company's Form 8-K Report dated September 28, 2006).
- (o) Agreement and Plan of Merger, dated as of October 31, 2006, by and between Merchants Group, Inc., American European Group, Inc., and American European Financial, Inc., (incorporated by reference to Exhibit 99.1 to the Company's Form 8-K dated October 31, 2006).
- (p) Agreement, dated December 22, 2006 among Merchants Group, Inc., Merchants Insurance Company of New Hampshire, Inc., Merchants Mutual Insurance Company, Merchants Preferred Insurance Company, MPIC, Inc., American European Group, Inc., Rutgers Casualty Insurance Company, and Rutgers Enhanced Insurance Company, relating to renewal rights (incorporated by reference to Exhibit 99.1 to the Company's Form 8-K dated December 22, 2006).
- (11) (a) Statement re computation of per share earnings (incorporated herein by reference to Note 9 to the Consolidated Financial Statements included in Item 8).
- (14.1) Merchants Group, Inc. Code of Conduct and Ethics (incorporated by reference to Exhibit 14.1 to the Company's Annual Report on Form 10-K filed on March 31, 2005).
- (14.2) Merchants Insurance Group Code of Business Conduct, amended 12/2004 (incorporated by reference to Exhibit 14.2 to the Company's Annual Report on Form 10-K filed on March 31, 2005).
- (21) List of Subsidiaries of Registrant (incorporated by reference to Exhibit No. 22 to the Company's Registration Statement (No. 33-9188) on Form S-1 filed on September 30, 1986).
- (23) Report and Consent of Independent Registered Public Accounting Firm (filed herewith).

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- (31) Rule 13a-14(a)/15d-14(a) Certifications (filed herewith).
- (32) Certification Pursuant to Section 906 of Sarbanes-Oxley Act of 2002 (subsections (a) and (b) of Section 1350, Chapter 63 of Title 18, United States Code (filed herewith).

* Indicates a management contract or compensation plan or arrangement.

The Company will forward upon request any exhibit not contained herein upon payment of a fee equal to the Company's reasonable expenses in furnishing the exhibits. Requests should be directed to:

**Investor Relations
Merchants Group, Inc.
250 Main Street
Buffalo, New York 14202**

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MERCHANTS GROUP, INC.
 SCHEDULE I SUMMARY OF INVESTMENTS -
 OTHER THAN INVESTMENTS IN RELATED PARTIES
 December 31, 2006
 (in thousands)

| Type of Investment | Amortized Cost/ Cost | Market Value | Amount at which shown in the balance sheet |
|---|----------------------------|-----------------|--|
| Fixed maturities: | | | |
| United States Government and government agencies and authorities | \$ 10,245 | \$ 10,139 | \$ 10,139 |
| Corporate securities | 26,781 | 26,448 | 26,448 |
| Mortgage and asset backed securities | 82,454 | 80,518 | 80,518 |
| Obligations of states and political subdivisions | 40,307 | 39,759 | 39,759 |
| Total fixed maturities | 159,787 | 156,864 | 156,864 |
| Preferred stocks | 3,250 | 3,563 | 3,563 |
| Short-term investments | 17,017 | 17,017 | 17,017 |
| Other | 26 | 84 | 84 |
| | \$ 180,080 | \$ 177,528 | \$ 177,528 |

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MERCHANTS GROUP, INC.
 SCHEDULE II AMOUNTS RECEIVABLE FROM/PAYABLE TO RELATED PARTIES,
 AND UNDERWRITERS, PROMOTERS AND EMPLOYEES OTHER
 THAN RELATED PARTIES

Years ended December 31, 2006, 2005 and 2004

(in thousands)

| | 2006 | 2005 | 2004 |
|---|------------|------------|------------|
| Receivable from (payable to) related parties, primarily Merchants Mutual Insurance Company (1): | | | |
| Balance at beginning of period | \$ (113) | \$ (5,571) | \$ (2,090) |
| Change during the period | (701) | 5,458 | (3,481) |
| Balance at end of period | \$ (814) | \$ (113) | \$ (5,571) |
| Retrospective commission receivable from (payable to) Merchants Mutual Insurance Company (2): | | | |
| Balance at beginning of period | \$ (2,590) | \$ (1,141) | \$ 305 |
| Change during the period | 675 | (1,449) | (1,446) |
| Balance at end of period | \$ (1,915) | \$ (2,590) | \$ (1,141) |

(1) Under a Services Agreement, Merchants Mutual Insurance Company (Mutual) provides employees, services and facilities for Merchants Insurance Company of New Hampshire, Inc. (MNH) to carry on its traditional insurance business on a fee basis. Under a Reinsurance Pooling Agreement, Mutual and MNH

pool or share premiums and losses on their traditional insurance business. The balance in the intercompany receivable (payable) account indicates the amount due from (to) Mutual for the excess (deficiency) of premiums collected over (from) payments for losses, services and facilities provided to MNH.

- (2) A Pooling Agreement between the Company and Mutual provides for retrospective commission income or expense based upon the actual cumulative experience of the pooled business since the agreement's inception, compared to a targeted loss and LAE ratio of 74%. Commissions are settled annually, six months after the end of the calendar year.

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MERCHANTS GROUP, INC.
 SCHEDULE III CONDENSED FINANCIAL INFORMATION OF REGISTRANT
 (in thousands except per share and share amounts)

BALANCE SHEET

| | December 31, | |
|--|---------------|---------------|
| | 2006 | 2005 |
| Assets | | |
| Investment in subsidiary | \$ 77,275 | \$ 73,033 |
| Other assets | 3,486 | 2,974 |
| Total assets | \$ 80,761 | \$ 76,007 |
| Liabilities and Stockholders' Equity | | |
| Other liabilities | \$ 540 | \$ 113 |
| Total liabilities | 540 | 113 |
| Stockholders' equity: | | |
| Preferred stock, \$.01 par value, authorized and unissued 3,000,000 shares | | |
| Preferred stock, no par value, \$424.30 stated value, no shares issued or outstanding at December 31, 2006 or 2005 | | |
| Common stock, \$.01 par value, authorized 10,000,000 shares; 2,145,652 shares issued and outstanding at December 31, 2006 and 2,132,652 shares issued and outstanding at December 31, 2005 | 33 | 33 |
| Additional paid in capital | 36,540 | 36,267 |
| Treasury stock, 1,139,700 shares at December 31, 2006 and 2005 | (22,766) | (22,766) |
| Accumulated other comprehensive loss | (2,276) | (2,540) |
| Accumulated earnings | 68,690 | 64,900 |
| Total stockholders' equity | 80,221 | 75,894 |
| Total liabilities and stockholders' equity | \$ 80,761 | \$ 76,007 |

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MERCHANTS GROUP, INC.
 SCHEDULE III CONDENSED FINANCIAL INFORMATION OF REGISTRANT

Continued
 (in thousands)

INCOME STATEMENT

| | Year ended December 31, | | |
|--------------------------------------|-------------------------|----------|----------|
| | 2006 | 2005 | 2004 |
| Revenues: | | | |
| Equity in net income of subsidiary | \$ 6,978 | \$ 7,004 | \$ 4,209 |
| Investment income | 99 | 27 | 8 |
| Total revenues | 7,077 | 7,031 | 4,217 |
| Expenses: | | | |
| General and administrative expenses | 1,676 | 489 | 685 |
| Operating income before income taxes | 5,401 | 6,542 | 3,532 |
| Income tax benefit | (536) | (157) | (230) |
| Net income | \$ 5,937 | \$ 6,699 | \$ 3,762 |

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MERCHANTS GROUP, INC.
 SCHEDULE III CONDENSED FINANCIAL INFORMATION OF REGISTRANT
 Continued
 (in thousands)

STATEMENT OF CASH FLOWS

Increase (Decrease) in Cash and Cash Equivalents:

| | Year ended December 31, | | |
|---|-------------------------|----------|----------|
| | 2006 | 2005 | 2004 |
| | (in thousands) | | |
| Cash flows from operating activities: | \$ (996) | \$ (179) | \$ (655) |
| Cash flows from investing activities: | | | |
| Receipt of subsidiary common stock dividend | 1,000 | 3,400 | 1,200 |
| Purchase of other investments, net | 1,834 | (2,412) | 210 |
| Cash flows from investing activities | 2,834 | 988 | 1,410 |
| Cash flows from financing activities: | | | |
| Cash dividends | (2,147) | (1,164) | (845) |
| Exercise of common stock options | 273 | 389 | 84 |
| Cash flows from financing activities | (1,874) | (775) | (761) |
| Net increase (decrease) in cash and cash equivalents | (36) | 34 | (6) |
| Cash and cash equivalents, beginning of year | 40 | 6 | 12 |
| Cash and cash equivalents, end of year | \$ 4 | \$ 40 | \$ 6 |
| Reconciliation of net income to net cash provided by operations: | | | |
| Net income | \$ 5,937 | \$ 6,699 | \$ 3,762 |
| Adjustments to reconcile net income to net cash provided by operations: | | | |
| Equity in income of subsidiary | (6,978) | (7,004) | (4,209) |
| Increase (decrease) in other liabilities | 427 | 53 | 2 |
| (Increase) decrease in other (non-investment) assets | (382) | 39 | (204) |
| Other, net | | 34 | (6) |
| Net cash used in operating activities | \$ (996) | \$ (179) | \$ (655) |

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MERCHANTS GROUP, INC.
SCHEDULE III CONDENSED FINANCIAL INFORMATION

Continued

NOTES TO CONDENSED FINANCIAL STATEMENTS

Cash dividends of \$1,000,000, \$3,400,000 and \$1,200,000 were paid to the Registrant by its consolidated subsidiary in the years ended December 31, 2006, 2005 and 2004, respectively.

The Company may be a defendant from time to time in legal proceedings in the ordinary course of its business. The Company is of the opinion that the ultimate aggregate liability, if any, resulting from such proceedings will not materially affect the financial condition of the Company.

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MERCHANTS GROUP, INC.
 SCHEDULE IV REINSURANCE
 YEARS ENDED DECEMBER 31, 2006, 2005 AND 2004
 (in thousands except percentages)

| | Gross amount | Ceded to third parties | Ceded to affiliates (1) | Assumed from third parties | Assumed from affiliates (1) | Net amount | Percentage of amount assumed to net |
|--------------------------------|--------------|------------------------|-------------------------|----------------------------|-----------------------------|------------|-------------------------------------|
| Year Ended December 31, 2006 | | | | | | | |
| Property and Casualty Premiums | \$47,652 | \$3,259 | \$45,024 | \$ 631 | \$37,740 | \$37,740 | 101.7% |
| Year ended December 31, 2005 | | | | | | | |
| Property and Casualty Premiums | \$53,532 | \$3,747 | \$50,957 | \$1,172 | \$45,135 | \$45,135 | 102.6% |
| Year ended December 31, 2004 | | | | | | | |
| Property and Casualty Premiums | \$53,900 | \$2,967 | \$52,452 | \$1,519 | \$53,102 | \$53,102 | 102.9% |

(1) Amounts are comprised of premiums assumed or ceded in accordance with the Reinsurance Pooling Agreement with Mutual.

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MERCHANTS GROUP, INC.
 SCHEDULE VI SUPPLEMENTAL INSURANCE INFORMATION CONCERNING
 PROPERTY CASUALTY SUBSIDIARIES
 Years ended December 31, 2006, 2005 and 2004
 (in thousands)

| | Reserves | | Discount | | | | Losses & loss adjustment expenses | | | Amortization | Paid | |
|--|---|------------------------|--------------------------------------|----------------------|------------------------|-----------------------------|---|-------------------------------------|--|--|------------------------------|--|
| | Deferred for losses policy and loss acquisition costs | adjustment expenses | if any, deducted from reserves | Unearned premiums | Net earned premiums | Net investment income | incurred (1) Current years | related to (2) Prior years | of deferred acquisition costs | losses & loss adjustment expenses | Direct premium written | |

Year ended:

| | | | | | | | | | | | |
|-------------------|---------|-----------|---------|----------|----------|---------|----------|-----------|----------|----------|----------|
| December 31, 2006 | \$5,635 | \$104,914 | \$3,593 | \$25,371 | \$41,173 | \$7,938 | \$26,317 | \$(4,170) | \$10,705 | \$30,192 | \$47,652 |
| December 31, 2005 | \$6,527 | \$115,191 | \$3,651 | \$29,662 | \$49,121 | \$7,733 | \$29,711 | \$(3,303) | \$12,771 | \$37,810 | \$53,532 |
| December 31, 2004 | \$7,570 | \$128,415 | \$4,531 | \$33,685 | \$57,123 | \$7,881 | \$38,524 | \$ (843) | \$14,852 | \$48,655 | \$53,900 |

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Report of Independent Registered Public Accounting Firm

To the Board of Directors and
Shareholders of Merchants Group, Inc.

In our opinion, the consolidated financial statements listed in the index appearing under Item 15(a)(1) present fairly, in all material respects, the financial position of Merchants Group, Inc. and its subsidiaries at December 31, 2006 and 2005, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2006, in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedules appearing under Item 15(a)(2) present fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. These financial statements and financial statement schedules are the responsibility of the Company's management; our responsibility is to express an opinion on these financial statements and financial statement schedules based on our audits. We conducted our audits of these statements in accordance with Standards of the Public Company Accounting Oversight Board (United States). Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As further discussed in Note 1 to the financial statements, the Board of Directors and Shareholders of Merchants Group, Inc. have approved the sale of all outstanding shares of the Company to American European Group, Inc.

/s/ PricewaterhouseCoopers LLP

Buffalo, New York

March 26, 2007

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MERCHANTS GROUP, INC.
CONSOLIDATED BALANCE SHEET
(in thousands)

| | December 31, | |
|---|--------------|------------|
| Assets | 2006 | 2005 |
| Investments: | | |
| Fixed maturities available for sale at fair value | \$ 156,864 | \$ 166,593 |
| Preferred stock at fair value | 3,563 | 4,312 |
| Other long-term investments at fair value | 84 | 734 |
| Short-term investments | 17,017 | 10,650 |
| | | |
| Total investments | 177,528 | 182,289 |
| | | |
| Cash | 23 | 82 |
| Interest due and accrued | 1,110 | 998 |
| Premiums receivable from affiliate, net of allowance for doubtful accounts of \$125 in 2006 and \$158 in 2005 | 12,034 | 13,540 |
| Deferred policy acquisition costs from affiliate | 5,635 | 6,527 |
| Reinsurance recoverable on unpaid losses | 11,575 | 13,807 |
| Prepaid reinsurance premiums from affiliate | 3,700 | 4,559 |
| Income taxes receivable | | 109 |
| Deferred income taxes | 5,220 | 5,367 |
| Other assets | 5,970 | 6,700 |
| | | |
| Total assets | \$ 222,795 | \$ 233,978 |

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

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MERCHANTS GROUP, INC.
CONSOLIDATED BALANCE SHEET

(in thousands except share and per share amounts)

| | December 31, | |
|--|--------------|------------|
| Liabilities and Stockholders Equity | 2006 | 2005 |
| Liabilities: | | |
| Reserve for losses and loss adjustment expenses (from affiliate \$51,435 and \$50,239) | \$ 104,914 | \$ 115,191 |
| Unearned premiums from affiliate | 25,371 | 29,662 |
| Payable to affiliate | 814 | 113 |
| Retrospective commission payable to affiliate | 1,915 | 2,590 |
| Federal income taxes payable | 285 | |
| Other liabilities (from affiliate \$3,903 and \$5,044) | 9,275 | 10,528 |
| | | |
| Total liabilities | 142,574 | 158,084 |
| | | |
| Stockholders equity: | | |
| Common stock, \$.01 par value, 10,000,000 shares authorized, 2,145,652 shares issued and outstanding at December 31, 2006 and 2,132,652 shares issued and outstanding at December 31, 2005 | 33 | 33 |
| Additional paid in capital | 36,540 | 36,267 |
| Treasury stock, 1,139,700 shares at December 31, 2006 and 2005 | (22,766) | (22,766) |
| Accumulated other comprehensive loss | (2,276) | (2,540) |
| Accumulated earnings | 68,690 | 64,900 |
| | | |
| Total stockholders equity | 80,221 | 75,894 |
| | | |
| Commitments and contingencies | | |
| | | |
| Total liabilities and stockholders equity | \$ 222,795 | \$ 233,978 |

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

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MERCHANTS GROUP, INC.
CONSOLIDATED STATEMENT OF OPERATIONS
(in thousands except per share amounts)

| | Year ended December 31, | | |
|--|-------------------------|-----------------|-----------------|
| | 2006 | 2005 | 2004 |
| Revenues: | | | |
| Net premiums earned from affiliate | \$ 41,173 | \$ 49,121 | \$ 57,123 |
| Net investment income | 7,938 | 7,733 | 7,881 |
| Net investment losses | (60) | | (221) |
| Other revenues from affiliate | 489 | 571 | 722 |
| Total revenues | 49,540 | 57,425 | 65,505 |
| Expenses: | | | |
| Net losses and loss adjustment expenses (from affiliate \$22,585, \$26,558 and \$35,137) | 22,147 | 26,408 | 37,681 |
| Amortization of deferred policy acquisition costs from affiliate | 10,705 | 12,771 | 14,852 |
| Other underwriting expenses (from affiliate \$6,967, \$7,888 and \$6,433) | 8,324 | 8,811 | 8,291 |
| Total expenses | 41,176 | 47,990 | 60,824 |
| Income before income taxes | 8,364 | 9,435 | 4,681 |
| Income tax provision | 2,427 | 2,736 | 919 |
| Net income | \$ 5,937 | \$ 6,699 | \$ 3,762 |
| Earnings per share: | | | |
| Basic | \$ 2.77 | \$ 3.17 | \$ 1.78 |
| Diluted | \$ 2.77 | \$ 3.16 | \$ 1.78 |
| Weighted average number of shares outstanding: | | | |
| Basic | 2,145 | 2,115 | 2,114 |
| Diluted | 2,145 | 2,118 | 2,118 |

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

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MERCHANTS GROUP, INC.
CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME
(in thousands)

| | Year ended December 31, | | |
|---|-------------------------|----------|----------|
| | 2006 | 2005 | 2004 |
| Net income | \$ 5,937 | \$ 6,699 | \$ 3,762 |
| Other comprehensive income (loss) before tax: | | | |
| Unrealized gains (losses) on securities | 459 | (3,039) | (1,926) |
| Reclassification adjustment for gains or losses included in net income | (60) | | 221 |
| Other comprehensive income (loss) before tax | 399 | (3,039) | (1,705) |
| Income tax provision (benefit) related to items of other comprehensive loss | 135 | (1,035) | (419) |
| Other comprehensive income (loss) | 264 | (2,004) | (1,286) |
| Comprehensive income | \$ 6,201 | \$ 4,695 | \$ 2,476 |

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

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MERCHANTS GROUP, INC.
CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY
(in thousands except per share amounts)

| | Year ended December 31, | | |
|---|-------------------------|-----------|-----------|
| | 2006 | 2005 | 2004 |
| Common stock: | | | |
| Beginning of year | \$ 33 | \$ 33 | \$ 32 |
| Exercise of common stock options | | | 1 |
| End of year | 33 | 33 | 33 |
| Additional paid in capital: | | | |
| Beginning of year | 36,267 | 35,878 | 35,795 |
| Exercise of common stock options | 273 | 389 | 83 |
| End of year | 36,540 | 36,267 | 35,878 |
| Treasury stock: | | | |
| Beginning and end of year | (22,766) | (22,766) | (22,766) |
| Accumulated other comprehensive income (loss): | | | |
| Beginning of year | (2,540) | (536) | 750 |
| Other comprehensive income (loss) | 264 | (2,004) | (1,286) |
| End of year | (2,276) | (2,540) | (536) |
| Accumulated earnings: | | | |
| Beginning of year | 64,900 | 59,365 | 56,448 |
| Net income | 5,937 | 6,699 | 3,762 |
| Cash dividends (\$1.00/share in 2006, \$.55/share in 2005, and \$.40/share in 2004), (to affiliate, \$255, \$140 and \$102) | (2,147) | (1,164) | (845) |
| End of year | 68,690 | 64,900 | 59,365 |
| Total stockholders' equity | \$ 80,221 | \$ 75,894 | \$ 71,974 |

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

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MERCHANTS GROUP, INC.
CONSOLIDATED STATEMENT OF CASH FLOWS
(in thousands)

| | Year ended December 31, | | |
|---|-------------------------|-----------|-----------|
| | 2006 | 2005 | 2004 |
| Cash flows from operations: | | | |
| Collection of premiums from affiliate | \$ 38,889 | \$ 47,175 | \$ 53,924 |
| Payment of losses and loss adjustment expenses (from affiliate \$(21,389), \$(20,413) and \$(22,299)) | (29,862) | (36,088) | (50,276) |
| Payment of underwriting expenses (from affiliate \$(17,837), \$(17,437) and \$(21,946)) | (19,306) | (18,781) | (23,550) |
| Investment income received | 7,754 | 8,002 | 8,259 |
| Investment expenses paid | (292) | (380) | (280) |
| Income taxes paid | (2,022) | (2,152) | (376) |
| Other cash receipts from affiliate | 489 | 571 | 722 |
| Net cash used in operations | (4,350) | (1,653) | (11,577) |
| Cash flows from investing activities: | | | |
| Proceeds from fixed maturities sold or matured | 33,130 | 56,653 | 46,124 |
| Purchase of fixed maturities | (22,949) | (41,962) | (37,547) |
| Net (increase) decrease in preferred stock | 1,000 | (850) | 2,000 |
| Net (increase) decrease in other long-term investments | 650 | 1,970 | (948) |
| Net increase in short-term investments | (6,367) | (3,238) | (6,294) |
| Settlement of securities transactions, net | | (4,751) | 5,644 |
| Net cash provided by investing activities | 5,464 | 7,822 | 8,979 |
| Cash flows from financing activities: | | | |
| Settlement of affiliate balances, net | 701 | (5,457) | 3,481 |
| Proceeds from exercise of common stock options | 273 | 389 | 84 |
| Cash dividends (to affiliate \$255, \$140 and \$102) | (2,147) | (1,164) | (845) |
| Net cash provided by (used in) financing activities | (1,173) | (6,232) | 2,720 |
| Increase (decrease) in cash | (59) | (63) | 122 |
| Cash, beginning of year | 82 | 145 | 23 |
| Cash, end of year | \$ 23 | \$ 82 | \$ 145 |

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

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MERCHANTS GROUP, INC.
CONSOLIDATED STATEMENT OF CASH FLOWS
RECONCILIATION OF NET INCOME TO NET CASH PROVIDED BY OPERATIONS

(in thousands)

| | Year ended December 31, | | |
|--|-------------------------|------------|-------------|
| | 2006 | 2005 | 2004 |
| Net income | \$ 5,937 | \$ 6,699 | \$ 3,762 |
| Adjustments: | | | |
| Net discount accretion on investments | (363) | (193) | (83) |
| Net investment losses | 60 | | 221 |
| (Increase) decrease in assets: | | | |
| Interest due and accrued | (112) | 81 | 181 |
| Premiums receivable from affiliate | 1,506 | 1,596 | 1,541 |
| Deferred policy acquisition costs from affiliate | 892 | 1,043 | 1,053 |
| Reinsurance recoverable on paid and unpaid losses | 2,232 | 1,823 | 7,085 |
| Prepaid reinsurance premiums from affiliate | 859 | 36 | (1,529) |
| Income taxes receivable | 109 | (109) | 881 |
| Deferred income taxes | 11 | 696 | (113) |
| Retrospective commission receivable from affiliate | | | 305 |
| Other assets | 730 | 1,941 | (1,919) |
| Increase (decrease) in liabilities: | | | |
| Reserve for losses and loss adjustment expenses (from affiliate \$1,196, \$6,145 and \$12,838) | (10,277) | (13,224) | (18,059) |
| Unearned premiums from affiliate | (4,291) | (4,023) | (2,491) |
| Retrospective commission payable to affiliate | (675) | 1,449 | 1,141 |
| Federal income taxes payable | 285 | | |
| Other liabilities (from affiliate \$(1,141), \$953 and \$(3,087)) | (1,253) | 532 | (3,553) |
| Net cash used in operations | \$ (4,350) | \$ (1,653) | \$ (11,577) |

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

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MERCHANTS GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. **Sale of Company**

On October 31, 2006, the Company entered into an Agreement and Plan of Merger (the Merger Agreement) with American European Group, Inc. (AEG), a Delaware corporation and American European Financial, Inc., a newly-formed Delaware corporation that is a wholly owned subsidiary of AEG (Merger Sub), pursuant to which Merger Sub will merge with and into the Company with the Company surviving (the Merger). Upon completion of the Merger, the Company will be a wholly owned subsidiary of AEG. Stockholder and regulatory approvals have been obtained, and the Merger is expected to be consummated in the first quarter of 2007.

2. **Significant Accounting Policies**

Principles of consolidation and basis of presentation

The consolidated financial statements of Merchants Group, Inc. (the Company) include the accounts of the Company, its wholly-owned subsidiary, Merchants Insurance Company of New Hampshire, Inc. (MNH), and M.F.C. of New York, Inc., an inactive premium finance company which is a wholly-owned subsidiary of MNH. MNH is a stock property and casualty insurance company domiciled in the state of New Hampshire. MNH offers property and casualty insurance to preferred risk individuals and small to medium sized businesses in the northeast United States, primarily in New York, New Hampshire and New Jersey where a majority of its policies are written. As a holding company, the Company has no operations.

The consolidated financial statements have been prepared in conformity with generally accepted accounting principles (GAAP) which differ in some respects from those followed in reports to insurance regulatory authorities. In its Annual Statement filed with regulatory authorities, MNH reported policyholders' surplus of \$71,671,000 and \$66,390,000 at December 31, 2006 and 2005, respectively. MNH's net income as reported in its Annual Statement was \$7,651,000 in 2006, \$8,708,000 in 2005 and \$5,191,000 in 2004. All significant intercompany balances and transactions have been eliminated.

The preparation of consolidated financial statements in conformity with GAAP requires management 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 amounts of revenues and expenses during the reporting period. Actual results may differ from those estimates.

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Table of Contents**Investments**

Fixed maturities are classified as available for sale and are presented at fair value. Fixed maturities consist of debt securities that management may not hold until maturity. All preferred stocks are classified as available for sale and are presented at fair value. The net aggregate unrealized gain or loss, net of applicable income taxes, related to fixed maturities and preferred stock classified as available for sale is included as a component of accumulated other comprehensive income (loss) in stockholders' equity.

Other long-term investments include collateralized mortgage obligation residuals, carried at unpaid principal balances which do not vary significantly from fair value. Short-term investments, consisting primarily of money market mutual funds, have original maturities of three months or less and are carried at cost, which approximates fair value. Realized gains and losses on the sale of investments are based on the cost of the specific investment sold.

Net unrealized holding gains or losses, net of taxes, are shown as other comprehensive income. Management monitors the Company's investment portfolio for declines in value that are other-than-temporary. When a decline in the fair value of a security has been determined to be other-than-temporary, the investment's cost is written down to fair value and a realized loss is recorded in the Consolidated Statement of Operations.

Net premiums earned

Premiums are recorded as revenue ratably over the terms of the policies written (principally one year). Unearned premiums are calculated using a monthly pro rata method.

Deferred policy acquisition costs

Policy acquisition costs, such as commissions (net of reinsurance commissions), premium taxes and certain other underwriting expenses which vary directly with premium volume are deferred and amortized over the terms of the related insurance policies. Deferred policy acquisition costs are evaluated on an aggregate basis at least quarterly to determine if recorded amounts exceed estimated recoverable amounts after allowing for anticipated investment income. Premium deficiency, if any, is recorded as amortization of deferred policy acquisition costs. Deferred policy acquisition costs were:

| | Year Ended December 31, | | |
|---------------------------|-------------------------|----------|----------|
| | 2006 | 2005 | 2004 |
| | (in thousands) | | |
| Beginning balance | \$ 6,527 | \$ 7,570 | \$ 8,623 |
| Acquisition cost deferred | 9,813 | 11,728 | 13,799 |
| Amortized to expense | (10,705) | (12,771) | (14,852) |
| Ending balance | \$ 5,635 | \$ 6,527 | \$ 7,570 |

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Reinsurance

Reinsurance assumed from business written through state reinsurance facilities or through a reinsurance pooling agreement with an affiliate (see note 2) has been reflected in unearned premiums, loss reserves, premiums earned and losses incurred based on reports received from such entities. Ceded reinsurance premiums, losses and ceding commissions are netted against earned premiums, losses and commission expense, respectively.

Reserve for losses and loss adjustment expenses

Liabilities for unpaid losses and loss adjustment expenses (LAE) are estimates of future payments to be made to settle all insurance claims for reported losses and estimates of incurred but not reported losses based upon past experience modified for current trends. With the exception of workers' compensation losses, loss reserves are not discounted. Estimated amounts of salvage and subrogation on paid and unpaid losses are deducted from the liability for unpaid claims. The estimated liabilities may be more or less than the amount ultimately paid when the claims are settled. Management and the Company's independent consulting actuary regularly review the estimates of reserves needed and any changes are reflected in current operating results.

The Company discounts its liability for workers' compensation case reserves on a tabular basis, using the National Council on Compensation Insurance Workers' Compensation Statistical Plan Table III A at a rate of 3.5%. The amount of discount at December 31, 2006 and 2005 is \$3,593,000 and \$3,651,000, respectively. Reserves for losses incurred but not reported and for LAE are not discounted.

Structured settlements have been negotiated for claims on certain insurance policies. Structured settlements are agreements to provide periodic payments to claimants, and are funded by annuities purchased from various life insurance companies. The Company remains primarily liable for those claims which have been funded with a structured settlement but which do not include Uniform Qualified Assignments, which relieve it of any contingent liability. Accordingly, a liability and a corresponding asset in the amount of \$5,187,000 and \$5,349,000 at December 31, 2006 and 2005, respectively, are recorded in the Company's Consolidated Balance Sheet in Other Liabilities and Other Assets, respectively.

Income taxes

The Company and its wholly-owned subsidiaries file a consolidated federal income tax return. The Company follows the asset and liability approach to account for income taxes, which requires the recognition of deferred tax liabilities and assets for the expected future tax consequences of temporary differences between the financial statement carrying amounts and the tax basis of assets and liabilities.

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Other financial instruments

The fair value of the Company's other financial instruments, principally premiums receivable and certain non-insurance related liabilities, does not vary significantly from the amounts assigned in these financial statements.

3. Related Party Transactions

The Company and MNH operate and manage their business with Merchants Mutual Insurance Company (Mutual) under a services agreement (the Services Agreement) that became effective January 1, 2003. At December 31, 2006, Mutual owned 11.9% of the Company's outstanding common stock. The Company and MNH do not have any operating assets or employees. In accordance with the Services Agreement, Mutual provides the Company with facilities, management and personnel required to operate its day-to-day business, including the following services: administrative services, underwriting services, claims services, and investment and cash management services. Effective January 1, 2003, Mutual and MNH agreed to pool, or share, underwriting results on their traditional insurance business (the Traditional Business) by means of a reinsurance pooling agreement (the Pooling Agreement). It does not apply to any new endeavor of either Mutual or MNH outside of their Traditional Business, unless the companies agree otherwise. The Pooling Agreement applies to premiums earned and losses incurred after the effective date. Due to the possibility of development of losses and LAE for accident years prior to the inception of the Pooling Agreement, the amount of net losses and LAE from affiliate for any given year may be more or less than the amount of net losses and LAE as shown on the Company's Consolidated Statement of Operations. The Pooling Agreement provides for MNH to cede, or transfer, to Mutual all premiums and risks on its Traditional Business during the term of the agreement, and then to assume from Mutual a percentage of all of Mutual's and MNH's Traditional Business (the Pooled Business). MNH assumed 25%, 30% and 35% of the Pooled Business in 2006, 2005, and 2004, respectively. MNH's share of the Pooled Business will be 25% in 2007. The Pooling Agreement also provides for retrospective commission income or expense based on the actual cumulative experience of the Pooled Business since its inception compared to a targeted loss and LAE ratio of 74%. Commissions are settled annually, 6 months after the end of the calendar year. Until settlement, retrospective commissions owed to or due from Mutual are recorded in the consolidated balance sheet as Retrospective commission payable to, or receivable from, affiliate.

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The payable to or receivable from affiliate (Mutual) is non-interest bearing and represents the net of premiums collected and loss and operating expense payments made by Mutual on behalf of MNH. This balance is settled in cash on a monthly basis.

On December 22, 2006 the Company, AEG and MNH entered into an agreement (the Renewal Rights Agreement) whereby, contingent upon completion of the Merger, The Company will sell the renewal rights to all of its Traditional Business to Mutual. Substantially all of MNH's business will be renewed by Mutual or one of its subsidiaries. The Renewal Rights Agreement provides that Mutual will continue to provide underwriting and claims services for MNH policies and claims. The Renewal Rights Agreement also provides, upon completion of the Merger, for the Pooling Agreement between Mutual and MNH to continue through December 31, 2008 and subject to certain conditions, December 31, 2009.

The Renewal Rights Agreement includes notice by Mutual of the termination of the Administrative Annex of the Services Agreement effective June 30, 2007 unless terminated earlier because the Merger has become effective. In addition, it includes conditional termination of the remaining annexes to the Services Agreement and the Reinsurance Pooling Agreement effective December 31, 2007 by Mutual, in the event the Renewal Rights Agreement does not become effective by June 30, 2007.

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Table of Contents**4. Investments****Investments in fixed maturities, preferred stock and other long-term investments**

The amortized cost and estimated fair value of investments in fixed maturities available for sale and the cost and estimated fair value of preferred stock and other long term investments are as follows:

| | Amortized Cost/Cost | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
|--|------------------------|------------------------------|-------------------------------|-------------------------|
| | (in thousands) | | | |
| December 31, 2006 | | | | |
| Fixed maturities: | | | | |
| U.S. Treasury securities and obligations of U.S. government corporations and agencies | \$ 10,245 | \$ | \$ 106 | \$ 10,139 |
| Obligations of states and political subdivisions | 40,307 | 4 | 552 | 39,759 |
| Corporate securities | 26,781 | 36 | 369 | 26,448 |
| Mortgage and asset backed securities | 82,454 | 28 | 1,964 | 80,518 |
| Total | \$ 159,787 | \$ 68 | \$ 2,991 | \$ 156,864 |
| Preferred stock | \$ 3,250 | \$ 313 | \$ | \$ 3,563 |
| Other long-term investments | \$ 26 | \$ 58 | \$ | \$ 84 |
| December 31, 2005 | | | | |
| Fixed maturities: | | | | |
| U.S. Treasury securities and obligations of U.S. government corporations and agencies | \$ 7,248 | \$ 6 | \$ 109 | \$ 7,145 |
| Obligations of states and political subdivisions | 45,927 | | 670 | 45,257 |
| Corporate securities | 17,641 | 2 | 496 | 17,147 |
| Mortgage and asset backed securities | 98,850 | 47 | 1,853 | 97,044 |
| Total | \$ 169,666 | \$ 55 | \$ 3,128 | \$ 166,593 |
| Preferred stock | \$ 4,248 | \$ 118 | \$ 54 | \$ 4,312 |
| Other long-term investments | \$ 676 | \$ 58 | \$ | \$ 734 |

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A summary of investment securities that as of December 31, 2006 and 2005 have been in a continuous unrealized loss position for less than twelve months and those that have been in a continuous unrealized loss position for twelve months or more follows:

| | Less than 12 months | | 12 months or more | |
|---|---------------------|------------|-------------------|------------|
| | Fair | Unrealized | Fair | Unrealized |
| | Value | Losses | Value | Losses |
| | (in thousands) | | | |
| December 31, 2006 | | | | |
| Fixed maturities: | | | | |
| U.S. Treasury securities and obligations of U.S. government corporations and agencies | \$ 4,228 | \$ 15 | \$ 5,911 | \$ 91 |
| Obligations of states and political subdivisions | 4,964 | 22 | 33,792 | 530 |
| Corporate securities | 5,196 | 31 | 12,772 | 338 |
| Mortgage and asset backed securities | 3,008 | 63 | 74,752 | 1,901 |
| Total | \$ 17,396 | \$ 131 | \$ 127,227 | \$ 2,860 |
| Preferred stock | \$ | \$ | \$ | \$ |
| Other long-term investments | \$ | \$ | \$ | \$ |
| December 31, 2005 | | | | |
| Fixed maturities: | | | | |
| U.S. Treasury securities and obligations of U.S. government corporations and agencies | \$ 2,980 | \$ 20 | \$ 2,915 | \$ 89 |
| Obligations of states and political subdivisions | 20,877 | 201 | 20,224 | 469 |
| Corporate securities | 8,278 | 235 | 8,766 | 261 |
| Mortgage and asset backed securities | 64,509 | 938 | 29,071 | 915 |
| Total | \$ 96,644 | \$ 1,394 | \$ 60,976 | \$ 1,734 |
| Preferred stock | \$ 1,296 | \$ 54 | \$ | \$ |
| Other long-term investments | \$ | \$ | \$ | \$ |

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None of the securities in the table above were determined to have any fundamental issues that would cause the Company to believe that they were other-than-temporarily impaired. All of the Company's securities in an unrealized loss position at December 31, 2006 and 2005 were rated as investment grade. Therefore, the Company believes that any impairment relates to the movement of interest rates and the Company has the intent and ability to retain its investments for a period of time sufficient to allow for an anticipated recovery in market value including until maturity, if necessary.

Included in net investment losses for 2006 and 2004 are \$118,000 and \$700,000, respectively, of write downs on securities which the Company determined had experienced an other-than-temporary decline in market value. There were no such write downs in 2005.

The amortized cost and fair value of fixed maturities by expected maturity at December 31, 2006 are shown below. Mortgage and asset backed securities are distributed in the table based upon management's estimate of repayment periods. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

| | Amortized Cost (in thousands) | Estimated Fair Value |
|--|-------------------------------------|-------------------------|
| Due in one year or less | \$ 27,577 | \$ 27,027 |
| Due after one year through five years | 104,846 | 103,081 |
| Due after five years through ten years | 17,011 | 16,590 |
| Due after ten years | 10,353 | 10,166 |
| Total | \$ 159,787 | \$ 156,864 |

Discount and premium pertaining to collateralized mortgage obligations are amortized over the securities' estimated redemption periods using the effective interest method. Yields used to calculate premium or discount are adjusted for prepayments quarterly.

Fixed maturities with a par value of \$850,000 were on deposit at December 31, 2006 and 2005 with various state insurance departments in compliance with applicable insurance laws.

Proceeds from sales of fixed maturity securities, preferred stock and common stock, and gross realized gains and losses related to such sales are as follows:

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| | Year ended December 31, | | |
|------------------------------------|-------------------------|------|-----------|
| | 2006 | 2005 | 2004 |
| | (in thousands) | | |
| Proceeds from sales | \$ 4,211 | \$ | \$ 10,641 |
| Gross realized gains | 58 | | 479 |
| Gross realized losses | | | |
| Other-than-temporary impairments | 118 | | 700 |
| <u>Net investment income</u> | | | |
| Net investment income consists of: | | | |

| | Year ended December 31, | | |
|-------------------------|-------------------------|----------|----------|
| | 2006 | 2005 | 2004 |
| | (in thousands) | | |
| Fixed maturities | \$ 7,379 | \$ 7,573 | \$ 7,873 |
| Short-term investments | 518 | 206 | 64 |
| Other | 333 | 334 | 297 |
| Total investment income | 8,230 | 8,113 | 8,234 |
| Investment expenses | 292 | 380 | 353 |
| Net investment income | \$ 7,938 | \$ 7,733 | \$ 7,881 |

5. Reinsurance

MNH follows the customary practice of reinsuring a portion of the exposure under its policies. Insurance is ceded principally to reduce net liability on individual risks and to protect against catastrophic losses. Although reinsurance does not legally discharge an insurer from its primary liability for the full amount of coverage provided by its policies, it does make the assuming reinsurer liable to the insurer to the extent of the reinsurance ceded.

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The effect of reinsurance transactions on premiums written and earned for the years ended December 31, 2006, 2005 and 2004 is as follows:

| | 2006 | | 2005 | | 2004 | |
|--------------------|---------------------|--------------------|---------------------|--------------------|---------------------|--------------------|
| | Premiums Written | Premiums Earned | Premiums Written | Premiums Earned | Premiums Written | Premiums Earned |
| | (in thousands) | | | | | |
| Direct | \$ 47,652 | \$ 50,732 | \$ 53,532 | \$ 53,603 | \$ 53,900 | \$ 55,528 |
| Assumed | | | | | | |
| With third parties | 631 | 651 | 1,172 | 1,259 | 1,519 | 1,814 |
| Pooling Agreement | 37,740 | 41,173 | 45,135 | 49,121 | 53,102 | 57,123 |
| Subtotal | 38,371 | 41,824 | 46,307 | 50,380 | 54,621 | 58,937 |
| Ceded | | | | | | |
| With third parties | (3,259) | (3,162) | (3,747) | (3,398) | (2,967) | (2,891) |
| Pooling Agreement | (45,024) | (48,221) | (50,957) | (51,464) | (52,452) | (54,451) |
| Subtotal | (48,283) | (51,383) | (54,704) | (54,862) | (55,419) | (57,342) |
| Net Premiums | \$ 37,740 | \$ 41,173 | \$ 45,135 | \$ 49,121 | \$ 53,102 | \$ 57,123 |

Reinsurance transactions had the following effect on net losses and LAE incurred for the years ended December 31, 2006, 2005 and 2004.

| | 2006 | 2005 | 2004 |
|--------------------|----------------|-----------|-----------|
| | (in thousands) | | |
| Direct | \$ 24,649 | \$ 30,986 | \$ 38,392 |
| Assumed | | | |
| With third parties | 570 | 1,414 | 1,453 |
| Pooling Agreement | 22,585 | 26,558 | 35,137 |
| Subtotal | 23,155 | 27,972 | 36,590 |
| Ceded | | | |
| With third parties | (696) | (4,209) | (3,754) |
| Pooling Agreement | (24,961) | (28,341) | (33,547) |
| Subtotal | (25,657) | (32,550) | (37,301) |
| Net losses and LAE | \$ 22,147 | \$ 26,408 | \$ 37,681 |

As a result of the reinsurance agreements maintained by MNH, MNH is exposed to certain credit risk if one or more of its primary reinsurers were to become financially unstable. As of December 31, 2006 and 2005, MNH recognized amounts to be recovered from its primary reinsurers related to ceded losses and ceded unearned premiums totaling \$15,275,000 and \$18,366,000, respectively. MNH generally does not require collateral for reinsurance recoverable.

Table of Contents**6. Reserve for Losses and Loss Adjustment Expenses**

Activity in the reserve for losses and LAE is summarized as follows:

| | 2006 | 2005 |
|---|----------------|------------|
| | (in thousands) | |
| Reserve for losses and LAE at beginning of year | \$ 115,191 | \$ 128,415 |
| Less reinsurance recoverables | (13,807) | (15,630) |
| Net balance at beginning of year | 101,384 | 112,785 |
| Provision for losses and LAE for claims occurring in: | | |
| Current year | 26,317 | 29,711 |
| Prior years | (4,170) | (3,303) |
| | 22,147 | 26,408 |
| Loss and LAE payments for claims occurring in: | | |
| Current year | (9,382) | (10,359) |
| Prior years | (20,810) | (27,450) |
| | (30,192) | (37,809) |
| Reserve for losses and LAE at end of year, net | 93,339 | 101,384 |
| Plus reinsurance recoverables | 11,575 | 13,807 |
| Balance at end of year | \$ 104,914 | \$ 115,191 |

In 2006 and 2005, the Company decreased reserves for prior years by \$4,170,000 and \$3,303,000, respectively, primarily due to favorable loss development related to private passenger auto liability and workers compensation policies, somewhat offset by unfavorable development on its commercial package policies.

7. Demand Loan

The Company has arranged for a \$2,000,000 unsecured credit facility from a bank. Any borrowings under this facility are payable on demand and carry an interest rate which can be fixed or variable and is negotiated at the time of each advance. This facility is available for general working capital purposes and for repurchases of the Company's common stock. No amount related to this facility was outstanding at December 31, 2006 and 2005.

Table of Contents**8. Income Taxes**

The provision (benefit) for income taxes consists of:

| | Year ended December 31, | | |
|----------------------------|-------------------------|----------|----------|
| | 2006 | 2005 | 2004 |
| | (in thousands) | | |
| Current | \$ 2,416 | \$ 2,040 | \$ 1,032 |
| Deferred | 11 | 696 | (113) |
| Total income tax provision | \$ 2,427 | \$ 2,736 | \$ 919 |

A reconciliation of the difference between the Company's total income tax provision and that calculated using statutory income tax rates is as follows:

| | Year ended December 31, | | |
|--|-------------------------|----------|----------|
| | 2006 | 2005 | 2004 |
| | (in thousands) | | |
| Computed provision at statutory rate | \$ 2,844 | \$ 3,208 | \$ 1,592 |
| Adjustments: | | | |
| Tax-exempt investment income | (357) | (368) | (315) |
| Dividend received deduction | (65) | (61) | (47) |
| Adjustments to prior years' taxes | | | (196) |
| Reversal of excess tax reserves related to uncertain tax positions | | (50) | (120) |
| Other | 5 | 7 | 5 |
| Total income tax provision | \$ 2,427 | \$ 2,736 | \$ 919 |

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Deferred tax (liabilities) assets are comprised of the following:

| | December 31, | |
|--|----------------|----------------|
| | 2006 | 2005 |
| | (in thousands) | |
| Deferred policy acquisition costs | \$ (1,916) | \$ (2,219) |
| Other | (125) | (150) |
| Total deferred tax liabilities | (2,041) | (2,369) |
| | | |
| Discounting of reserve for losses and loss adjustment expenses | 4,486 | 4,552 |
| Unearned premiums | 1,489 | 1,726 |
| Unrealized net investment losses | 1,159 | 1,295 |
| Other | 127 | 163 |
| Total deferred tax assets | 7,261 | 7,736 |
| | | |
| Net deferred income taxes | \$ 5,220 | \$ 5,367 |

Although realization is not assured, based upon the evidence available the Company believes that it is more likely than not that the net deferred income tax asset will be realized. The amount of the deferred tax asset considered realizable, however, could be reduced in the near term if estimates of future taxable income are not achieved.

In July 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48). FIN 48 prescribes a comprehensive model for how a company should recognize measure, present, and disclose in its financial statements uncertain tax positions that it has taken or expects to take on a tax return. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company does not believe that the adoption of FIN 48 will have a material impact on its consolidated financial statements.

9. Stockholders Equity

Dividends

The Company depends on dividends from its subsidiary, MNH, to pay cash dividends to its stockholders and to meet its expenses. MNH is subject to New Hampshire state insurance laws which restrict its ability to pay dividends without the prior approval of state regulatory authorities. These restrictions limit dividends to those that, when added to all other dividends paid within the preceding twelve months, would not exceed 10% of an insurer's policyholders surplus as of the preceding December 31. The maximum amount of dividends that MNH could pay during any twelve-month period ending in 2007 without the prior approval of the New Hampshire Insurance Commissioner is \$7,167,000. MNH paid \$1,000,000, \$2,000,000 and \$750,000 of dividends to the Company in August 2006, January 2007 and March 2007, respectively.

Table of Contents**Stock option plan**

The Company's stock option plan (the Plan), which reserved 200,000 shares of common stock for issuance to the Company's and MNH's officers and key employees of Mutual, expired in 1996. Under the Plan, qualified and non-qualified stock options were granted at amounts not less than the fair market value of the Company's stock on the date of grant. Options granted under the Plan have a 10 year life and vested in cumulative annual increments of 25% commencing one year from the date of grant.

In accounting for the Plan, the Company remains under the expense recognition provisions of Accounting Principles Board Opinion No. 25 Accounting for Stock Issued to Employees but follows the disclosure provisions of Statement of Financial Accounting Standards (SFAS) No. 123 Accounting for Stock Based Compensation. No options were granted in 2006, 2005 or 2004 and, therefore, no compensation expense was recognized in those years.

A summary of the status of the Company's outstanding options as of December 31, 2006, 2005 and 2004, and changes during the years ending on those dates is presented below:

| | 2006 | | 2005 | | 2004 | |
|------------------------------------|-------------|--|-------------|--|-------------|--|
| | Options | Weighted Average Exercise Price | Options | Weighted Average Exercise Price | Options | Weighted Average Exercise Price |
| | Outstanding | | Outstanding | | Outstanding | |
| Beginning of year | 13,000 | \$ 21.00 | 31,500 | \$ 21.00 | 35,500 | 21.00 |
| Granted | | | | | | |
| Exercised | (13,000) | 21.00 | (18,500) | 21.00 | (4,000) | 21.00 |
| Forfeited | | | | | | |
| End of year | | 21.00 | 13,000 | 21.00 | 31,500 | 21.00 |
| Options exercisable at year-end | | 21.00 | 13,000 | 21.00 | 31,500 | 21.00 |

Treasury stock

The Company did not repurchase any shares of its common stock in 2006, 2005 or 2004. The Company was holding 1,139,700 shares in treasury at December 31, 2006.

Preferred stock

The Company's Preferred stock, no par value, \$424.30 stated value, consists of 10,000 shares authorized; no shares were issued or outstanding at December 31, 2006 or December 31, 2005. The Company also has 3,000,000 shares of \$.01 par value preferred stock which is authorized and unissued.

Table of Contents**10. Earnings Per Share**

The computations for basic and diluted earnings per share are as follows:

| | Year Ended December 31, | | |
|--|---|----------|----------|
| | 2006 | 2005 | 2004 |
| | (in thousands except per share amounts) | | |
| Basic: | | | |
| Net income | \$ 5,937 | \$ 6,699 | \$ 3,762 |
| Weighted average shares outstanding | 2,145 | 2,115 | 2,114 |
| Basic earnings per share | \$ 2.77 | \$ 3.17 | \$ 1.78 |
| Diluted: | | | |
| Net income | \$ 5,937 | \$ 6,699 | \$ 3,762 |
| Weighted average shares outstanding | 2,145 | 2,115 | 2,114 |
| Plus incremental shares from assumed conversion of stock options | | 3 | 4 |
| Weighted average shares outstanding-adjusted | 2,145 | 2,118 | \$ 2,118 |
| Diluted earnings per share | \$ 2.77 | \$ 3.16 | \$ 1.78 |

11. Underwriting Results by Product

The following table shows, for each of the years in the three year period ended December 31, 2006, the amount of the Company's net premiums earned for each of its major products and the calendar year loss and allocated loss adjustment expense (ALAE) ratio for each product. The loss and ALAE ratio is one measure of product profitability and shows the relationship of incurred losses and allocated loss adjustment expenses to net premiums earned for a given period.

| | For The Year Ended December 31, | | | | | |
|----------------------------------|---------------------------------|-------------------------|---------------------------|-------------------------|---------------------------|-------------------------|
| | 2006 | | (000 s) 2005 | | 2004 | |
| | Net Premiums Earned | Loss & ALAE Ratio | Net Premiums Earned | Loss & ALAE Ratio | Net Premiums Earned | Loss & ALAE Ratio |
| Private passenger auto liability | \$ 3,446 | 24.7% | \$ 5,870 | 21.0% | \$ 9,543 | 59.0% |
| Homeowners | 3,869 | 69.1% | 4,732 | 50.3% | 5,541 | 63.6% |
| Commercial auto liability | 10,256 | 40.9% | 11,616 | 32.0% | 12,532 | 53.5% |
| Workers compensation | 4,284 | 117.1% | 4,532 | 9.1% | 4,535 | 31.4% |
| Commercial package | 13,894 | 35.8% | 15,343 | 63.9% | 15,764 | 76.7% |
| General liability | 781 | 12.7% | 1,147 | 244.5% | 700 | 165.5% |
| Other | 4,643 | 41.1% | 5,881 | 37.3% | 8,508 | 43.5% |
| Total | \$ 41,173 | 47.9% | \$ 49,121 | 45.9% | \$ 57,123 | 59.9% |

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12. **Benefit Programs**

Mutual maintains a capital accumulation plan which is a profit sharing plan under Section 401(a) of the Internal Revenue Code that covers all employees who have completed six months of service. Mutual matches at least 15% and up to 100% of employee contributions, based on the combined net operating profits of Mutual and MNH. Additional contributions may be made at the discretion of the Board of Directors of Mutual. The portion of the 2006, 2005 and 2004 service fees charged to the Company by Mutual relating to Mutual's contribution to its capital accumulation plan were \$348,000, \$301,000 and \$213,000, respectively.

Mutual has established a supplemental executive retirement plan covering certain employees. The portion of the 2006, 2005 and 2004 service fees charged to the Company by Mutual relating to Mutual's contribution to its supplemental executive retirement plan were \$58,000, \$52,000 and \$36,000, respectively.

13. **Commitments and Contingencies**

MNH, like many other property and casualty insurance companies, is subject to environmental damage claims asserted by or against its insureds. Management is of the opinion that based on various court decisions throughout the country, such claims should not be recoverable under the terms of MNH's insurance policies because of either specific or general coverage exclusions contained in the policies. However, there is no assurance that the courts will agree with MNH's position in every case, nor can there be assurance that material claims will not be asserted under policies which a court will find do not explicitly or implicitly exclude claims for environmental damages. Management, however, is not aware of any pending claim or group of claims which would result in a liability that would have a material adverse effect on the financial condition of MNH.

In addition to the foregoing, MNH may be a defendant from time to time in a number of other legal proceedings in the ordinary course of its business. Management of the Company is of the opinion that the ultimate aggregate liability, if any, resulting from such proceedings will not materially affect the financial condition of MNH or the Company.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

Merchants Group, Inc.

Date: March 28, 2007

BY: /s/ Robert M. Zak
 Robert M. Zak, Senior Vice President
 and Chief Operating Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

| SIGNATURE | TITLE | DATE |
|--|---|----------------|
| /s/ Robert M. Zak Robert M. Zak | Director, Sr. VP & Chief Operating Officer (principal executive officer) | March 28, 2007 |
| /s/ Kenneth J. Wilson Kenneth J. Wilson | Vice President & CFO (principal financial and accounting officer) | March 28, 2007 |
| /s/ Thomas E. Kahn Thomas E. Kahn | Director, Chairman of the Board | March 28, 2007 |
| /s/ Brent D. Baird Brent D. Baird | Director | March 28, 2007 |
| /s/ Andrew A. Alberti Andrew A. Alberti | Director | March 28, 2007 |
| /s/ Frank J. Colantuono Frank J. Colantuono | Director | March 28, 2007 |
| /s/ Henry P. Semmelhack Henry P. Semmelhack | Director | March 28, 2007 |