21ST CENTURY INSURANCE GROUP
Form 10-Q
July 27, 2006

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

FORM 10-Q

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

For the quarterly period ended June 30, 2006

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

For the transition period from ______ to ______

Commission File Number 0-6964

(Exact name of registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation or organization)	**95-1935264** (I.R.S. Employer Identification No.)
6301 Owensmouth Avenue **Woodland Hills, California** (Address of principal executive offices)	**91367** (Zip Code)
(818) 704-3700 (Registrant's telephone number, including area code)	**www.21st.com** (Registrant's web site)

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 x No ¨

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

Large accelerated filer ¨ Accelerated filer x 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 x

The number of shares outstanding of the issuer's common stock as of July 13, 2006 was 86,335,335.

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PART I - FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

21ST CENTURY INSURANCE GROUP
CONDENSED CONSOLIDATED BALANCE SHEETS
Unaudited

AMOUNTS IN THOUSANDS, EXCEPT SHARE DATA	**June 30, 2006**	December 31, 2005
Assets		
Fixed maturity investments available-for-sale, at fair value (amortized cost: $1,472,300 and $1,365,948)	**$1,426,728**	$1,354,707
Equity securities available-for-sale, at fair value (cost: $0 and $49,210)	**—**	47,367
Total investments	**1,426,728**	1,402,074
Cash and cash equivalents	**40,188**	68,668
Accrued investment income	**17,304**	16,585
Premiums receivable	**98,887**	100,900
Reinsurance receivables and recoverables	**6,521**	6,539
Prepaid reinsurance premiums	**2,072**	1,946
Deferred income taxes	**57,321**	56,209
Deferred policy acquisition costs	**68,248**	59,939
Leased property under capital lease, net of deferred gain of $1,313 and $1,534 and net of accumulated amortization of $39,542 and $36,995	**20,568**	22,651
Property and equipment, at cost less accumulated depreciation of $100,295 and $89,595	**148,213**	145,811
Other assets	**41,323**	38,907
Total assets	**$1,927,373**	$1,920,229
Liabilities and stockholders' equity		
Unpaid losses and loss adjustment expenses	**$ 495,092**	$ 523,835
Unearned premiums	**321,166**	319,676
Debt	**121,619**	127,972
Claims checks payable	**38,363**	42,681
Reinsurance payable	**748**	643
Other liabilities	**95,220**	75,450
Total liabilities	**1,072,208**	1,090,257
Commitments and contingencies		
Stockholders' equity:		
Common stock, par value $0.001 per share; 110,000,000 shares authorized; shares issued 86,341,626 and 85,939,889	**86**	86
Additional paid-in capital	**435,894**	425,454
Treasury stock; at cost shares: 6,291 and 5,929	**(89)**	(84)
Retained earnings	**450,774**	414,898
Accumulated other comprehensive loss	**(31,500)**	(10,382)
Total stockholders' equity	**855,165**	829,972
Total liabilities and stockholders' equity	**$1,927,373**	$1,920,229

See accompanying Notes to Condensed Consolidated Financial Statements.

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21ST CENTURY INSURANCE GROUP
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
Unaudited

AMOUNTS IN THOUSANDS, EXCEPT SHARE DATA	*Three Months Ended June30,*		*Six Months Ended June 30,*	
	2006	2005	**2006**	2005
Revenues				
Net premiums earned	**$ 325,512**	$ 336,845	**$ 651,336**	$ 673,209
Net investment income	**17,174**	17,006	**34,929**	34,043
Other income	**10**	367	**10**	367
Net realized investment gains (losses)	**30**	(1,267)	**(1,037)**	(1,727)
Total revenues	**342,726**	352,951	**685,238**	705,892
Losses and expenses				
Net losses and loss adjustment expenses	**223,094**	248,284	**459,590**	499,315
Policy acquisition costs	**64,887**	63,755	**124,219**	128,078
Other underwriting expenses	**9,504**	8,765	**22,104**	16,123
Other expense	**923**	—	**923**	—
Interest and fees expense	**1,854**	2,031	**3,752**	4,088
Total losses and expenses	**300,262**	322,835	**610,588**	647,604
Income before provision for income taxes	**42,464**	30,116	**74,650**	58,288
Provision for income taxes	**14,143**	9,621	**25,011**	18,356
Net income	**$ 28,321**	$ 20,495	**$ 49,639**	$ 39,932
Earnings per common share				
Basic earnings per share	**$ 0.33**	$ 0.24	**$ 0.58**	$ 0.47
Diluted earnings per share	**$ 0.33**	$ 0.24	**$ 0.57**	$ 0.47
Weighted-average shares outstanding — basic	**85,968,155**	85,704,165	**85,918,791**	85,613,043
Weighted-average shares outstanding — diluted	**86,232,103**	85,890,984	**86,373,845**	85,803,214

See accompanying Notes to Condensed Consolidated Financial Statements.

21ST CENTURY INSURANCE GROUP
CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY
Unaudited

	Common Stock	*$0.001 par value*					
AMOUNTS IN THOUSANDS, EXCEPT SHARE DATA	*Issued Shares*	*Amount*	*Additional Paid-in Capital*	*Treasury Stock*	*Retained Earnings*	*Accumulated Other Comprehensive Loss*	*Total*
Balance - January 1, 2006	85,939,889	$ 86	$425,454	$ (84)	$414,898	$(10,382)	$829,972
Comprehensive income (loss)					49,639 [1]	(21,118) [2]	28,521
Cash dividends declared on common stock ($0.16 per share)					(13,763)		(13,763)
Exercise of stock options	293,187		3,844				3,844
Issuance of restricted stock	108,550						—
Forfeiture of 362 shares of restricted stock			5	(5)			—
Stock-based compensation cost			6,478				6,478
Excess tax benefits of stock-based compensation			113				113
Balance - June 30, 2006	86,341,626	$ 86	$435,894	$ (89)	$450,774	$(31,500)	$855,165

(1) Net income for the six months ended June 30, 2006.

(2) Net change in accumulated other comprehensive loss follows:

	Six Months Ended June 30, 2006
Unrealized holding losses arising during the period, net of tax benefit of $11,734	$(21,792)
Reclassification adjustment for investment losses included in net income, net of tax benefit of $363	674
Total	$(21,118)

See accompanying Notes to Condensed Consolidated Financial Statements.

21ST CENTURY INSURANCE GROUP
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
Unaudited

AMOUNTS IN THOUSANDS, EXCEPT SHARE DATA		
Six Months Ended June 30,	**2006**	2005
Operating activities		
Net income	**$ 49,639**	$ 39,932
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	**13,304**	14,995
Net amortization of investment premiums and discounts	**4,496**	4,840
Stock-based compensation cost	**6,478**	138
Provision for deferred income taxes	**9,431**	5,903
Net realized investment losses	**1,037**	1,717
Changes in assets and liabilities		
Premiums receivable	**2,013**	234
Deferred policy acquisition costs	**(8,309)**	(3,446)
Reinsurance receivables and recoverables	**(3)**	1,377
Federal income taxes	**2,786**	(69)
Other assets	**(1,866)**	5,241
Unpaid losses and loss adjustment expenses	**(28,743)**	(20)
Unearned premiums	**1,490**	5,207
Claims checks payable	**(4,318)**	(170)
Other liabilities	**16,983**	(5,638)
Net cash provided by operating activities	**64,418**	70,241
Investing activities		
Purchases of:		
Fixed maturity investments available-for-sale	**(180,179)**	(76,575)
Equity securities available-for-sale	**(35,627)**	(160,730)
Property and equipment	**(13,346)**	(12,591)
Maturities and calls of fixed maturity investments available-for-sale	**12,618**	17,225
Sales of:		
Fixed maturity investments available-for-sale	**55,346**	27,192
Equity securities available-for-sale	**84,836**	152,688
Net cash used in investing activities	**(76,352)**	(52,791)
Financing activities		
Repayment of debt	**(6,740)**	(5,953)
Dividends paid (per share: $0.16 and $0.08)	**(13,763)**	(6,847)
Proceeds from the exercise of stock options	**3,844**	1,975
Excess tax benefits from stock-based compensation	**113**	—
Net cash used in financing activities	**(16,546)**	(10,825)
Net (decrease) increase in cash and cash equivalents	**(28,480)**	6,625
Cash and cash equivalents, beginning of period	**68,668**	34,697
Cash and cash equivalents, end of period	**$ 40,188**	$ 41,322
Supplemental information:		
Income taxes paid	**$ 12,863**	$ 9,434
Interest paid	**3,682**	4,017

See accompanying Notes to Condensed Consolidated Financial Statements.

21ST CENTURY INSURANCE GROUP
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
June 30, 2006
DOLLAR AMOUNTS IN THOUSANDS, EXCEPT WHERE NOTED

NOTE 1. FINANCIAL STATEMENT PRESENTATION

General

21st Century Insurance Group and subsidiaries (the "Company") prepared the accompanying unaudited condensed consolidated financial statements in accordance with the rules and regulations of the Securities and Exchange Commission for interim reporting. As permitted under those rules and regulations, certain notes or other information that are normally required by accounting principles generally accepted in the United States of America ("GAAP") have been condensed or omitted if they substantially duplicate the disclosures contained in the annual audited consolidated financial statements. The unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2005.

These unaudited condensed consolidated financial statements include all adjustments (including normal, recurring accruals) that are considered necessary for the fair presentation of our financial position and results of operations in accordance with GAAP. Intercompany accounts and transactions have been eliminated in consolidation. Operating results for the six-month period ended June 30, 2006 are not necessarily indicative of results that may be expected for the remaining interim periods or the year as a whole.

Earnings Per Share ("EPS")

For each of the quarters ended June 30, 2006 and 2005, the numerator for the calculation of both basic and diluted earnings per share is equal to net income reported for that period. The difference between basic and diluted EPS denominators is due to dilutive common stock equivalents (stock options and restricted stock). Basic earnings per share excludes dilution and reflects net income divided by the weighted-average shares of common stock outstanding during the periods presented. The denominator for the computation of basic EPS was 85,968,155 and 85,918,791 shares for the three and six months ended June 30, 2006, respectively, and 85,704,165 and 85,613,043 shares for the three and six months ended June 30, 2005, respectively.

Diluted earnings per share is based upon the weighted-average shares of common stock and dilutive common stock equivalents outstanding during the periods presented. Common stock equivalents arising from dilutive stock options and restricted common stock are computed using the treasury stock method. For the three and six months ended June 30, 2006, this amounted to 86,232,103 and 86,373,845 shares, respectively, which include 263,948 and 455,054 dilutive common stock equivalents, respectively. For the three and six months ended June 30, 2005, this amounted to 85,890,984 and 85,803,214 shares, respectively, which include 186,819 and 190,171 dilutive common stock equivalents, respectively.

Options to purchase an aggregate of 6,157,293 and 5,359,356 shares of common stock during the three and six months ended June 30, 2006, respectively, and 7,475,427 and 7,341,859 shares of common stock during the three and six months ended June 30, 2005, respectively, were not included in the computation of diluted earnings per share because the options' exercise prices were greater than the average market prices of the common stock for each respective period. These options expire at various points in time through 2016.

Stock-Based Compensation

Prior to January 1, 2006, the Company accounted for its stock-based compensation plans under the measurement and recognition provisions of Accounting Principles Board Opinion No. (“APB”) 25, *Accounting for Stock Issued to Employees*, and related Interpretations, as permitted by Statement of Financial Accounting Standards No. (“FAS”) 123, *Accounting for Stock-Based Compensation*. Under the intrinsic-value method prescribed by APB 25, compensation cost for stock options was measured at the date of grant as the excess, if any, of the quoted market price of the Company’s stock over the exercise price of the options. All employee stock options were granted at or above the grant date market price. Accordingly, no compensation cost was recognized for fixed stock option grants in prior periods; however, stock-based compensation measured in accordance with the fair-value based method was included as a pro forma disclosure in the consolidated financial statement footnotes.

21ST CENTURY INSURANCE GROUP
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
June 30, 2006
DOLLAR AMOUNTS IN THOUSANDS, EXCEPT WHERE NOTED

Effective January 1, 2006, the Company adopted FAS 123 (revised 2004), *Share-Based Payment* ("FAS 123R"), which requires all stock-based payments to employees, including grants of employee stock options, to be recognized in the statements of operations based on their fair values. Determining the fair value of share-based awards at the grant date requires judgment in estimating the volatility and dividends over the expected term that the stock options will be outstanding prior to exercise. Judgment is also required in estimating the amount of stock-based awards expected to be forfeited prior to vesting. If actual results differ significantly from these estimates, stock-based compensation expense could be materially impacted.

In accordance with FAS 123R, the Company began recognizing the cost of all employee stock options on a straight-line basis over their respective vesting periods, net of estimated forfeitures, using the modified-prospective transition method. Under this transition method, results for prior periods have not been restated and 2006 results include:

- Stock-based compensation cost related to stock options granted on or prior to, but not vested as of, December 31, 2005, based on the grant date fair value originally estimated for the pro forma disclosures in accordance with the original provisions of FAS 123; and

- All stock-based payments granted subsequent to December 31, 2005, based on the grant date fair value estimated in accordance with the provisions of FAS 123R.

FAS 123R also prescribes the recognition of expense using the non-substantive vesting period approach for grants made after December 31, 2005. This expense attribution method requires recognition of compensation expense from the date of grant to the earlier of the vesting date or the date retirement eligibility is achieved for awards with retirement eligibility options. The use of the non-substantive vesting period approach will not affect the overall amount of compensation expense recognized, but could accelerate the recognition of expense for grants made since January 1, 2006. However, the Company will continue to follow the nominal vesting approach for the remaining portion of unvested awards that were granted prior to January 1, 2006 and will continue to recognize expense from the grant date to the earlier of the actual date of retirement or the vesting date.

Generally, stock-based awards are forfeited when employees terminate prior to the vesting date and any compensation cost previously recognized with respect to such unvested stock awards is reversed in the period of forfeiture. Upon share option exercise or restricted share unit conversion, the Company issues new shares, unless the Company elects to use available treasury shares. The Company records forfeitures of restricted stock as treasury share repurchases.

Prior to the adoption of FAS 123R, the Company previously presented all benefits of tax deductions resulting from the exercise of share-based compensation as operating cash flows in the Condensed Consolidated Statements of Cash Flows. FAS 123R requires the benefits of tax deductions in excess of the compensation cost recognized for those options (excess tax benefits) to be classified as financing cash flows.

Recent Accounting Standards

In June 2006, the Financial Accounting Standards Board ("FASB") issued interpretation of FASB Statement No. 109, *Accounting for Uncertainty in Income Taxes* ("FIN 48"). This interpretation clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes.* FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. This interpretation will be effective January 1, 2007. The Company is currently assessing the effect of implementing FIN 48.

Statement of Position ("SOP") 05-1*, Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection with Modifications or Exchanges of Insurance Contracts,* becomes effective January 1, 2007. SOP 05-1 provides guidance on accounting for deferred acquisition costs on internal replacements of insurance and investment contracts other than those specifically described in FAS 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*. The SOP defines an internal replacement as a modification in product benefits, features, rights, or coverage that occurs by the exchange of a contract for a new contract, or by amendment, endorsement, or rider to a contract, or by the election of a feature or coverage within a contract. The Company is currently assessing the effect of implementing this guidance.

21ST CENTURY INSURANCE GROUP
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
June 30, 2006
DOLLAR AMOUNTS IN THOUSANDS, EXCEPT WHERE NOTED

NOTE 2. STOCK-BASED COMPENSATION

2006 Stock-based Compensation Summary

The effect of the adoption of FAS 123R on the condensed consolidated statements of operations and cash flows is as follows:

AMOUNTS IN THOUSANDS, EXCEPT SHARE DATA	*Three Months Ended June 30, 2006* Without FAS 123R [1]	FAS 123R Impact	With FAS 123R	*Six Months Ended June 30, 2006* Without FAS 123R [1]	FAS 123R Impact	With FAS 123R
Total revenues	$342,726	$ —	$342,726	$685,238	$ —	$685,238
Losses and expenses						
Net losses and loss adjustment expenses	222,335	759	223,094	457,697	1,893	459,590
Policy acquisition costs	64,439	448	64,887	123,284	935	124,219
Other underwriting expenses	9,070	434	9,504	19,835	2,269	22,104
Other expense	923	—	923	923	—	923
Interest and fees expense	1,854	—	1,854	3,752	—	3,752
Total losses and expenses	298,621	1,641	300,262	605,491	5,097	610,588
Income before provision for income taxes	44,105	(1,641)	42,464	79,747	(5,097)	74,650
Provision for income taxes	14,431	(288)	14,143	26,056	(1,045)	25,011
Net income	$ 29,674	$(1,353)	$ 28,321	$ 53,691	$(4,052)	$ 49,639
Basic earnings per share [2]	$ 0.35	$ (0.02)	$ 0.33	$ 0.62	$ (0.05)	$ 0.58
Diluted earnings per share [2]	$ 0.34	$ (0.02)	$ 0.33	$ 0.62	$ (0.05)	$ 0.57

The six months ended June 30, 2006 results include $0.7 million and $1.4 million, respectively, of accelerated costs incurred during the first quarter to recognize the effect of retirement eligibility in accordance with the non-substantive vesting period approach and actual vesting in accordance with an executive retention agreement, respectively. As compensation costs for certain employees are included in deferred policy acquisition costs, pre-tax compensation cost related to stock-based compensation of $0.9 million was deferred, for the six months ended June 30, 2006. The remaining unrecognized compensation cost related to unvested awards as of June 30, 2006, was $13.4 million and the weighted-average period over which this cost will be recognized is 2.1 years. The six-month period ended June 30, 2006, results included $113 thousand of excess tax benefits as a financing cash inflow and an increase of additional paid-in capital.

2005 Stock-based Compensation Pro Forma Summary

Had compensation cost for the Company's stock-based compensation plans been determined in the prior year based on the fair-value-based method for all awards, net income would have been reduced by $1.3 million and $2.6 million for the three and six months ended June 30, 2005, respectively. The Company followed the nominal vesting period approach, which recognizes compensation cost over the vesting period unless the employee retired before the end of the vesting period at which time the Company recognizes any remaining unrecognized compensation cost at the date of retirement. The Company did not determine the amount of stock-based compensation cost that would have been deferred as policy acquisition costs in its pro forma footnotes under FAS 123.

[1] Includes $0.3 million and $0.5 million stock-based compensation related to restricted shares and $0.1 million and $0.2 million associated tax, as the previous accounting under APB 25 was consistent with that of FAS 123, for the three months and six months ended June 30, 2006, respectively.

[2] Earnings per share figures may not total due to rounding.

21ST CENTURY INSURANCE GROUP
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
June 30, 2006
DOLLAR AMOUNTS IN THOUSANDS, EXCEPT WHERE NOTED

The pro forma net income and earnings per share amounts follow:

AMOUNTS IN THOUSANDS, EXCEPT SHARE DATA	*Three Months Ended June 30, 2005*	*Six Months Ended June 30, 2005*
Net income, as reported	$20,495	$39,932
Add: Stock-based employee compensation expense included in reported net income, net of related tax effects	68	90
Deduct: Total stock-based employee compensation expense determined under fair-value-based method for all awards, net of related tax effects	(1,298)	(2,565)
Net income, pro forma	$19,265	$37,457
Basic and diluted earnings per share		
As reported	$ 0.24	$ 0.47
Pro forma	$ 0.22	$ 0.44

Stock Option Plans

The stockholders approved the 2004 Stock Option Plan (the “2004 Plan”) at the Annual Meeting of Shareholders on May 26, 2004. The 2004 Plan supersedes the 1995 Stock Option Plan (the “1995 Plan”), which remains in effect only as to outstanding awards under the 1995 Plan. The 2004 Plan authorizes a Committee of the Board of Directors to grant stock options for up to 4,000,000 shares to eligible employees and nonemployee directors, subject to the terms of the 2004 Plan. Additionally, under the 2004 Plan, the Committee may grant stock options that were subject to outstanding awards under the 1995 Plan to the extent such awards expire, are terminated, are canceled, or are forfeited for any reason without shares being issued.

Options granted to employees generally have ten-year terms and vest ratably over three years. Nonemployee director options vest over one year, provided that the nonemployee director is in the service of the Company during that time. Options granted to nonemployee directors expire one year after a nonemployee director ceases service with the Company, or ten years from the date of grant, whichever is sooner.

Issuable and Issued Securities

A summary of securities issuable and issued for the Company’s stock option plans at June 30, 2006, follows:

AMOUNTS IN THOUSANDS	*1995 Stock Option Plan*	*2004 Stock Option Plan*
Total number of securities authorized	10,000	4,000
Number of securities issued	(975)	(204)
Number of securities issuable upon the exercise of all outstanding options	(6,710)	(3,617)
Number of securities forfeited	(2,600)	(74)
Number of forfeited securities returned to plan	2,600	74
Unused options assumed by 2004 Stock Option Plan	(2,315)	2,315
Number of securities available for future grants under each plan	—	2,494

21ST CENTURY INSURANCE GROUP
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
June 30, 2006
DOLLAR AMOUNTS IN THOUSANDS, EXCEPT WHERE NOTED

Current Activity

A summary of the Company's stock option activity for the six months ended June 30, 2006 follows:

AMOUNTS IN THOUSANDS, EXCEPT PRICE DATA	*Number of Options*	*Weighted-Average Exercise Price*
Options outstanding December 31, 2005	8,869	$ 16.22
Granted in 2006	2,000	16.55
Exercised in 2006	(293)	13.11
Forfeited in 2006	(9)	14.59
Canceled in 2006	(240)	19.51
Options outstanding June 30, 2006	10,327	16.30

A summary of the Company's stock option activity and related information follows:

	Three Months Ended June30,		*Six Months Ended June 30,*	
AMOUNTS IN THOUSANDS	**2006**	2005	**2006**	2005
Fair value of stock options granted	**$ 900**	$2,214	**$9,994**	$8,186
Intrinsic value of options exercised	**266**	114	**483**	353
Grant date fair value of options vested	**884**	284	**7,399**	5,241
Proceeds from exercise of stock options	**3,126**	666	**3,844**	1,975
Tax benefit realized as a result of stock option exercises	**53**	23	**97**	70
SHARE DATA				
Weighted-average fair value per option granted	**$ 4.82**	$ 4.46	**$ 5.00**	$ 4.75

Black-Scholes Assumptions

The fair value of each option grant was estimated on the date of grant using the Black-Scholes option-pricing model with the following assumptions:

Six Months Ended June 30,	**2006**	2005 Pro Forma
Risk-free interest rate:		
Minimum	**4.5%**	3.7%
Maximum	**4.8%**	4.3%
Dividend yield	**1.9%**	1.1%
Volatility factor of the expected market price of the Company's common stock:		
Minimum	**29.4**	28.6
Maximum	**29.4**	32.2
Expected option term	**6 years**	6 years

The expected term for options granted during the six months ended June 30, 2006, was calculated using the simplified method in accordance with Staff Accounting Bulletin No. 107. The expected volatility of employee stock options was based on the historical volatility of key competitors in the property & casualty insurance industry (based on six years of closing stock prices). The Company believes that the use of historical competitor volatility better reflects current market expectations of the Company's stock price volatility. The Company's own historical stock price volatility is not representative of expected volatility due to significant prior year events, such as the effects of the 1994 Northridge earthquake and SB 1899, which would not be expected to significantly impact results in the future. The annual risk-free interest rate is based on a traded zero-coupon U.S. Treasury bond on the grant date with a term equal to the option's expected term.

21ST CENTURY INSURANCE GROUP
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
June 30, 2006
DOLLAR AMOUNTS IN THOUSANDS, EXCEPT WHERE NOTED

Outstanding Options

The following table summarizes information about stock options outstanding at June 30, 2006 (amounts in thousands, except price data):

	Outstanding				*Exercisable*			
Range of Exercise Prices	*Number of Options*	*Weighted-Average Remaining Contractual Term*	*Weighted-Average Exercise Price*	*Aggregate Intrinsic Value*	*Number of Options*	*Weighted-Average Remaining Contractual Term*	*Weighted-Average Exercise Price*	*Aggregate Intrinsic Value*
$11.68 -$13.00	1,260	6.7 Years	$11.73	$3,361	1,249	6.7 Years	$11.72	$3,345
13.01 - 15.00	2,910	8.2 Years	14.28	355	1,491	8.1 Years	14.30	153
15.01 - 17.00	3,357	8.0 Years	16.38	—	1,490	5.8 Years	16.18	—
17.01 - 19.00	1,776	4.2 Years	18.05	—	1,776	4.2 Years	18.05	—
19.01 - 22.00	246	1.4 Years	20.75	—	246	1.4 Years	20.75	—
22.01 - 29.25	778	2.9 Years	25.43	—	778	2.9 Years	25.43	—
$11.68 -$29.25	10,327	6.7 Years	$16.30	$3,716	7,030	5.6 Years	$16.65	$3,498

Restricted Shares Plan

The Restricted Shares Plan, which was approved by the Company's stockholders, currently authorizes grants of up to 1,421,920 shares of common stock to be made available to key employees. In general, one third of the shares granted vest on the anniversary date of each of the three years following the year of grant. The Company may also grant vested shares that contain sale restrictions. The Company becomes entitled to an income tax deduction in an amount equal to the taxable income reported by the holders upon vesting of the restricted shares.

Total compensation expense relating to the Restricted Shares Plan was $0.4 million and $0.5 million for the three and six months ended June 30, 2006, respectively, and $0.1 million for the three and six months ended June 30, 2005. Unrecognized compensation cost in connection with restricted stock grants totaled $2.2 million at June 30, 2006. The cost is expected to be recognized over a weighted-average period of 2.4 years.

Restricted Shares Issuable and Issued

A summary of securities issuable and issued for the Company's Restricted Shares Plan at June 30, 2006, follows:

AMOUNTS IN THOUSANDS	*Restricted Shares Plan*

Total number of securities authorized	1,422
Number of securities issued	(1,252)
Number of forfeited securities returned to plan	162
Number of securities remaining available for future grants under the plan	332

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Current Restricted Shares Activity

The following table summarizes activity under the Restricted Shares Plan for the six months ended June 30, 2006:

AMOUNTS IN THOUSANDS, EXCEPT PRICE DATA	*Number of Shares*	*Weighted-Average Market Price Per Share on Date of Grant*
Non-vested, December 31, 2005	87	$ 14.08
Vested in 2006	(33)	14.38
Granted in 2006	109	15.90
Non-vested, June 30, 2006	163	15.22

A summary of the Restricted Shares Plan activity and related information follows:

	Three Months Ended June30,		*Six Months Ended June 30,*	
AMOUNTS IN THOUSANDS	**2006**	2005	**2006**	2005
Fair value of restricted stock awards granted	**$ 80**	$ 1,267	**$ 1,724**	$ 1,267
Fair value of restricted stock awards vested	**475**	30	**475**	183
SHARE DATA				
Weighted-average fair value per share for restricted shares granted	**$ 16.01**	$ 14.10	**$ 15.90**	$ 14.10

NOTE 3. HOMEOWNER AND EARTHQUAKE LINES IN RUNOFF

California Senate Bill 1899 (“SB 1899”), effective from January 1, 2001 to December 31, 2001, allowed the re-opening of previously closed earthquake claims arising out of the 1994 Northridge earthquake. More than ninety-nine percent of the claims submitted and litigation brought against the Company as a result of California SB 1899 have been resolved. The Company’s total loss and loss adjustment expenses (“LAE”) reserves for SB 1899 claims as of June 30, 2006 and December 31, 2005, were less than $0.1 million and $0.5 million, respectively.

Loss and LAE incurred for the homeowner and earthquake lines in runoff were $0.3 million for the three and six months ended June 30, 2006, compared to $0.2 million and $0.4 million for the same periods in 2005, respectively.

NOTE 4. COMMITMENTS AND CONTINGENCIES

Legal Proceedings

In the normal course of business, the Company is named as a defendant in lawsuits related to claims and insurance policy issues, both on individual policy files and by class actions seeking to attack the Company’s business practices. Many suits seek unspecified extra-contractual and punitive damages as well as contractual damages under the

Company's insurance policies in excess of the Company's estimates of its obligations under such policies. The Company cannot estimate the amount or range of loss that could result from an unfavorable outcome on these suits and it denies liability for any such alleged damages. The Company has not established reserves for potential extra-contractual or punitive damages, or for contractual damages in excess of estimates the Company believes are correct and reasonable under its insurance policies. Nevertheless, extra-contractual and punitive damages, if assessed against the Company, could be material in an individual case or in the aggregate. The Company may choose to settle litigated cases for amounts in excess of its own estimate of contractual damages to avoid the expense and risk of litigation. Other than possibly for the contingencies discussed below, the Company does not believe the ultimate outcome of these matters will be material to its results of operations, financial condition or cash flows.

In addition, the Company denies liability and has not established a reserve for the matters discussed below. A range of potential losses in the event of a negative outcome is discussed where known.

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Poss v. 21st Century Insurance Company was filed on June 13, 2003, in Los Angeles Superior Court. The complaint sought injunctive and unspecified restitutionary relief against the Company under Business and Professions Code ("B&P") Sec. 17200 for alleged unfair business practices in violation of California Insurance Code Sec. 1861.02(c) relating to Company rating practices. Based on California's Proposition 64, passed in November 2004, the court granted the Company's motion to dismiss the complaint, but allowed the addition of a second plaintiff, Leacy. The court stayed discovery in this litigation pending appellate court decisions involving similar issues by other parties. To date, these decisions have favored the Company's position. Because this matter is in the pleading stages and no discovery has taken place, no estimate of the range of potential losses in the event of a negative outcome can be made at this time.

Cecelia Encarnacion, individually and as the Guardian Ad Litem for Nubia Cecelia Gonzalez, a Minor, Hilda Cecelia Gonzalez, a Minor, and Ramon Aguilera v. 20th Century Insurance was filed on July 3, 1997, in Los Angeles Superior Court. Plaintiffs allege bad faith, emotional distress, and estoppel involving the Company's (the Company was formerly named 20th Century Insurance) handling of a 1994 homeowner's claim. On March 1, 1994, Ramon Aguilera, a homeowner policyholder, shot and killed Mr. Gonzalez (the minor children's father) and was later sued by Ms. Encarnacion for wrongful death. On August 30, 1996, judgment was entered against Ramon Aguilera for $5.6 million. The Company paid for Aguilera's defense costs through the civil trial; however, the homeowner's policy did not provide indemnity coverage for the incident, and the Company refused to pay the judgment. After the trial, Aguilera assigned a portion of his action against the Company to Encarnacion and the minor children. Aguilera and the Encarnacion family then sued the Company alleging that the Company had promised to pay its bodily injury policy limit if Aguilera pled guilty to involuntary manslaughter. In August 2003, the trial court held a bench trial on the limited issues of promissory and equitable estoppel, and policy forfeiture. On September 26, 2003, the trial court issued a ruling that the Company cannot invoke any policy exclusions as a defense to coverage. On May 14, 2004, the court granted the Encarnacion plaintiffs' motion for summary adjudication, ordering that the Company must pay the full amount of the underlying judgment of $5.6 million, plus interest, for a total of $10.5 million. The Company disagrees with this ruling as it appears inconsistent with the court's simultaneous ruling denying the Company's motion for summary judgment on grounds that there are triable issues of material fact as to whether plaintiffs are precluded from recovering damages as a consequence of Aguilera's inequitable conduct. The Company also believes that the court's decision was not supported by the evidence in the case, demonstrating that no promise to settle was ever made. The Company has appealed the judgment as to the Encarnacions. The trial as to Aguilera concluded on December 9, 2005, on his claims for bad faith, emotional distress, punitive damages and attorney fees. A jury found he sustained no damages as to these claims. The Company's exposure in this case includes the aforementioned $10.5 million judgment plus post-judgment interest, which currently totals $1.8 million.

Insurance Company cases (Ramona Goldenburg) was originally filed as *Bryan Speck, individually, and on behalf of others similarly situated v. 21st Century Insurance Company, 21st Century Casualty Company, and 21st Century Insurance Group*. The original action was filed on June 20, 2002, in Los Angeles Superior Court. Plaintiff seeks California class action certification, injunctive relief, and unspecified actual and punitive damages. The complaint contends that the Company uses "biased" software in determining the value of total-loss automobiles. Specifically, Plaintiff alleges that database providers use improper methodology to establish comparable auto values and populate their databases with biased figures and that the Company and other carriers allegedly subscribe to the programs to unfairly reduce claims costs. This case is consolidated with similar actions against other insurers for discovery and pre-trial motions. A court-ordered appraisal of Speck's vehicle was favorable to the Company and Ramona Goldenberg was substituted as a Plaintiff, replacing Speck, and a new appraisal has been ordered. The Company intends to vigorously defend the suit with other defendants in the coordinated proceedings. This matter is in the pleading stage of litigation and no reasonable estimate of potential losses in the event of a negative outcome can be made at this time.

Thomas Theis, on his own behalf and on behalf of all others similarly situated v. 21st Century Insurance was filed on June 17, 2002, in Los Angeles Superior Court. Plaintiff seeks California class action certification, injunctive relief, and unspecified actual and punitive damages. The complaint contends that after insureds receive medical treatment, the Company used a medical-review program to adjust expenses to reasonable and necessary amounts for a given geographic area and the adjusted amount is “predetermined” and “biased.” This case is consolidated with similar actions against other insurers for discovery and pre-trial motions. Depositions have recently been taken and the Company intends to vigorously defend the suit. This matter is in the discovery stage of litigation and no reasonable estimate of potential losses in the event of a negative outcome can be made at this time.

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Silvia Quintana, on her own behalf and on behalf of all others similarly situated v. 21st Century Insurance was filed on November 16, 2005. This purported class action, filed in San Diego, names the Company in four causes of action: 1) violation of B&P Section 17200, 2) conversion, 3) unjust enrichment and, 4) declaratory relief. Silvia Quintana alleges that the Company's demand for reimbursement of the medical payments it made to her pursuant to her insurance contract violates the "made-whole rule." The Company anticipates that if the matter survives the initial pleading stage, it will be consolidated, for discovery and pre-trial motions, with actions alleging similar facts against other insurers. This matter is in the initial stages of pleading and no reasonable estimate of potential losses in the event of a negative outcome can be made at this time.

NOTE 5. ACCUMULATED OTHER COMPREHENSIVE LOSS

Accumulated other comprehensive loss is a component of stockholders' equity and includes all changes in unrealized gains and losses; reclassification adjustments for investment losses and gains included in net income; and changes in minimum pension liability in excess of unamortized prior service cost.

A summary of accumulated other comprehensive loss follows:

	June 30, 2006	December 31, 2005
Net unrealized losses on available-for-sale investments, net of deferred income taxes of $15,950 and $4,579	**$(29,622)**	$ (8,504)
Minimum pension liability in excess of unamortized prior service cost, net of deferred income taxes of $1,011 and $1,011	**(1,878)**	(1,878)
Total accumulated other comprehensive loss	**$(31,500)**	$(10,382)

NOTE 6. EMPLOYEE BENEFIT PLANS

The Company has both funded and unfunded non-contributory defined benefit pension plans, which together cover essentially all employees who have completed at least one year of service. For certain key employees designated by the Board of Directors, the Company sponsors an unfunded non-qualified supplemental executive retirement plan. The supplemental plan benefits are based on years of service and compensation during the three highest of the last ten years of employment prior to retirement and are reduced by the benefit payable from the pension plan and 50% of the social security benefit. For other eligible employees, the pension benefits are based on employees' compensation during all years of service. The Company's funding policy for the qualified plan is to make annual contributions as required by applicable regulations.

Components of Net Periodic Cost

Net pension costs for all plans were as follows:

	Three Months Ended June 30,		*Six Months Ended June 30,*	
	2006	2005	**2006**	2005

Service cost	**$ 1,693**	$ 1,762	**$ 3,565**	$ 3,524
Interest cost	**1,898**	1,855	**3,869**	3,710
Expected return on plan assets	**(2,112)**	(1,830)	**(4,220)**	(3,660)
Amortization of prior service cost	**39**	27	**73**	54
Amortization of net loss	**628**	507	**1,306**	1,014
Total	**$ 2, 146**	$ 2,321	**$ 4,593**	$ 4,642

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Pension Plan Contributions

The Company previously disclosed in its consolidated financial statements for the year ended December 31, 2005, that it did not expect to contribute to its qualified defined benefit pension plan in 2006. As of June 30, 2006, no contributions have been made. However, the amount and timing of future contributions to the Company's qualified defined benefit pension plan depends on a number of assumptions including statutory funding requirements, the market performance of the plan's assets and future changes in interest rates that affect the actuarial measurement of the plan's obligations.

Contributions to our non-qualified defined benefit pension plan generally are limited to amounts needed to make benefit payments to retirees, which are expected to total approximately $0.9 million in 2006.

Defined Contribution Plans

The Company sponsors a contributory savings and security plan for eligible employees and officers. The Company provides matching contributions equal to 75% of the lesser of 6% of an employee's eligible compensation or the amount contributed by the employee up to the maximum allowable under Internal Revenue Service reg