MERCHANTS GROUP INC
Form 10-Q
August 13, 2001

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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
OR
[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934
FOR THE TRANSITION PERIOD FROM ________ TO ________.

FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2001

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)

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of July 31, 2001.

2,317,652 SHARES OF COMMON STOCK.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

MERCHANTS GROUP, INC.

CONSOLIDATED BALANCE SHEET

(in thousands)

Assets	December 31, 2000	June 30, 2001 (unaudited)
Investments:		
Fixed maturities:		
Held to maturity at amortized cost (fair value $13,576 in 2000 and $13,841 in 2001)	$ 12,874	$ 12,940
Available for sale at fair value (amortized cost $183,392 in 2000 and $179,405 in 2001)	183,283	181,510
Preferred stock at fair value	13,911	14,536
Other long-term investments at fair value	1,036	1,516
Short-term investments	4,550	3,755
Total investments	215,654	214,257
Cash	5	4
Interest due and accrued	2,816	2,371
Premiums receivable, net of allowance for doubtful accounts of $395 in 2000 and $418 in 2001	19,843	21,036
Deferred policy acquisition costs	12,331	12,176
Ceded reinsurance balances receivable	13,089	16,121
Prepaid reinsurance premiums	4,326	4,075
Deferred income taxes	6,263	4,799
Other assets	7,537	7,867
Total assets	$281,864	$282,706

See Notes to the Consolidated Financial Statements

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MERCHANTS GROUP, INC.

CONSOLIDATED BALANCE SHEET

(in thousands except share amounts)

Liabilities and Stockholders' Equity	December 31, 2000	June 30, 2001 (unaudited)
Liabilities:		
Reserve for losses and loss adjustment expenses	$ 145,075	$ 146,653
Unearned premiums	50,857	50,023

Payable to affiliate	608	1,792
Other liabilities	15,202	13,232
Total liabilities	211,742	211,700
Stockholders' equity:		
Common stock, 10,000,000 shares authorized, 2,430,752 shares issued and outstanding at December 31, 2000 and 2,318,552 shares issued and outstanding at June 30, 2001	32	32
Additional paid in capital	35,680	35,680
Treasury stock, 811,100 shares at December 31, 2000 and 923,300 shares at June 30, 2001	(16,063)	(18,123)
Accumulated other comprehensive income (loss)	(875)	1,113
Accumulated earnings	51,348	52,304
Total stockholders' equity	70,122	71,006
Commitments and contingent liabilities	--	--
Total liabilities and stockholders' equity	$ 281,864	$ 282,706

See Notes to the Consolidated Financial Statements

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MERCHANTS GROUP, INC.

CONSOLIDATED STATEMENT OF OPERATIONS

(in thousands except per share amounts)

	Three Months Ended June 30, 2000	Three Months Ended June 30, 2001	S En 2000
		(unaudited)	
Revenues:			
Net premiums earned	$23,606	$23,154	$46,639
Net investment income	3,388	3,472	6,844
Net realized investment gains	5	39	5
Other revenues	16	117	82
Total revenues	27,015	26,782	53,570
Expenses:			
Net losses and loss adjustment expenses	16,703	17,620	34,196
Amortization of deferred policy			

acquisition costs	6,256	6,136	12,359
Other underwriting expenses	1,273	1,116	2,960
Total expenses	24,232	24,872	49,515
Income before income taxes	2,783	1,910	4,055
Income tax provision	982	693	1,437
Net income	$ 1,801	$ 1,217	$ 2,618
Basic and diluted earnings per share	$.72	$.52	$1.04
Weighted average shares outstanding:			
Basic	2,488	2,357	2,524
Diluted	2,489	2,359	2,526

See Notes to the Consolidated Financial Statements

MERCHANTS GROUP, INC.

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

(in thousands)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2000	2001	2000	2001
	(unaudited)			
Net income	$ 1,801	$ 1,217	$ 2,618	$ 1,428
Other comprehensive income (loss) before taxes:				
Unrealized gains (losses) on securities	195	467	(596)	3,302
Reclassification adjustment for gains and losses included in net income	--	(39)	--	(82)
Other comprehensive income (loss) before taxes	195	428	(596)	3,220
Income tax provision (benefit) related to items of other comprehensive income	74	164	(294)	1,232
Other comprehensive income (loss)	121	264	(302)	1,988

Comprehensive income	$ 1,922	$ 1,481	$ 2,316	$ 3,416

See Notes to the Consolidated Financial Statements

MERCHANTS GROUP, INC.

CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY

(in thousands)

	Six Months Ended June 30, 2000	Six Months Ended June 30, 2001
	(unaudited)	
Common stock, beginning and end	$ 32	$ 32
Additional paid in capital beginning and end:	35,680	35,680
Treasury stock:		
Beginning of period	(13,139)	(16,063)
Purchase of treasury shares	(2,352)	(2,060)
End of period	(15,491)	(18,123)
Accumulated other comprehensive income (loss):		
Beginning of period	(1,188)	(875)
Other comprehensive income (loss)	(302)	1,988
End of period	(1,490)	1,113
Accumulated earnings:		
Beginning of period	48,002	51,348
Net income	2,618	1,428
Cash dividends	(503)	(472)
End of period	50,117	52,304
Total stockholders' equity	$68,848	$71,006

See Notes to the Consolidated Financial Statements

MERCHANTS GROUP, INC.

CONSOLIDATED STATEMENT OF CASH FLOWS

(in thousands)

	Six Months Ended June 30, 2000	Six Months Ended June 30, 2001
	(unaudited)	
Cash flows from operations:		
Collection of premiums	$46,239	$44,657
Payment of losses and loss adjustment expenses	(35,547)	(37,661)
Payment of other underwriting expenses	(17,191)	(17,193)
Investment income received	6,678	6,919
Investment expenses paid	(216)	(157)
Income taxes paid	(1,353)	(830)
Other	81	252
Net cash used in operations	(1,309)	(4,013)
Cash flows from investing activities:		
Proceeds from fixed maturities sold or matured	35,276	53,140
Purchase of fixed maturities	(24,516)	(47,978)
Net increase in preferred stock	(416)	(117)
Net (increase) decrease in other long-term investments	62	(480)
Net (increase) decrease in short-term investments	(5,581)	795
Net cash provided by investing activities	4,825	5,360
Cash flows from financing activities:		
Settlement of affiliate balances	(85)	1,184
Decrease in demand loan, net	(575)	-
Purchase of treasury stock	(2,352)	(2,060)
Cash dividends	(503)	(472)
Net cash used in financing activities	(3,515)	(1,348)
Increase (decrease) in cash	1	(1)
Cash:		
Beginning of period	2	5
End of period	$ 3	$ 4

See Notes to the Consolidated Financial Statements

MERCHANTS GROUP, INC.

CONSOLIDATED STATEMENT OF CASH FLOWS

RECONCILIATION OF NET INCOME TO NET CASH

PROVIDED BY OPERATIONS

(in thousands)

	Six Months Ended June 30, 2000	Six Months Ended June 30, 2001
	(unaudited)	
Net income	$2,618	$1,428
Adjustments:		
Accretion of bond discount	(231)	(718)
Realized investment gains	(5)	(82)
(Increase) decrease in assets:		
Interest due and accrued	(151)	445
Premiums receivable	(1,314)	(1,193)
Deferred policy acquisition costs	(308)	155
Ceded reinsurance balances receivable	(503)	(3,032)
Prepaid reinsurance premiums	(5,061)	251
Deferred income taxes	235	233
Other assets	(176)	(274)
Increase (decrease) in liabilities:		
Reserve for losses and loss adjustment expenses	(1,127)	1,578
Unearned premiums	6,223	(834)
Other liabilities	(1,509)	(1,970)
Net cash used in operations	$(1,309)	$(4,013)

See Notes to the Consolidated Financial Statements

MERCHANTS GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. PRINCIPLES OF CONSOLIDATION AND BASIS OF PRESENTATION

The consolidated balance sheet as of June 30, 2001 and the related consolidated statements of operations, of comprehensive income, of changes in stockholders' equity and of cash flows for the three and six month periods ended June 30, 2000 and 2001, respectively, are unaudited. In the opinion of management, the interim financial statements reflect all adjustments necessary for a fair presentation of financial position and results of operations. Such adjustments consist only of normal recurring items. Interim results are not necessarily indicative of results for a full year.

The consolidated financial statements include the accounts of Merchants Group, Inc. (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. The accompanying consolidated financial statements should be read in conjunction with the following notes and the Notes to Consolidated Financial Statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2000.

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. All significant intercompany balances and transactions have been eliminated.

2. RELATED PARTY TRANSACTIONS

The Company and MNH have no paid employees. Under a management agreement dated September 29, 1986 (the Management Agreement), Merchants Mutual Insurance Company (Mutual), which owned 11.0% of the Company's common stock at June 30, 2001, provides the Company and MNH with the facilities, management and personnel required to manage their day-to-day business. All underwriting, administrative, claims and investment expenses incurred on behalf of Mutual and MNH are shared on an allocated cost basis, determined as follows: for underwriting and administrative expenses, the respective share of total direct premiums written for Mutual and MNH serves as the basis of allocation; for claims expenses, the average number of outstanding claims is used; investment expenses are shared based on each company's share of total invested assets.

3. EARNINGS PER SHARE

Basic and diluted earnings per share were computed by dividing net income by the weighted average number of shares of common stock outstanding during each period, increased by the assumed exercise of 8,000 shares of common stock options for the three and six month periods in 2001 and 2000, respectively, which would have resulted in 2,015 and 900 additional shares outstanding for the three month periods, respectively, and 1,949 and 1,407 additional shares outstanding for the six month

periods, respectively, assuming the proceeds to the Company from exercise were used to purchase shares of the Company's common stock at its average market value per share during the respective period.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

RESULTS OF OPERATIONS FOR THE SIX MONTHS ENDED JUNE 30, 2001 AS COMPARED TO THE SIX MONTHS ENDED JUNE 30, 2000

Total revenues for the six months ended June 30, 2001 were $53,878,000, an increase of $308,000 or 1%, from $53,570,000 for the six months ended June 30, 2000.

Direct premiums written for the six months ended June 30, 2001 were $49,735,000, a decrease of $8,559,000 or 15%, from $58,294,000 for the six months ended June 30, 2000. Voluntary direct premiums written for the six months ended June 30, 2001 were $48,212,000, a decrease of $9,527,000 or 17%, from $57,739,000 for the six months ended June 30, 2000.

Voluntary personal lines direct premiums written for the six months ended June 30, 2001 were $18,605,000, an increase of $587,000 or 3%, from $18,018,000 for the six months ended June 30, 2000. Private passenger automobile (PPA) direct premiums written, which represented 76% of total voluntary personal lines direct premiums written for the six months ended June 30, 2001 and 2000, increased 2% from the year earlier period. Homeowners direct premiums written for the six months ended June 30, 2001 increased 7% compared to the six months ended June 30, 2000 primarily due to a 7% increase in policies in force at June 30, 2001 as compared to June 30, 2000.

The Company implemented a program to underwrite specialized commercial auto insurance (the Auto Program) during the quarter ended June 30, 2000. All policies issued under the Auto Program were 100% reinsured through certain Lloyds syndicates and therefore had no impact on net premiums written, net premiums earned or net losses and loss adjustment expenses (LAE) incurred by the Company. The Company recorded all direct underwriting expenses incurred, including commissions with respect to the acquisition of these policies, which were offset by reinsurance commission income. The resulting net impact of the Auto Program reduced other underwriting expenses by $82,000 in the six month period ended June 30, 2000. The Auto Program was discontinued in 2001 and had no impact on current year net income.

Voluntary commercial lines direct premiums written for the six months ended June 30, 2001 were $29,607,000, a decrease of $10,114,000 or 25%, from $39,721,000 for the six months ended June 30, 2000. This decrease was primarily attributable to the aforementioned discontinuation of the Auto Program, which produced $6,579,000 of direct written premiums in the six months ended June 30, 2000.

The Company has and continues to experience higher loss frequency for certain of its commercial lines of business not adequately covered by premiums collected from those lines of business. As a response to these higher losses, the Company has filed for and received approval of rate increases in certain lines of business, revised its underwriting guidelines, and removed discretionary pricing credits where warranted. As a consequence of these actions, voluntary commercial lines direct premiums written,

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excluding Auto Program premiums written, for the six months ended June 30, 2001 decreased $3,519,000 or 11%, to $29,623,000 from $33,142,000 for the six months ended June 30, 2000. Direct premiums written for all of the Company's commercial lines of business, except commercial package policies, decreased in the six months ended June 30, 2001 compared to the six months ended June 30, 2000. Commercial lines policies in force at June 30, 2001 decreased 15% compared to commercial lines policies in force at June 30, 2000. The Company expects that its tightening of underwriting guidelines and increases in rates will cause the decreases in voluntary direct premiums written to accelerate through the end of the year.

Involuntary direct premiums written, primarily PPA insurance, which comprised 3% and 1% of all direct premiums written during the six months ended June 30, 2001 and 2000, respectively, increased by $967,000, or 174%, to $1,523,000 in the six months ended June 30, 2001 from $556,000 for the six months ended June 30, 2000. The Company believes it is likely that, due to a decrease in the willingness of several major competitors to insure non-standard business voluntarily, the number of policies written by the New York Automobile Insurance Plan (NYAIP) will continue to increase and therefore the amount of the Company's involuntary direct written premiums will also continue to increase. However, the Company is unable to predict the volume of future assignments from the NYAIP.

Net premiums written decreased $1,878,000, or 4%, to $45,924,000 for the six months ended June 30, 2001 from $47,802,000 for the six months ended June 30, 2000, due to the 4% decrease in non-Auto Program direct premiums written.

Net premiums earned for the six months ended June 30, 2001 were $46,507,000, a decrease of less than 1% from $46,639,000 for the six months ended June 30, 2000. This decrease is attributable to the fact that the unearned premiums at December 31, 2000 contributed more to earned premiums in the six months ended June 30, 2000 than the unearned premiums at December 31, 1999, contributed to earned premiums in the six months ended June 30, 2000, thereby substantially offsetting the effect on net premiums earned of the aforementioned 4% decrease in net premiums written.

Net investment income was $7,035,000 for the six months ended June 30, 2001, an increase of 3% from $6,844,000 for the six months ended June 30, 2000. The average pre-tax yield associated with the investment portfolio increased 9 basis points to 6.75% for the six months ended June 30, 2001. Average invested assets for the six months ended June 30, 2001 increased 1% compared to the year earlier period.

Other revenues were $254,000 for the six months ended June 30, 2001, an increase of $172,000, or 210%, from $82,000 for the six months ended June 30, 2000. This increase primarily resulted from an increase in installment fee income and a decrease in charge-offs related to uncollectible premiums receivable.

Losses and LAE were $36,381,000 for the six months ended June 30, 2001, an increase of $2,185,000 or 6%, from $34,196,000 for the six months ended June 30, 2000. The loss and LAE ratio increased to 78.2% for the six months ended June 30, 2001 from 73.3% for the six months ended June 30, 2000. The increase in the loss and LAE ratio resulted from increased claims frequency and severity experienced in 2001, primarily for private passenger automobile, commercial automobile and workers' compensation policies.

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The ratio of amortized deferred policy acquisition costs and other underwriting expenses to net premiums earned was 32.8% for both of the six month periods ended June 30, 2001 and June 30, 2000. Commissions, premium taxes and other state assessments that vary directly with the Company's premium volume represented 20.2% of net premiums earned in the six months ended June 30, 2001 compared to 20.1% for the six months ended June 30, 2000.

The Company's effective income tax rate for the six months ended June 30, 2001 was 36.3%. This rate was calculated based upon the Company's estimate of its effective income tax rate for all of 2001. Non-taxable investment income, primarily tax-exempt income, reduced the Company's effective tax rate by approximately four percentage points as compared to statutory rates.

RESULTS OF OPERATIONS FOR THE THREE MONTHS ENDED JUNE 30, 2001 AS COMPARED TO THE THREE MONTHS ENDED JUNE 30, 2000

Total revenues for the three months ended June 30, 2001 were $26,782,000, a decrease of $233,000, or 1%, from $27,015,000 for the three months ended June 30, 2000.

Voluntary personal lines direct premiums written for the three months ended June 30, 2001 were $10,092,000, an increase of $538,000, or 6%, from $9,554,000 for the three months ended June 30, 2000. PPA direct premiums written increased 5% from the year earlier period, primarily due to a 6% increase in average premium per policy. Homeowners direct premiums written for the three months ended June 30, 2001 increased 8% compared to the three months ended June 30, 2000 primarily due to a 7% increase in policies in force.

Voluntary commercial lines direct premiums written excluding Auto Program premiums written for the three months ended June 30, 2001 were $16,441,000, a decrease of $1,952,000, or 11%, from $18,393,000 for the three months ended June 30, 2000. This decrease in commercial lines direct written premiums is attributable to the same factors affecting voluntary commercial lines direct premiums written for the six months ended June 30, 2001, and is expected to accelerate, as discussed earlier in this item.

Involuntary direct premiums written for the three months ended June 30, 2001 were $1,005,000, an increase of $705,000, or 235%, from $300,000 for the three months ended June 30, 2000. Involuntary written premiums are affected by the size of the involuntary markets in which the Company operates, primarily the New York Automobile Insurance Plan.

Net investment income was $3,472,000 for the three months ended June 30, 2001, an $84,000, or 2%, increase from $3,388,000 for the three months ended June 30, 2000, primarily due to a 1% increase in average invested assets.

Losses and LAE were $17,620,000 for the three months ended June 30, 2001, an increase of $917,000, or 5%, from $16,703,000 for the three months ended June 30, 2000. The loss and LAE ratio increased to 76.1% for the three months ended June 30, 2001 from 70.8% for the three months ended June 30, 2000. The increase in the loss and LAE ratio is attributable to the same factors affecting losses and LAE for the six months ended June 30, 2001 discussed earlier in this item.

The ratio of amortized deferred policy acquisition costs and other underwriting expenses to net premiums earned decreased to 31.3% for the three months ended June 30, 2001 from 31.9% for the three months ended June 30, 2000. Commissions, premium taxes and other state assessments that vary with the Company's premium volume represented 19.4% of net premiums earned in the three months ended June 30, 2001 compared to 20.4% for the three months ended June 30, 2000.

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. Historically, the excess of premiums collected over payments on claims, combined with cash flow from investments, has provided the Company with short-term funds in excess of normal operating demands for cash.

The Company's objectives with respect to its investment portfolio include maximizing total returns within investment guidelines while protecting stockholders' equity and maintaining flexibility. Like other property and casualty insurers, the Company relies on premiums as a major source of cash, and therefore liquidity. Cash flows from the Company's investment portfolio, either in the form of interest or principal payments, are an additional source of liquidity. Because the duration of the Company's investment portfolio relative to the duration of its liabilities are closely managed, increases or decreases in market interest rates are not expected to have a material effect on the Company's liquidity or its results of operations.

The Company generally 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 a component of accumulated other comprehensive income within stockholders' equity. At June 30, 2001, the Company had recorded $1,113,000 of unrealized gains, net of taxes, associated with its investments classified as "available for sale" as accumulated other comprehensive income. During the six months ended June 30, 2001 the Company recorded $1,988,000 of unrealized gains, net of tax, associated with its available for sale investments as other comprehensive income.

At June 30, 2001, the Company's portfolio of fixed maturities represented 90.8% of invested assets. Management believes that this level of bond holdings is consistent with the Company's liquidity needs because it anticipates that cash receipts from net premiums written and investment income will enable the Company to satisfy its cash obligations. Furthermore, a portion of the Company's bond portfolio is invested in mortgage-backed and other asset-backed securities which, in addition to interest income, provide monthly paydowns of bond principal.

At June 30, 2001, $83,125,000, or 42.7%, 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 an active secondary market and their effect on the Company's liquidity does not differ

from that of other fixed maturity investments. The Company does not own any other derivative financial instruments.

At June 30, 2001, $10,522,000, or 4.9% of the Company's investment portfolio was invested in non-investment grade securities compared to $9,806,000, or 4.7% at June 30, 2000. All of the Company's non-investment grade securities are currently performing to the Company's purchase expectations.

During the six months ended June 30, 2001, the Company repurchased 112,200 shares of its common stock at an average price per share of $18.36. The Company was holding 923,300 shares of its common stock in treasury at June 30, 2001.

The Company has arranged for a $2,000,000 unsecured credit facility from a bank in the form of a master grid note. 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. At June 30, 2001, no amount was outstanding on this loan.

As a holding company, the Company is dependent on cash dividends from MNH to meet its obligations, pay any cash dividends and repurchase its shares. 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 statutory policyholders' surplus as of the preceding December 31st. The maximum amount of dividends that MNH could pay during any twelve month period ending in 2001 without the prior approval of the New Hampshire Insurance Commissioner is $5,061,000. MNH paid $5,200,000 of dividends to the Company in 2000. Dividends were paid in February 2000, May 2000 and September 2000, of $2,200,000, $1,500,000 and $1,500,000, respectively. MNH paid dividends to the Company of $2,200,000 and $1,350,000 on February 15, 2001 and May 24, 2001, respectively, and as such is restricted from paying another dividend to the Company until September 2001. On July 26, 2001, the Board of Directors of MNH declared a $1,510,000 cash dividend payable to MGI on September 6, 2001. The Company paid cash dividends to its common stockholders of $.20 per share in the first half of 2001 amounting to $472,000.

Under the Management Agreement, Mutual provides employees, services and facilities for MNH to conduct its insurance business on a cost reimbursed basis. The balance in the payable to or receivable from affiliate account represents the amount owing to or owed by Mutual to the Company for the difference between premiums collected and payments made for losses, employees, services and facilities by Mutual on behalf of MNH.

Industry and regulatory guidelines suggest that the ratio of a property-casualty insurer's annual net premiums written to its statutory surplus should not exceed 3 to 1. MNH has consistently followed a business strategy that would allow it to meet this 3 to 1 regulatory guideline. For the first six months of 2001, MNH's ratio of net premiums written to statutory surplus, annualized for a full year, was 1.7 to 1.

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. Mutual currently owns 11.0% of the Company's common stock. Under the Management Agreement, Mutual provides the Company and MNH with all facilities and personnel to operate their business. The only officers of the Company or MNH who are paid full time employees are employees of Mutual whose services are purchased under the Management Agreement. Also, the operation of the Company's insurance business, which offers substantially the same lines of insurance as Mutual through the same independent insurance agents, creates a very close relationship among the companies.

During 1998, Mutual initiated discussions with the Company concerning proposals for the acquisition of the Company by Mutual. The Company determined that the terms proposed by Mutual were inadequate. The Company also determined that the Management Agreement prevents the Company's shareholders from realizing the Company's fair value in a sale or merger, and on July 23, 1998 the Company gave notice to Mutual of its intention to terminate the Management Agreement. The provisions of the Management Agreement require five year's prior written notice for its termination. The Company does not expect the notice of termination to have any material, short-term effect on the Company's operations. However, the Company believes that the Management Agreement, as currently written, creates conflicts of interest between the Company and Mutual in their joint operations and prevents the Company's shareholders from realizing the fair value of their shares.

Item 3. 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 $214,257,000 at June 30, 2001 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 accelerated prepayment risk generally caused by interest rate movements. If interest rates were to 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 reinvestment of the accelerated receipts was made in lower yielding securities.

The following table provides information related to the Company's fixed maturity investments at June 30, 2001. 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.

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Fixed Maturities

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

Held to Maturity	2001	2002	2003	2004	2005	T A
Mortgage & asset backed securities	$ 0	$ 642	$ 1,644	$ 1,556	$ 1,355	$ 7
Average interest rate	0.0%	7.2%	7.1%	7.1%	7.1%	
Total	$ 0	$ 642	$ 1,644	$ 1,556	$ 1,355	$ 7
AVAILABLE FOR SALE						
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	$4, 987	$ 3,832	$ 1,000	$ 0	$ 0	$ 21
Average interest rate	5.3%	6.9%	5.1%	0.0%	0.0%	
Obligations of states and political subdivisions	2,245	1,483	5,357	0	0	
Average interest rate	5.1%	5.6%	5.3%	0.0%	0.0%	
Corporate securities	10,734	25,454	28,873	1,071	0	2
Average interest rate	6.8%	6.6%	5.9%	19.2%	0.0%	
Mortgage & asset backed securities	19,195	17,766	14,868	6,339	1,743	10
Average interest rate	6.8%	6.7%	6.8%	6.9%	7.0%	
Total	$ 37,161	$ 48,535	$ 50,098	$ 7,410	$ 1,743	$ 34

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.

PART II. OTHER INFORMATION

Item 4. Submission of Matters to a Vote of Security Holders

On May 2, 2001 the Company held its annual meeting of stockholders. During the meeting, Brent D. Baird and Richard E. Garman were re-elected Directors of the Company for three year terms to expire at the annual meeting in 2004. Andrew A. Alberti, Frank J. Colantuono, Thomas E. Kahn, Henry P. Semmelhack and Robert M. Zak are Directors of the Company whose terms of office as Director continue beyond the date of the meeting. Mr. Alberti's and Mr. Colantuono's terms expire in 2002 and Mr. Kahn's, Mr. Semmelhack's and Mr. Zak's terms expire in 2003.

Also during the meeting, stockholders ratified the appointment of PricewaterhouseCoopers LLP to serve as the Company's independent accountants for the year ending December 31, 2001.

A summary of stockholder voting with respect to the election of Directors is as follows:

	Election of B. Baird	Election of R. Garman
For	2,211,202	2,213,052
Withheld	8,150	6,300

A summary of stockholder voting with respect to the ratification of PricewaterhouseCoopers to serve as the Company's independent accountants for the year ending December 31, 2001 is as follows:

For	2,215,177
Against	800
Abstained	3,375

Item 6. EXHIBITS AND REPORTS ON FORM 8-K

(b) Reports on Form 8-K.

No reports on Form 8-K were filed during the period for which this report is filed.

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"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 Quarterly Report on Form 10-Q 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. Such forward-looking statements involve certain assumptions, risks and uncertainties that could cause actual results to differ materially from those included in or contemplated by the statements. These assumptions, risks and uncertainties include, but are not limited to, those associated with factors affecting the property-casualty insurance industry generally, including price competition, size and frequency of claims, increasing crime rates, escalating damage awards, natural disasters, fluctuations in interest rates and general business conditions; the Company's dependence on investment income; the geographic 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; government regulation of the insurance industry; exposure to environmental claims; dependence of the Company on its relationship with Mutual; and the other risks and uncertainties discussed or indicated in all documents filed by the Company with the Commission. The Company expressly disclaims any obligation to update any forward-looking statements as a result of developments occurring after the date of this report.

SIGNATURES

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

MERCHANTS GROUP, INC.
(Registrant)

Date: August 13, 2001

By:/s/ Kenneth J. Wilson

Kenneth J. Wilson
Chief Financial Officer and
Treasurer (duly authorized
officer of the registrant and
chief accounting officer)