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MERCHANTS GROUP INC  
Form 10-Q  
November 08, 2002

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

Form 10-Q

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 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 SEPTEMBER 30, 2002

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  No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of October 31, 2002.

2,110,152 SHARES OF COMMON STOCK.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

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MERCHANTS GROUP, INC.

CONSOLIDATED BALANCE SHEET

(in thousands)

Assets -----	December 31, 2001 -----	September 30, 2002 ----- (unaudited)
Investments:		
Fixed maturities:		
Held to maturity at amortized cost (fair value \$14,035 in 2001 and \$6,764 in 2002)	\$ 13,042	\$ 6,458
Available for sale at fair value (amortized cost \$178,815 in 2001 and \$183,459 in 2002)	182,170	186,652
Preferred stock at fair value	9,422	8,240
Other long-term investments at fair value	1,593	1,962
Short-term investments	6,905	5,935
	-----	-----
Total investments	213,132	209,247
Cash	1,197	25
Interest due and accrued	2,309	1,828
Premiums receivable, net of allowance for doubtful accounts of \$431 in 2001 and \$299 in 2002	21,685	15,005
Deferred policy acquisition costs	12,354	9,340
Ceded reinsurance balances receivable	18,810	19,314
Prepaid reinsurance premiums	3,559	1,462
Receivable from affiliate	--	957
Deferred income taxes	4,790	4,925
Other assets	8,727	8,659
	-----	-----
Total assets	\$286,563 =====	\$270,762 =====

See Notes to the Consolidated Financial Statements

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MERCHANTS GROUP, INC.

CONSOLIDATED BALANCE SHEET

(in thousands except share amounts)

December 31, 2001  
-----

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### Liabilities and Stockholders' Equity

<b>Liabilities:</b>			
Reserve for losses and loss adjustment expenses	\$ 151,355		\$
Unearned premiums	50,179		
Payable for securities	--		
Demand loan	200		
Payable to affiliate	852		
Other liabilities	15,426		
	-----		
Total liabilities	218,012		
	-----		
<b>Stockholders' equity:</b>			
Common stock, 10,000,000 shares authorized, 2,224,452 shares issued and outstanding at December 31, 2001 and 2,110,152 shares issued and outstanding at September 30, 2002		32	
Additional paid in capital		35,795	
Treasury stock, 1,025,400 shares at December 31, 2001 and 1,139,700 shares at September 30, 2002		(20,332)	
Accumulated other comprehensive income		1,812	
Accumulated earnings		51,244	
		-----	
Total stockholders' equity		68,551	
		-----	
<b>Commitments and contingent liabilities</b>			
Total liabilities and stockholders' equity		\$ 286,563	\$
		=====	=====

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		Nine Months	
	Ended September 30, 2001	2002	Ended September 30, 2001	2002
	-----	-----	-----	-----
	(unaudited)			
<b>Revenues:</b>				
Net premiums earned	\$ 23,230	\$ 20,198	\$ 69,737	\$ 64,897
Net investment income	3,244	2,593	10,279	7,890
Net realized investment gains	30	--	112	1,383
Other revenues	161	128	415	565
	-----	-----	-----	-----
Total revenues	26,665	22,919	80,543	74,735
	-----	-----	-----	-----

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Expenses:				
Net losses and loss adjustment expenses	20,298	14,752	56,679	48,501
Amortization of deferred policy acquisition costs	6,156	5,552	18,480	17,398
Other underwriting expenses	1,441	1,523	4,374	4,664
	-----	-----	-----	-----
Total expenses	27,895	21,827	79,533	70,563
	-----	-----	-----	-----
Income (loss) before income taxes	(1,230)	1,092	1,010	4,172
Income tax provision (benefit)	(421)	442	391	1,676
	-----	-----	-----	-----
Net income (loss)	\$ (809)	\$ 650	\$ 619	\$ 2,496
	=====	=====	=====	=====
Basic and diluted earnings (loss)				
per share	\$ (.35)	\$ .31	\$ .26	\$ 1.17
	=====	=====	=====	=====
Weighted average shares outstanding:				
Basic	2,317	2,110	2,365	2,130
Diluted	2,321	2,114	2,367	2,134

See Notes to the Consolidated Financial Statements

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MERCHANTS GROUP, INC.

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

(in thousands)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2001	2002	2001	2002
	-----	-----	-----	-----
	(unaudited)			
Net income (loss)	\$ (809)	\$ 650	\$ 619	\$ 2,496
	-----	-----	-----	-----
Other comprehensive income before taxes:				
Unrealized gains on securities	1,276	849	4,578	1,392
Reclassification adjustment for gains and losses included in net income	(28)	--	(110)	(1,383)
	-----	-----	-----	-----
Other comprehensive income before taxes	1,248	849	4,468	9
Income tax provision related to items of other comprehensive income	464	325	1,696	8
	-----	-----	-----	-----

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Other comprehensive income	784	524	2,772	1
	-----	-----	-----	-----
Comprehensive income (loss)	\$ (25)	\$ 1,174	\$ 3,391	\$ 2,497
	=====	=====	=====	=====

See Notes to the Consolidated Financial Statements

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MERCHANTS GROUP, INC.

CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY

(in thousands)

	Nine Months Ended September 30,	
	2001	2002
	-----	-----
	(unaudited)	
Common stock, beginning and end	\$ 32	\$ 32
	-----	-----
Additional paid in capital, beginning and end:	35,680	35,795
	-----	-----
Treasury stock:		
Beginning of period	(16,063)	(20,332)
Purchase of treasury shares	(2,161)	(2,434)
	-----	-----
End of period	(18,224)	(22,766)
	-----	-----
Accumulated other comprehensive income (loss):		
Beginning of period	(875)	1,812
Other comprehensive income	2,772	1
	-----	-----
End of period	1,897	1,813
	-----	-----
Accumulated earnings:		
Beginning of period	51,348	51,244
Net income	619	2,496
Cash dividends	(704)	(644)
	-----	-----
End of period	51,263	53,096
	-----	-----
Total stockholders' equity	\$ 70,648	\$ 67,970
	=====	=====

See Notes to the Consolidated Financial Statements

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MERCHANTS GROUP, INC.

CONSOLIDATED STATEMENT OF CASH FLOWS

(in thousands)

	Nine Months Ended September 30,	
	2001	2002
	----- (unaudited)	
Cash flows from operations:		
Collection of premiums	\$ 69,102	\$ 60,522
Payment of losses and loss adjustment expenses	(56,144)	(50,410)
Payment of other underwriting expenses	(22,926)	(20,707)
Investment income received	10,282	8,625
Investment expenses paid	(228)	(242)
Income taxes paid	(906)	(1,158)
Other	410	565
	-----	-----
Net cash used in operations	(410)	(2,805)
	-----	-----
Cash flows from investing activities:		
Proceeds from fixed maturities sold or matured	75,248	103,184
Purchase of fixed maturities	(80,696)	(99,567)
Net decrease in preferred stock	2,597	1,048
Net increase in other long-term investments	(517)	(370)
Net (increase) decrease in short-term investments	(5,165)	970
	-----	-----
Net cash provided by (used in) investing activities	(8,533)	5,265
	-----	-----
Cash flows from financing activities:		
Settlement of affiliate balances	(772)	(1,809)
Cash borrowed to purchase securities	12,597	1,455
Decrease in demand loan, net	--	(200)
Purchase of treasury stock	(2,161)	(2,434)
Cash dividends	(704)	(644)
	-----	-----
Net cash provided by (used in) financing activities	8,960	(3,632)
	-----	-----
Increase (decrease) in cash	17	(1,172)
Cash:		
Beginning of period	5	1,197
	-----	-----
End of period	\$ 22	\$ 25
	=====	=====

See Notes to the Consolidated Financial Statements

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MERCHANTS GROUP, INC.

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## CONSOLIDATED STATEMENT OF CASH FLOWS

### RECONCILIATION OF NET INCOME TO NET CASH

#### PROVIDED BY OPERATIONS

(in thousands)

	Nine Months Ended September 30, 2001                      2002	
	-----	-----
	(unaudited)	
Net income	\$ 619	\$ 2,496
Adjustments:		
Amortization (accretion) of bond premium (discount)	(853)	12
Realized investment gains	(112)	(1,383)
(Increase) decrease in assets:		
Interest due and accrued	623	481
Premiums receivable	(1,603)	6,680
Deferred policy acquisition costs	(151)	3,014
Ceded reinsurance balances receivable	(3,833)	(504)
Prepaid reinsurance premiums	225	2,097
Deferred income taxes	(66)	(143)
Other assets	(556)	68
Increase (decrease) in liabilities:		
Reserve for losses and loss adjustment expenses	4,699	(1,643)
Unearned premiums	347	(12,718)
Other liabilities	251	(1,262)
	-----	-----
Net cash used in operations	\$ (410)	\$ (2,805)
	=====	=====

See Notes to the Consolidated Financial Statements

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MERCHANTS GROUP, INC.

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

The consolidated balance sheet as of September 30, 2002 and the related consolidated statements of operations, and of comprehensive income for the three and nine month periods ended September 30, 2002, and of changes in stockholders' equity and of cash flows for the nine month periods ended September 30, 2001 and 2002, 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

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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, 2001.

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

With the exception of the Chief Operating Officer of MNH, 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 12.1% of the Company's common stock at September 30, 2002, 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 43,500 and 8,000 shares of common stock options for the three and nine month periods in 2001 and by

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the assumed exercise of 35,500 shares of common stock options for each of the three and nine month periods in 2002. The common stock options assumed to be exercised would have resulted in 3,641 and 3,953 additional shares outstanding for the three month periods ended September 30, 2002 and 2001, respectively, and 3,887 and 2,229 additional shares outstanding for the nine month periods ending September 30, 2002 and 2001, 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

See "Safe Harbor Statement under the Private Securities Litigation Reform Act," on page 22 of this report which is incorporated in this Item by reference.

Results of Operations for the Nine Months Ended September 30, 2002 As Compared to the Nine Months Ended September 30, 2001

Total revenues for the nine months ended September 30, 2002 were \$74,735,000, a decrease of \$5,808,000 or 7%, from \$80,543,000 for the nine months ended September 30, 2001.



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Direct premiums written for the nine months ended September 30, 2002 were \$56,036,000, a decrease of \$19,836,000 or 26%, from \$75,872,000 for the nine months ended September 30, 2001. Voluntary direct premiums written for the nine months ended September 30, 2002 were \$51,537,000, a decrease of \$21,233,000 or 29%, from \$72,770,000 for the nine months ended September 30, 2001.

Voluntary personal lines direct premiums written for the nine months ended September 30, 2002 were \$29,676,000, an increase of less than 1% from \$29,614,000 for the nine months ended September 30, 2001. The slight increase in voluntary personal lines direct premiums written is due to rate increases implemented in some territories offset by the effect of the Company's decision not to accept new private passenger automobile (PPA) applications effective April 1, 2002 in certain states where the Company intends to reduce its PPA exposures due to unfavorable market conditions. Total voluntary personal lines policies in force at September 30, 2002 were 38,911, a decrease of 2% from 39,692 at September 30, 2001. Voluntary PPA policies in force decreased 7% to 21,988 at September 30, 2002 from 23,674 at September 30, 2001.

Voluntary commercial lines direct premiums written for the nine months ended September 30, 2002 were \$21,861,000, a decrease of \$21,295,000 or 49%, from \$43,156,000 for the nine months ended September 30, 2001. Commercial lines new business units decreased 67% compared to the year earlier period. Direct premiums written decreased for every commercial line of business for the nine months ended September 30, 2002 compared to the nine months ended September 30, 2001.

The decrease in voluntary commercial lines direct premiums written is consistent with the actions undertaken by the Company in the fourth quarter of 2001 to exit certain classes of commercial insurance, thereby reducing direct premiums written in business segments that it believes do not provide the opportunity to earn a satisfactory return. The Company believes that a portion of the decrease in

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voluntary commercial lines direct premiums written was due in part to some commercial business, other than in the exited classes and related policies, moving to other insurance carriers including the Company's affiliate, Merchants Mutual Insurance Company. As a result of the withdrawal from certain classes of commercial insurance, the Company expects its commercial business to decline during the remainder of 2002 and the first quarter of 2003.

Involuntary direct premiums written, primarily PPA insurance, which comprised 8% and 4% of all direct premiums written during the nine months ended September 30, 2002 and 2001, respectively, increased by \$1,396,000, or 45%, to \$4,498,000 for the nine months ended September 30, 2002 from \$3,102,000 for the nine months ended September 30, 2001, primarily due to an increase in the number of policies written by the New York Automobile Insurance Plan (NYAIP). The Company is unable to predict the volume of future assignments it will receive from the NYAIP.

Net premiums written decreased \$16,032,000, or 23%, to \$54,277,000 for the nine months ended September 30, 2002 from \$70,309,000 for the nine months ended September 30, 2001, due primarily to the 26% decrease in direct premiums written. Net premiums earned for the nine months ended September 30, 2002 were \$64,897,000, a decrease of 7% from \$69,737,000 for the nine months ended September 30, 2001. The percentage decrease in net premiums earned will continue to grow in the next quarter, due to the aforementioned decrease in net premiums written.

Net investment income was \$7,890,000 for the nine months ended September 30,

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2002, a decrease of 23% from \$10,279,000 for the nine months ended September 30, 2001. The average pre-tax yield associated with the investment portfolio decreased 116 basis points to 5.51% for the nine months ended September 30, 2002. Average invested assets for the nine months ended September 30, 2002 decreased 3% compared to the year earlier period.

Net realized investment gains were \$1,383,000 for the nine months ended September 30, 2002 compared to \$112,000 for the nine months ended September 30, 2001. In April 2002, the Company sold its entire position of United States Treasury Inflation Index Notes (TIPS) and recorded a realized gain of \$1,303,000.

Other revenues were \$565,000 for the nine months ended September 30, 2002, an increase of \$150,000, or 36%, from \$415,000 for the nine months ended September 30, 2001. This increase primarily resulted from the Company's mid-2001 implementation of late payment fees.

Losses and LAE were \$48,501,000 for the nine months ended September 30, 2002, a decrease of \$8,178,000 or 14%, from \$56,679,000 for the nine months ended September 30, 2001. The loss and LAE ratio decreased to 74.7 for the nine months ended September 30, 2002 from 81.3 for the nine months ended September 30, 2001. Incurred losses for the nine months ended September 30, 2001 included \$1,990,000 of losses and LAE related to the September 2001 terrorist attack on the World Trade Center (WTC event), which added 2.9 points to that period's loss and LAE ratio. Without the effect of the WTC event, the Company's loss and LAE ratio for the nine months ended September 30, 2001 would have been 78.4. The decrease in the loss and LAE ratio not pertaining to the WTC event

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related primarily to the current accident year and was attributable to a decrease in claims frequency and severity in the Company's commercial lines of business.

The ratio of amortized deferred policy acquisition costs and other underwriting expenses to net premiums earned increased to 34.0% for the nine months ended September 30, 2002 from 32.8% for the nine months ended September 30, 2001. Commissions, premium taxes and state assessments that vary directly with the Company's premium volume represented 21.9% of net premiums earned in the nine months ended September 30, 2002 compared to 20.3% for the nine months ended September 30, 2001.

The Company's effective income tax rate for the nine months ended September 30, 2002 was 40.2%. This rate was calculated based upon the Company's estimate of its effective income tax rate for all of 2002.

Results of Operations for the Three Months Ended September 30, 2002 As Compared to the Three Months Ended September 30, 2001

Total revenues for the three months ended September 30, 2002 were \$22,919,000, a decrease of \$3,746,000, or 14%, from \$26,665,000 for the three months ended September 30, 2001.

Voluntary personal lines direct premiums written for the three months ended September 30, 2002 were \$11,094,000, an increase of \$85,000, or 1%, from \$11,009,000 for the three months ended September 30, 2001. PPA direct premiums written decreased less than 1% from the year earlier period. Homeowners direct premiums written for the three months ended September 30, 2001 increased 4% compared to the three months ended September 30, 2001. The increase in voluntary personal lines direct premiums written for the three months ended September 30, 2002 is attributable to the same factors affecting voluntary personal lines

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direct premiums written for the nine months ended September 30, 2002, discussed earlier in this item.

Voluntary commercial lines direct premiums written for the three months ended September 30, 2002 were \$5,192,000, a decrease of \$8,357,000, or 62%, from \$13,549,000 for the three months ended September 30, 2001. This decrease in commercial lines direct written premiums is attributable to the same factors affecting voluntary commercial lines direct premiums written for the nine months ended September 30, 2002, as discussed earlier in this item.

Involuntary direct premiums written for the three months ended September 30, 2002 were \$1,629,000, an increase of \$50,000, or 3%, from \$1,579,000 for the three months ended September 30, 2001. Involuntary written premiums are affected by the size of the involuntary markets in which the Company operates, primarily the NYAIP.

Net investment income was \$2,593,000 for the three months ended September 30, 2002, a \$651,000, or 20%, decrease from \$3,244,000 for the three months ended September 30, 2001, primarily due to a 4% decrease in average invested assets and a 122 basis point decrease in the average investment portfolio yield.

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Losses and LAE were \$14,752,000 for the three months ended September 30, 2002, a decrease of \$5,546,000, or 27%, from \$20,298,000 for the three months ended September 30, 2001. The loss and LAE ratio decreased to 73.0 for the three months ended September 30, 2002 from 87.4 for the three months ended September 30, 2001. Incurred losses for the three months ended September 30, 2001 included \$1,990,000 of losses and LAE related to the WTC event, which added 8.6 points to the loss and LAE ratio for that period. Without the effect of the WTC event, the Company's loss and LAE ratio for the three months ended September 30, 2001 would have been 78.8. The decrease in the loss and LAE ratio not pertaining to the WTC event is attributable to the same factors affecting losses and LAE for the nine months ended September 30, 2002 discussed earlier in this item.

The ratio of amortized deferred policy acquisition costs and other underwriting expenses to net premiums earned increased to 35.0% for the three months ended September 30, 2002 from 32.7% for the three months ended September 30, 2001. Commissions, premium taxes and other state assessments that vary with the Company's premium volume represented 21.9% of net premiums earned in the three months ended September 30, 2002 compared to 20.1% for the three months ended September 30, 2001, primarily due to increased reinsurance commissions paid on a higher volume of assumed premiums from various reinsurance facilities.

### 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. For the nine months ended September 30, 2002, the Company's operating activities used \$2,805,000 of cash, an increase of \$2,395,000 or 584% compared to the nine months ended September 30, 2001. The Company's intention to continue to reduce direct premiums written in business segments where returns are unsatisfactory will likely result in continued negative cash flows from operations. The Company believes that careful management of the relationship between assets and liabilities will minimize the likelihood that unanticipated investment portfolio sales will be necessary to fund insurance operations and that the effect of any such sale on the Company's stockholders' equity will not be material.

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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 is less than the duration of its liabilities, increases or decreases in market interest rates are not expected to have a material effect on the Company's liquidity.

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

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September 30, 2002, the Company had recorded \$1,813,000 of net unrealized gains, net of taxes, associated with its investments classified as "available for sale" as accumulated other comprehensive income. During the nine months ended September 30, 2002 the Company recorded \$1,000 of net unrealized gains, net of tax, associated with its available for sale investments as a component of other comprehensive income.

At September 30, 2002, the Company's portfolio of fixed maturities represented 92.3% of invested assets. Management believes that this level of bond holdings is consistent with the Company's liquidity needs because 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 September 30, 2002, \$103,685,000, or 53.7%, 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 September 30, 2002, \$4,647,000, or 2.2% of the Company's investment portfolio was invested in non-investment grade securities compared to \$10,302,000, or 4.5% at September 30, 2001. The Company's non-investment grade securities at September 30, 2002 included a real estate investment trust (REIT) with a cost basis of \$1,012,500 and a market value of approximately \$715,000. In November 2002, the Company sold approximately one-half of its position in this REIT and realized a loss of \$216,000. The Company expects to sell the remainder of this REIT investment during the fourth quarter of 2002 resulting in a similar loss.

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 September 30, 2002, no amount was outstanding on this loan.

During the nine months ended September 30, 2002, the Company repurchased 114,300 shares of its common stock at an average price per share of \$21.29. The Company was holding 1,139,700 shares of its common stock in treasury at September 30,

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2002. The Company has suspended its program of repurchasing shares of its common stock on the open market. See Relationship with Mutual.

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 2002 without the prior approval of the New Hampshire

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Insurance Commissioner is \$5,263,000. MNH paid \$5,060,000 of dividends to the Company in 2001. Dividends were paid in February 2001, May 2001 and September 2001, of \$2,200,000, \$1,350,000 and \$1,510,000, respectively. MNH paid dividends to the Company of \$2,300,000 and \$900,000 on February 19, 2002 and May 30, 2002, respectively. On October 24, 2002, the Board of Directors of MNH declared a \$500,000 cash dividend payable on November 25, 2002 to common stockholders of record on November 25, 2002. The Company paid cash dividends to its common stockholders of \$.10 per share in each of the first three quarters of 2002 amounting to \$644,000 in the aggregate.

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.

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 nine months of 2002, MNH's ratio of net premiums written to statutory surplus, annualized for a full year, was 1.3 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 an 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 12.1% 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. With the exception of the Chief Operating Officer of MNH, 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 the Company determined that the Management Agreement, as currently written, creates a conflict of interest between the Company and Mutual in their joint operations. Accordingly, on July 23, 1998 the Company gave notice to Mutual of its intention to terminate the Management Agreement and, therefore, the Management Agreement will terminate on July 23, 2003 unless the parties

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agree to renew or extend it.

The Company is evaluating its existing insurance business and its relationship with Mutual as well as other opportunities in the insurance marketplace. The Board and MNH's Chief Operating Officer, in consultation with financial and other industry professionals, are formulating a plan to develop one or more opportunities that have the potential for meaningful profitability. The

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Company continues in negotiations with Mutual to develop a new relationship for the operational management of the Company's existing business only. The Company is also exploring the possibility that in the future it will appoint its own management separate from that of Mutual to oversee its existing business and to develop and oversee other opportunities independent of Mutual. It is likely that agreements between MNH and Mutual or other entities related to these matters will require the approval of the New Hampshire Insurance Department (NHID), MNH's state of domicile, the New York Insurance Department (NYID), Mutual's state of domicile, and possibly the insurance departments of other states, as well. State insurance departments have broad discretion to approve or disallow actions or agreements of their subject insurers in order to protect the interests of the public and policyholders. MNH and Mutual are conducting ongoing discussions with representatives of the NHID and the NYID regarding the structure of a possible future relationship.

The Company has suspended the repurchasing of shares of its common stock on the open market at least until its negotiations with Mutual have been completed, its revised plan has been adopted, and these matters have been approved by the applicable regulators.

In June 2002, MNH gave notice to Mutual that it is terminating the quota share reinsurance between MNH and Mutual as of December 31, 2002. The agreement became effective on January 1, 1993 and allowed Mutual to cede and MNH to assume, up to 10% of Mutual's direct voluntary written premiums and related losses and LAE in exchange for a reinsurance commission of 35%. Mutual has not ceded any of its direct voluntary written premiums to MNH since 1995. The termination is subject to the prior approval of the New York Superintendent of Insurance.

### 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 \$209,553,000 at September 30, 2002 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 September 30, 2002. 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	2002	2003	2004	2005	2006	Th
-----	-----	-----	-----	-----	-----	af
Mortgage & asset backed securities	\$ 29	\$ 2,425	\$ 1,809	\$ 1,620	\$ 398	\$
Average interest rate	7.0%	7.0%	7.0%	7.1%	7.2%	
	-----	-----	-----	-----	-----	-----
Total	\$ 29	\$ 2,425	\$ 1,809	\$ 1,620	\$ 398	\$
	=====	=====	=====	=====	=====	=====
Available for Sale						
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	\$ 0	\$ 4,194	\$ 0	\$14,252	\$ 0	\$
Average interest rate	0.0%	4.1%	0.0%	3.6%	0.0%	
Obligations of states and political subdivisions	\$ 0	6,365	1,373	2,823	499	
Average interest rate	0.0%	7.2%	4.1%	3.2%	3.2%	
Corporate securities	3,003	27,746	6,833	17,850	0	2
Average interest rate	7.4%	4.8%	7.6%	4.0%	0.0%	
Mortgage & asset backed securities	13,840	31,771	22,404	14,066	6,166	7
Average interest rate	5.6%	5.6%	5.7%	5.7%	5.8%	
	-----	-----	-----	-----	-----	-----
Total	\$16,843	\$70,076	\$30,610	\$48,991	\$6,665	\$10
	=====	=====	=====	=====	=====	=====

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. See "Safe Harbor Statement under the Private Securities Litigation Reform Act," on page 22 of this report which is incorporated in this Item by reference.

Item 4. Controls and Procedures

The Company's disclosure controls and procedures are designed to ensure that the information required to be disclosed in reports filed under the Securities Act of 1934 is recorded, processed, summarized and reported within the time periods

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specified in the rules and forms of the Securities and Exchange Commission. The Chief Operating Officer and the Chief Financial Officer have reviewed the effectiveness of the Company's disclosure controls and procedures within the last 90 days and have concluded that the disclosure controls and procedures are effective. There were no significant changes in our internal controls or in other factors that could significantly effect these controls subsequent to the last day they were evaluated by the Company's Chief Operating Officer and Chief Financial Officer.

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### PART II. OTHER INFORMATION

Item 1. Legal Proceedings.

None.

Item 2. Changes in Securities and Use of Proceeds.

None.

Item 3. Defaults Upon Senior Securities.

None.

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

None.

Item 5. Other Information.

None.

Item 6. Exhibits and Reports on Form 8-K

- (a) Exhibits.  
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 3D to Amendment No. 1 to the Company's Registration Statement No. 33-9188 on Form S-1 filed on November 7, 1986.
- 4 Instruments defining the rights of security holders, including indentures - N/A.
- 5 Opinion re legality - N/A.
- 10(a) Management Agreement dated as of September 29, 1986 by and among Merchants Mutual Insurance Company, Registrant and Merchants Insurance Company of 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) Agreement of Reinsurance No. 6922 between Merchants Mutual Insurance Company, Merchants Insurance Company of New Hampshire, Inc. and General Reinsurance Corporation (incorporated by reference to Exhibit No. 10e to the



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Company's Registration Statement (No. 33-9188) on Form S-1 filed on September 30, 1986).

- (c) Agreement of Reinsurance No. 7299 between Merchants Mutual Insurance Company, Merchants Insurance Company of New Hampshire, Inc. and General Reinsurance Corporation, (incorporated by reference to Exhibit No. 10o to the Company's 1987 Annual Report on Form 10-K (File No. 1-9640) filed on March 19, 1988).
- (d) Agreement of Reinsurance dated January 27, 1993, between Merchants Mutual Insurance Company and Merchants Insurance Company of New Hampshire, Inc. (incorporated by reference to Exhibit (3) in the Company's Current Report on Form 8-K (File No. 1-9640) filed on January 29, 1993).
- (e) Agreement of Reinsurance No. 8009 between Merchants Mutual Insurance Company, Merchants Insurance Company of New Hampshire, Inc. and General Reinsurance Corporation, (incorporated by reference to Exhibit 10e to the Company's 1995 Annual Report on Form 10-K filed on March 28, 1996).
- (f) Property and Casualty Excess of Loss Reinsurance Agreement between Merchants Mutual Insurance Company, Merchants Insurance Company of New Hampshire, Inc. and American Reinsurance Company, including endorsement, (incorporated by reference to Exhibit 10g to the Company's 1998 Annual Report on Form 10-K filed on March 29, 1999).
- (g) Property Catastrophe Excess of Loss Reinsurance Agreement between Merchants Mutual Insurance Company, Merchants Insurance Company of New Hampshire, Inc. and the Subscribing Reinsurers Executing the Interest and Liabilities Agreements Attached Hereto, effective January 1, 2002 (filed herewith).
- (h) 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 10h to the Company's 2000 Annual Report on Form 10-K filed on March 28, 2001).
- \* (i) Merchants Mutual Capital Accumulation Plan (incorporated by reference to Exhibit No. 10g to the Company's Registration Statement (No. 33-9188) on Form S-1 filed on September 30, 1986).
- \* (j) Merchants Mutual Capital Accumulation Plan, fifth amendment, effective January 1, 1999 (incorporated by reference to Exhibit 10j to the Company's 2000 Annual Report on Form 10-K filed on March 28, 2001).

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- \* (k) Merchants Mutual Capital Accumulation Plan Trust Agreement (restated as of January 1, 1996 (incorporated by reference to Exhibit 10(i) to the Company's 1996 Annual Report on Form 10-K (File No. 1-9640) filed on March 28, 1997).
- \* (l) Merchants Mutual Supplemental Executive Retirement Plan dated as of

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December 29, 1989 and Agreement of Trust dated as of December 29, 1989 (incorporated by reference to Exhibit No. 10k to the Company's 1989 Annual Report on Form 10-K (File No. 1-9640) filed on March 21, 1990).

- \* (m) Amendment dated June 10, 1992 to Agreement of Trust under Merchants Mutual Supplemental Executive Retirement Plan dated as of December 29, 1989 (incorporated by reference to Exhibit No. 10r to the Company's 1992 Annual Report on Form 10-K (File No. 1-9640) filed on March 31, 1993).
  - \* (n) Merchants Group, Inc. 1986 Stock Option Plan As Amended Through February 16, 1993 (incorporated by reference to Exhibit No. 10e to the Company's 1992 Annual Report on Form 10-K (File No. 1-9640) filed on March 31, 1993).
  - \* (o) 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).
  - \* (p) 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).
  - \* (q) Merchants Mutual Insurance Company Adjusted Return on Equity Long Term Incentive Compensation Plan January 1, 2000 (incorporated by reference to Exhibit 10q to the Company's 2000 Annual Report on Form 10-K filed on March 28, 2001).
  - \* (r) Employee Retention Agreement between Robert M. Zak and Merchants Mutual Insurance Company dated as of March 1, 1999 (incorporated by reference to Exhibit No. 10a to the Company's June 30, 1999 Quarterly Report on Form 10-Q filed on August 12, 1999).
  - \* (s) Employee Retention Agreement between Edward M. Murphy and Merchants Mutual Insurance Company dated as of March 1, 1999 (incorporated by reference to Exhibit 10r to the Company's 1998 Annual Report on Form 10-K filed on March 29, 1999).
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- \* (t) Employee Retention Agreement between Kenneth J. Wilson and Merchants Mutual Insurance Company dated as of March 1, 1999 (incorporated by reference to Exhibit 10s to the Company's 1998 Annual Report on Form 10-K filed on March 29, 1999).
  - \* (u) Consulting Agreement between Stephen C. June and Merchants Insurance Company of New Hampshire, Inc. ("MNH") dated as of May 7, 2001 incorporated by reference to Exhibit 10t to the Company's 2001 Annual Report on Form 10-K filed on March 21, 2002.
  - \* (v) Employment Agreement between Stephen C. June and MNH dated as of April 1, 2002 incorporated by reference to Exhibit 10u to the Company's 2001 Annual Report on Form 10-K filed on March 21, 2002.
- 11 Statement re computation of per share earnings - N/A.
- 12 Statement re computation of ratios - N/A.

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- 15 Letter re unaudited interim financial information - N/A.
- 18 Letter re change in accounting principles - N/A.
- 19 Report furnished to security holder - N/A.
- 22 Published report regarding matters submitted to vote of security holders - N/A.
- 23 Consents of experts and counsel - N/A.
- 24 Power of attorney - N/A.
- 99(a) Certification Pursuant to Section 906 of the 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.

- (b) Reports on Form 8-K.

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

\* \* \* \* \*

"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. Forward-looking statements may 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 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, 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 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 Mutual and the uncertainty concerning what will happen if the Management Agreement with Mutual is either not renewed or extended beyond its termination date of July 23, 2003, or replaced with a different arrangement; the Company's intention to reduce written premium in business segments that it believes no longer provide a satisfactory return; and the other risks and uncertainties discussed or

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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: November 8, 2002

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

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### CERTIFICATIONS

I, Robert M. Zak, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Merchants Group, Inc.
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statement made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by the report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:
  - a. designed such disclosure controls and procedures that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which periodic reports are being prepared;
  - b. evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this report (the Evaluation Date); and
  - c. presented in this report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

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5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditor and the audit committee of registrant's board of directors (or persons performing the equivalent function):
- a. all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
  - b. any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

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6. The registrant's other certifying officers and I have indicated in this report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: November 8, 2002

By: /s/ Robert M. Zak

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Robert M. Zak, Senior Vice President and  
Chief Operating Officer  
(Chief Executive Officer)

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CERTIFICATIONS

I, Kenneth J. Wilson, certify that:

- 1. I have reviewed this quarterly report on Form 10-Q of Merchants Group, Inc.
- 2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statement made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by the report;
- 3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
- 4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant

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and we have:

- a. designed such disclosure controls and procedures that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which periodic reports are being prepared;
  - b. evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this report (the Evaluation Date); and
  - c. presented in this report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditor and the audit committee of registrant's board of directors (or persons performing the equivalent function):
- a. all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
  - b. any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

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6. The registrant's other certifying officers and I have indicated in this report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: November 8, 2002

By:/s/ Kenneth J. Wilson

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Kenneth J. Wilson, Vice President and  
Chief Financial Officer  
(Chief Financial Officer)

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