21ST CENTURY INSURANCE GROUP
Form 10-K
February 23, 2006

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

FORM 10-K

x **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the fiscal year ended December 31, 2005

Commission File Number 0-6964

21ST CENTURY INSURANCE GROUP
(Exact name of registrant as specified in its charter)

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

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

Title of each class	**Name of each exchange on which registered**
Common Stock, Par Value $0.001	New York Stock Exchange

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.
Yes o No x

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Act.
Yes o No x

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant’s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. x

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

Large accelerated filer o Accelerated filer x Non-accelerated filer o

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

The aggregate market value of the voting stock held by non-affiliates of 21st Century Insurance Group, based on the average high and low prices for shares of the registrant's Common Stock on June 30, 2005, as reported by the New York Stock Exchange, was approximately $462,000,000.

There were 85,936,476 shares of common stock outstanding on February 3, 2006.

Documents Incorporated By Reference:
Part III of this Form 10-K incorporates by reference certain information from the registrant's definitive proxy statement for the Annual Meeting of Stockholders to be filed with the Securities and Exchange Commission within 120 days after the close of the year ended December 31, 2005.

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PART I

ITEM 1. **BUSINESS**

General
21st Century Insurance Group is an insurance holding company registered on the New York Stock Exchange. For convenience, the terms "Company", "21st", "we", "us", or "our" are used to refer collectively to the parent company and its subsidiaries.

Founded in 1958, we are a direct-to-consumer provider of personal auto insurance. With $1.4 billion of revenue in 2005, we insure over 1.5 million vehicles in California, Texas, Illinois, and six other states. We provide superior policy features and customer service at a competitive price. Customers can purchase insurance, service their policy, or report a claim at *www.21st.com* or on the phone with our licensed insurance professionals at 1-800-211-SAVE. Service is offered in English and Spanish, both on the phone and on the web, 24 hours a day, 365 days a year.

Effective December 4, 2003, 21st Century Insurance Group was incorporated under the laws of the State of Delaware. Previously, the Company was incorporated in California. The term "Company," unless the context requires otherwise, refers to 21st Century Insurance Group and its consolidated subsidiaries, all of which are wholly-owned: 21st Century Insurance Company, 21st Century Casualty Company, 21st Century Insurance Company of the Southwest, 20th Century Insurance Services, Inc., and i21 Insurance Services. The latter two companies are not property and casualty insurance subsidiaries, and their results are immaterial.

The common stock of the Company is traded on the New York Stock Exchange under the trading symbol "TW." Through several of its subsidiaries, American International Group, Inc. ("AIG") currently owns approximately 62% of the Company's outstanding common stock.

Copies of our filings with the Securities and Exchange Commission ("SEC") on Form 10-K, Form 10-Q, Form 8-K and proxy statements are available, along with copies of earnings releases, on the Company's web site at *www.21st.com* as soon as reasonably practicable after such material is electronically filed with or furnished to the SEC. Copies may also be obtained free of charge directly from the Company's Investor Relations Department (6301 Owensmouth Avenue, Woodland Hills, California 91367, phone 818-673-3996).

The public may also read and copy any materials the Company files with the SEC at the SEC's Public Reference Room at 450 Fifth Street, N.W., Washington, D.C. 20549 (information on the operation of the Public Reference Room is available by calling the SEC at 1-800-SEC-0330). The SEC also maintains a web site that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC at *www.sec.gov*.

Some Useful Definitions
The insurance industry uses terminology that is unfamiliar to many people. Included here are definitions and descriptions that should be useful as you read this report.

Not all financial measures used in insurance are presented in accordance with accounting principles generally accepted in the United States of America ("GAAP"). Non-GAAP financial measures are not intended to replace, and should be read in conjunction with, the GAAP financial results. The reconciliations of non-GAAP financial measures to the most directly comparable GAAP measures are located in *Item 7. Management's Discussion and Analysis - Results of Operations* and *Liquidity and Capital Resources*.

Balance Sheet terms

- *Deferred policy acquisition costs ("DPAC")* - The unamortized portion of the policy acquisition costs described below.

- *Unpaid losses and loss adjustment expenses* - The estimated liabilities for Losses and Loss Adjustment Expense ("LAE") include the accumulation of estimates of losses for claims reported on or prior to the balance sheet dates, estimates (based upon actuarial analysis of historical data) of losses for claims incurred but not reported, the development of case reserves to ultimate values, and estimates of expenses for investigating, adjusting and settling all incurred claims. Amounts reported are estimates of the ultimate costs of settlement, net of estimated salvage and subrogation.

- *Reinsurance receivables and recoverables* - These amounts are reflected as assets on the balance sheet and consist of two components: first, the ceded portion of the reserves described in unpaid losses and LAE above are shown as recoverables and second, the actual billings due from our reinsurers on ceded losses and LAE paid are recorded as receivables.

- *Unearned premiums* - That portion of our direct premiums written that has not yet been earned. It is the amount of premium we would return to policyholders if all policies were cancelled as of the balance sheet date. The ceded portion of this liability is shown as an asset labeled "Prepaid reinsurance premiums."

- *Statutory surplus* - Represents equity as of the end of a fiscal period for the Company's insurance subsidiaries, determined in accordance with statutory accounting principles prescribed by insurance regulatory authorities. Stockholders' equity is the most directly comparable GAAP measure.

Income statement terms

- *Direct premiums written* - The total policy premiums, net of cancellations, associated with policies underwritten and issued. We use direct premiums written, which excludes the impact of premiums ceded to reinsurers, as a measure of the underlying growth of our insurance business from period to period. We do not currently assume premiums from other companies.

- *Net premiums written* - The sum of direct premiums written less ceded premiums written. Ceded premiums written is the portion of our direct premiums that we transfer to our reinsurers in accordance with the terms of our reinsurance contracts, based upon the risks they accept. See Note 10 of the Notes to Consolidated Financial Statements for a summary of our reinsurance agreements.

- *Net premiums earned* - Represents the portion of net premiums written that is recognized as income in the financial statements for the periods presented and earned on a pro-rata basis over the term of the policies.

- *Net losses and loss adjustment expenses incurred* - The estimated liability for the indemnity and settlement costs of all insured events occurring during the period. These estimates are necessarily subject to the outcome of future events, such as changes in medical and repair costs as well as economic and social conditions that impact the settlement of claims. The methods of making such estimates and for establishing the resulting reserves are reviewed and updated as applicable, and any resulting adjustments are reflected in current operations.

- *Policy acquisition costs* - Consist of premium taxes, advertising, and other variable costs incurred with writing business. These costs are deferred and amortized over the 6-month policy period in which the related premiums are earned.

- *Other underwriting expenses* - Consist of all other costs involved in the support of the insurance business other than losses, LAE and policy acquisition costs. This includes servicing policies and all other corporate support functions.

Income statement performance ratios - The following ratios are used to measure our performance, not only period-to-period, but as a common comparison tool against our peers in the marketplace. The three most common ratios follow:

- *Loss and LAE ratio* - The result of dividing net losses and LAE incurred by net premiums earned. It is a measure of the percentage of our premium revenue that goes towards investigating and settling claims.

- *Underwriting expense ratio* - The result of dividing the sum of policy acquisition costs and other underwriting expenses by net premiums earned. It is a measure of how efficiently we attract, acquire, and service the business we write.

- *Combined ratio* - The sum of the loss and LAE ratio and the underwriting expense ratio. This ratio measures a company's overall underwriting profitability. If the combined ratio is at or above 100, an insurance company cannot be profitable without investment income (and may not be profitable if investment income is insufficient). For example, our goal as a Company is to maintain a combined ratio of 96% or less. This means that for every $1.00 of

premium that we earn, we will incur $0.96 or less in related costs. The $0.04 margin is referred to as our underwriting profit and, when coupled with our investment results, other income and other expenses, becomes our pre-tax income.

Types and Limits of Insurance Coverage

- Our private passenger auto insurance contract generally covers: bodily injury liability; property damage; medical payments; personal injury protection, uninsured and underinsured motorist; rental reimbursement; uninsured motorist property damage; towing; comprehensive; and collision. All of these policies are written for a six-month term except for Involuntary Market policies assigned to us, which are for twelve months.

- Minimum levels of bodily injury and property damage are required by state law and typically cover the other party's claims when our policyholder is at fault. Uninsured and underinsured motorist typically are optional coverages and cover our policyholder when the other party is at fault and has insufficient liability insurance to cover the insured's injuries and loss of income. Comprehensive and collision coverages are also optional and cover damage to the policyholder's automobile whether or not the insured is at fault. Medical payments coverage typically is optional. In some states, we are required to offer personal injury protection coverage.

- Various limits of liability are underwritten with maximum limits of $500,000 per person and $500,000 per accident. Our most popular bodily injury liability limits in force are $100,000 per person and $300,000 per accident.

- Our personal umbrella policy ("PUP") is written with a 12-month policy term with liability coverage limits of $1 million to $5 million in excess of the underlying automobile liability coverage we write. Since May 2002, we have required minimum underlying automobile limits, written by us, of $250,000 per person and $500,000 per accident for PUP policies sold. We reinsure 90% of any PUP loss.

Long-Term Financial Goals
We have four key long-term financial goals:

- 96% combined ratio
- 15% growth in direct premiums written
- 15% return on equity
- Strong financial ratings

Our financial goals are the framework we use for making critical business decisions regarding market entries, marketing programs, product offerings and operating plans. Although we may not achieve each of these goals in a given calendar year, we believe that achieving them over the long-term will help us to provide superior returns to our shareholders.

96% Combined Ratio Long-Term Goal
Combined ratio is the most important measure of our overall profitability. It is also an important component of our return on equity and influences our financial ratings. Consequently, we consider our 96% combined ratio goal the most important of our long-term financial goals. We strive to achieve a 96% combined ratio by accurately pricing our risks, being a disciplined underwriter, expertly handling customer service and claims, retaining our customers and controlling expenses.

15% Growth Long-Term Goal
We aim to grow our direct premiums written profitably at a rate that exceeds the overall growth rate for our industry and key competitors. Although we may not achieve our 15% growth goal in a given calendar year, over the long-term, we plan to achieve our growth goal by establishing and expanding our business in markets outside of California, and by being innovative in our marketing methods and product offerings.

15% Return on Equity ("ROE") Long-Term Goal
ROE is net income (loss) divided by average stockholders' equity. We aim to achieve an ROE that exceeds our Weighted Average Cost of Capital and that also exceeds the average ROE for our industry. In addition, we plan to achieve an ROE that makes us an attractive investment when compared to other financial services companies. Our operating metrics that influence ROE are combined ratio, investment yield, and the amount of capital and our capital structure.

Strong Financial Ratings
A strong financial rating is an important element of our public profile. It supports our sales and marketing efforts, helps us attract and retain talented team members and minimizes our borrowing costs. We engage independent rating agencies to measure our overall financial strength. Our goal is to achieve and maintain financial strength ratings that are in one of the top five rating grades awarded by the relevant rating agency.

The Company's financial stability is demonstrated by our A+ financial strength rating, our very high capital adequacy ratios and the fact that we have been in business for nearly 50 years. The following are our financial ratings by rating agency:

Financial Ratings by Rating Agency

	2005	2004	2003	2002	2001
A.M Best[1]	**A+**	A+	A+	A+	A+
Standard & Poor's	**A+**	A+	A+	A+	A+
Fitch[2]	**A+**	A	—	—	—

[1] A.M. Best has placed the Company Under Review with Negative Implications.

[2] Fitch upgraded the Company's rating to A+ in February 2005.

Geographic Concentration of Business

National concentration. The following table presents a geographical summary of our direct premiums written for the past five years:

AMOUNTS IN MILLIONS	*Direct Premiums Written*				
Years Ended December 31,	**2005**	2004	2003	2002	2001
Personal auto lines[3]					
California	**$1,262.3**	$1,290.9	$1,194.5	$967.3	$879.4
Arizona[4]	**31.5**	27.8	16.2	13.0	—
Texas	**19.1**	—	—	—	—
Illinois	**11.4**	4.4	—	—	—
Ohio	**8.3**	1.6	—	—	—
Nevada	**5.3**	6.3	6.7	8.1	8.9
Indiana	**4.6**	1.3	—	—	—
Washington	**2.9**	3.7	4.6	5.8	8.5
Oregon	**1.0**	1.2	1.4	1.6	2.0
Total personal auto lines	**1,346.4**	1,337.2	1,223.4	995.8	898.8
Lines in runoff [5]					
Homeowner and earthquake	—	—	0.1	2.4	30.5
Total	**$1,346.4**	$1,337.2	$1,223.5	$998.2	$929.3

Most of our policyholders (94% of direct premiums written) are based in California, however, all of our 2005 growth came from expansion outside of California. Direct premiums written outside of California comprised 6% of total direct premiums written in 2005, compared to 3% of total premiums written in 2004. The following geographic expansion efforts are part of our transformation from a business concentrated in California to a national competitor:

- First quarter of 2004 - began writing personal auto policies in Illinois, Indiana, and Ohio.
- Third quarter of 2004 - opened a service center in Dallas, diversifying our call center operations.
- First quarter of 2005 - began writing personal auto policies in Texas.
- Second quarter of 2006 - planned entrance into three additional states.
- Third quarter of 2006 - planned entrance into three additional states.

California concentration. The table below summarizes the concentrations of our California vehicles-in-force for the personal auto lines, excluding Involuntary Market policies and personal umbrella and motorcycle coverages as of the end of each of the past five years. December 31, 2004 data from the California Department of Motor Vehicles (the most recent available) indicates that 22.6% of its registrations were for vehicles in Los Angeles County. Primarily as a result of our growth in other areas of California, our concentration of LA County vehicles insured has declined from 42.0% in 2001 to 28.8% at the end of 2005, approaching a natural distribution of business in the state.

Voluntary Personal Auto Lines	*Concentration of California Vehicles in Force*				
Years Ended December 31,	**2005**	2004	2003	2002	2001
Los Angeles County	**28.8%**	30.3%	32.3%	37.2%	42.0%
San Diego County	**13.8**	13.6	13.5	13.4	13.4
Southern California, excluding Los Angeles and San Diego Counties[6]	**20.0**	20.3	21.4	23.5	25.9
Central and Northern California[7]	**37.4**	35.8	32.8	25.9	18.7

Total	**100.0%**	100.0%	100.0%	100.0%	100.0%

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[3] Includes motorcycle and personal umbrella coverages, which are immaterial for all periods presented.

[4] Excludes $12.8 million in 2001 not consolidated prior to our acquisition of a majority of the voting interests in 21st Century Insurance Company of the Southwest (previously named 21st Century Insurance Company of Arizona).

[5] We no longer have any homeowner policies in force. We ceased writing earthquake coverage in 1994, but we have remaining loss reserves from the 1994 Northridge earthquake. See further discussion in Item 7 under the captions *Results of Operations - Homeowner and Earthquake Lines in Runoff Results, Critical Accounting Estimates - Losses and Loss Adjustment Expenses*, and in Note 16 to the Notes to Consolidated Financial Statements.

[6] Includes the following counties: Imperial, Kern, Orange, Riverside, Santa Barbara, San Bernardino and Ventura.

[7] Includes all California counties other than Los Angeles County, San Diego County, and those specified above in Footnote 6.

Personal Auto Product Innovations
Starting in May 2002, we began offering motorcycle coverage primarily to our auto policyholders in California. In August 2002, we introduced a new private passenger auto policy in California that does not have certain standard features found in our primary policy. This limited-feature product is similar in most respects to the product offered by many of our competitors, and is positioned as a lower-cost alternative for customers who believe they need less coverage than provided by our standard product. In October 2002, we began providing quotes at higher rate levels to consumers who did not meet California's statutory "good driver" definition. The foregoing product innovations account for approximately 12.9% of new auto policies written in California in 2005.

Marketing
Our marketing and underwriting strategy is to appeal to careful and responsible drivers who desire a feature-rich product at a competitive price. We use direct mail, broadcast and print media, outdoor, community events and the Internet to generate inbound telephone calls, which are served by company employees who are licensed insurance agents. Because our centralized operations are company staffed, we can deliver a highly efficient and professional experience for our callers 24 hours per day, 365 days per year through a convenient, toll-free 800-211-SAVE telephone number. Consumers may also obtain an auto rate quotation and purchase a policy on our web site at *www.21st.com*.

Over half of all Spanish-speaking residents in the United States live in California, Arizona, Illinois, and Texas. We offer full service in Spanish via our web site, including policy purchase, and bilingual professionals 24 hours per day, 365 days per year through a dedicated toll-free telephone number at 888-920-2121. Additionally we utilize Spanish language advertising and marketing materials.

The following table summarizes advertising expenditures (in millions) and total new policies written for the past five years:

Years Ended December 31,	**2005**	2004	2003	2002	2001
Total advertising expenditures	**$ 70.1**	$ 66.7	$ 53.9	$ 43.3	$ 16.9
New policies written	**170,224**	225,349	265,589	189,652	63,264

Advertising expenditures increased in 2005 and 2004 as a result of the Company's geographic expansion efforts.

Consumer Advocacy
For the fifth consecutive year, we are actively engaged in a community education effort for the proper installation and use of child safety seats. According to the National Highway Traffic Safety Administration, motor vehicle crashes are the leading cause of death for children from 2 to 14 years of age. Data show that 80% of child safety seats are improperly installed and are a potential source of injury for children. Our child safety program is endorsed by the California Highway Patrol ("CHP") and the Governors' Offices of Arizona, Illinois, Indiana, Ohio and Texas. Educational safety events typically include the participation of political representatives, local media, law enforcement, trained safety technicians and our managers and team members. Since inception, the Company has held more than 60 education events, technicians have inspected over 6,600 vehicles and discarded (and then destroyed) more than 2,500 broken or recalled child safety seats. We have donated over 5,200 brand-new child safety seats so that no family leaves an education event without every child in a properly fitted child safety seat.

We have also partnered with the CHP and the Arizona Department of Public Safety in public education programs on safe driving. Using billboard advertising in English and Spanish, we have entertained and hopefully made positive impressions on the serious topics of "Drive Sober" and "Just Drive," referring to distracted driving (cell phones, eating, reading, etc. while driving). All of the materials are co-branded by 21st, the CHP and the Arizona Department of

Public Safety, as applicable.

We have several publications and community events designed to assist customers and potential customers in making choices about their auto insurance and automobile safety. We also publish the *Child Safety Seat: A Parent's Guide, Crash Test Ratings Guide*, and a 30-minute documentary, *The Golden Road - Today's Senior Driver. The Golden Road* is designed to help senior drivers and their families correctly assess seniors' driving abilities and decrease driving dangers. Both guides and *The Golden Road* are distributed through public events, direct mail promotions and downloads from our web site. In an unprecedented synchronization of schedules to spotlight the second annual "Senior Safe Mobility Day", all 14 California public broadcasting stations aired *The Golden Road* statewide on October 25, 2005.

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Competition

The personal automobile insurance market is highly competitive and is comprised of a large number of well-capitalized companies, many of whom are several times larger, operate in more states and offer a wider variety of products than we do. In the total US personal auto market of $160+ billion of direct premiums written, we have a less than 1% market share. According to A.M. Best, in California, we were the seventh largest writer of personal auto insurance in 2004 (latest year for which information is available).

Market shares in California of the top ten writers of personal automobile insurance, based on direct premiums written, according to A.M. Best, for the past five years were as follows:

	Market Share in California Based on Direct Premiums Written				
Years Ended December 31,	2004	2003	2002	2001	2000
21st Century Insurance Group	**7%**	**6%**	**6%**	**6%**	**6%**
State Farm Group	14	14	14	13	13
Farmers Group	10	10	11	12	12
Mercury General Group	9	9	9	8	8
Automobile Club of Southern California Group	9	9	9	9	9
California State Auto Group	9	9	9	10	10
Allstate Insurance Group	8	8	9	11	10
Progressive Insurance Group	3	3	2	2	2
USAA Group	3	3	3	3	3
Government Employees Group (GEICO)	3	3	3	3	3

Pricing and Underwriting

We have developed a highly segmented and sophisticated pricing model that is on par with the best pricing models in the industry. Through a combination of rating variables and interactions among variables, we are able to achieve higher levels of pricing accuracy than historically have been employed. This model, which we employ in active markets outside of California, allows us to grow by out-segmenting established competitors while providing greater stability in our results.

California law defines the primary rating characteristics that must be used for automobile policies include driving record (e.g., history of accidents and moving violations), annual mileage and number of years the driver has been licensed. A number of other "optional" rating factors are also permitted and used in California, which include characteristics such as automobile garaging location, make and model of car, policy limits and deductibles, and gender and marital status.

We are required to offer insurance to any California applicant who meets the statutory definition of a "good driver." This definition includes, but is not limited to, all drivers licensed during the previous three years with no more than one violation point count under criteria contained in the California Vehicle Code. These criteria include a variety of moving violations and certain at-fault accidents.

The regulatory system in California requires the prior approval of insurance rates. Within the regulatory framework, we establish our premium rates based primarily on actuarial analyses of our own historical loss and expense data. This data is compiled and analyzed to establish overall rate levels as well as classification differentials.

Our rates are established at levels intended to generate underwriting profits and vary for individual policies based on a number of rating characteristics. These rates are a blend of base rates and class plan filings made with the California Department of Insurance (“CDI”). Base rates are the primary amount projected to generate an adequate underwriting profit. Class plan changes are filings that serve to modify the factors that impact the base rates so that each individual receives a rate, to the extent permitted by regulation, that reflects their respective losses and expenses. Class plan changes are intended to be revenue neutral to us.

We regularly review the effectiveness of our rating plans and the overall adequacy of our rates by state and program. The following table summarizes increases (decreases) in our premium rates for each of the past five years:

	Increases (Decreases) in Our Premium Rates				
Years Ended December 31,	**2005**	2004	2003	2002	2001
Personal Auto Lines excluding PUP					
California	**—**	—	3.9%	5.7%	4.0%
Arizona	**0.9**	4.8	3.0	3.7	16.5
Texas	**(3.3)**	—	—	—	—
Illinois	**0.8**	—	—	—	—
Indiana	**(8.6)**	(8.6)	—	—	—
Ohio	**(6.6)**	(7.3)	—	—	—
Nevada	**—**	6.4	—	22.0	12.6
Oregon	**—**	—	—	3.1	14.0
Washington	**—**	7.4	—	10.7	44.9
Lines in runoff					
Homeowner	**N/A**	N/A	N/A	13.2	4.0
Earthquake	**N/A**	N/A	N/A	N/A	N/A

Our objective is to offer a price that, to the fullest extent possible, reflects the loss and expense expectations for every consumer. Accurate pricing is important because it rewards and encourages safe driving. Accurate pricing also increases stability in our results, reducing the impact of mix changes in our book of business.

For us, underwriting is the process of confirming that rating information (such as the VIN of the vehicles, identification of all drivers in the household, accident and violation history, etc.) is accurate, complete and properly applied in our rating approach. The underwriting process occurs at the inception of the policy, whenever a change is requested and at renewal. In certain circumstances, we will non-renew a policy due to a substantial increase in risk.

Customer Service

We offer policy support for our customers directly with our own licensed professionals. We operate 24/7/365 and provide service in both English and Spanish. Customers contact us through their method of choice - phone call, interactive voice response, mail, email, or web site. A full service bilingual web site includes options to buy a policy, pay a bill, make a policy change, or report a claim. Our goal is accurate, prompt, comprehensive and enthusiastic customer service, and we strive for superior customer retention.

To maximize efficiencies, 21st Century Insurance links its multiple call centers into one "virtual" resource. APS is our state-of-the-art, real time policy service system. We completed the APS conversion of our California 21st Century Insurance policies during 2005.

Underwriting Expense Ratio - Personal Auto Lines

Under GAAP, the underwriting expense ratio is defined as underwriting expenses divided by net premiums earned, and underwriting expenses are recognized over the period that net premiums are earned. The statutory underwriting expense ratio is stated as a percentage of premiums written rather than premiums earned because most underwriting expenses are recognized when policies are written. Information extracted from statutory filings by A.M. Best for the top ten California personal automobile insurance companies for 2004, the most recent year available, indicates that our direct statutory underwriting expense ratio for private passenger auto (defined as direct underwriting expenses on a statutory basis divided by direct premiums written) was lower than 7 of our 9 largest competitors in California for 2004. Our GAAP underwriting results and ratios are discussed in *Item 6. Selected Financial Data* and *Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations - Results of Operations.*

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Customer Retention and Vehicles in Force

Customer retention in California, measured based on the number of vehicles in force, were as follows as of the end of each of the past five years:

Years Ended December 31,	**2005**	2004	2003	2002	2001
Average customer retention - California personal auto[8]	**92%**	93%	92%	93%	92%
California vehicles in force[9]	**1,428,358**	1,477,625	1,383,175	1,178,459	1,051,982
All other states vehicles in force	**127,001**	62,922	33,332	27,174	23,489
Total vehicles in force	**1,555,359**	1,540,547	1,416,507	1,205,633	1,075,471

Claims

It is the mission of our claim operation to settle claims fairly and promptly while fully complying with all applicable laws and regulations. We recognize that it is important to support not only our customers' financial recovery from an accident but also their emotional recovery from an unpleasant and disruptive accident experience.

The task of delivering on the claims promise to our customers is a challenging one, particularly in today's legal and regulatory environment. Of the thousands of new claims reported weekly, involving automobile thefts, traffic accidents, or other types of damages or injuries, each one entails relating on an empathetic level with a person suffering a loss who deserves individual attention. Yet our adjusters at the same time must remain objective and focused on the activity necessary to investigate the facts of the loss and determine the resulting damages. In every case, acting promptly to resolve the claim while treating people fairly is the way we keep lawsuits to a minimum, especially while faced with demanding claimants and their attorneys. The claim operation functions within the bounds of an ever-expanding field of insurance regulations put in place to protect the public and ensure fairness. The task is made more difficult by the incidence of insurance fraud and padding of claims committed by a small percentage of claimants and unscrupulous attorneys, medical providers and the like. A recent study by the Insurance Research Council, for example, states that 22% of all claims for bodily injury arising from automobile accidents in California involve elements of fraud or buildup. So, while we wish to see that legitimate claims are fairly and quickly paid, it is also incumbent that our adjusters be vigilant to recognize and investigate suspicious claims.

As mentioned, the handling of claims is the subject of regulation by the States. Extensive civil case law also exists on most issues covered by insurance. Laws and regulations vary from state to state, with new ones added every year. It is the adjuster's job to investigate and make fair determinations of liability under the law while resolving the claim in compliance with regulations. Adjusters must be trained and knowledgeable to be able to comply with the requirements that affect their handling of each claim. We could not face these challenges without attracting and retaining outstanding professionals through careful hiring practices and one of the most comprehensive adjuster training programs in the industry. Through retention of quality people, we have a very seasoned management staff and an average tenure in the claims area of over nine years.

The adjustment of claims is an involved process requiring the coordination of many tasks. The claim operation is charged with confirming coverage for the type of loss, investigating liability to determine responsibility for the accident, assessing damages resulting from the loss, and negotiating a fair resolution. For our products to remain competitive and affordable, claim settlements must be fair and legitimate, and the design of our claim process must operate efficiently and in a cost effective manner.

Our claim process is designed to deliver what customers expect: friendly, convenient and efficient service. Reports of accidents are taken by telephone or over the web at *www.21st.com*. Our claim call centers operate 24/7/365 and can assist customers in Spanish as well as English. Translation services for other languages are readily available to our staff. The report is digitally recorded with the customer's permission, which means in most cases the customer need only describe the accident to us one time. A variety of options are offered to the customer for inspection and car repair to suit their particular needs. At the conclusion of the claim report, an assignment is routed electronically to inspect the vehicle at a location of the customer's choosing, or to dispatch a tow truck to bring a heavily damaged vehicle to one of our Vehicle Inspection Centers. Mobile inspection and repair services are available for minor damage. Our Direct Repair Program is a particularly easy way to get repairs done, chosen by about 35% of our customers. The Direct Repair Program (DRP) is a carefully selected network of approximately 200 repair shops that meet our high standards for service, work quality, equipment and training. DRPs guarantee their repairs for as long as the claimant owns their vehicle. Repairs at a DRP shop are scheduled electronically and managed by the shop. Quality of the repairs and accuracy of the repair invoice is closely monitored by a thorough re-inspection program by our staff who regularly visit the DRP shops and re-inspect about 40% of the vehicles in various stages of the repair process. By integrating technology with personalized service, one call to 21st is all that is necessary to expedite an automobile damage claim.

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[8] Represents an overall measure of customer retention, including new customers as well as long-time customers. Retention rates for new customers typically are lower than for long-time customers.

[9] Includes PUP and motorcycle.

Another customer-friendly policy feature of 21st Century Insurance is the inclusion of towing and roadside service with every policy. This service is handled by a vendor providing 24 hour a day service for our customers throughout the United States and Canada with just a toll free call.

At the center of our claim handling operation is our new claim system known as APS. Deployed in August of 2004, APS has been used for all claims reported since that time, and over 90% of the Company's pending claims are now on the new system. Claims are automatically assigned to adjusters by the type of claim and handling required. Our adjusters work in specialized areas that include liability and damages investigations, material damage estimating, total loss evaluations, litigation and subrogation. With APS, information is available seamlessly to each of these specialties at all times. For example, an adjuster assigned to contact the parties and investigate liability for an accident will view the repair estimate and digital photos taken by the adjuster in the field. Documents received in the mail such as medical bills or obtained over the web such as police reports are scanned into the electronic claim file. This allows more than one person to work on aspects of the claim at the same time, communicate with each other and, more importantly, with the customer about the claim. APS enables any adjuster in any of our locations to provide service on any claim regardless of where it occurred, reducing the need to maintain staff in every geographic territory.

Litigation can result when disputes of fact or damage arise among the people involved in an accident, and when they remain unresolved after discussion and negotiation. Claim litigation usually involves personal injury claims made by third parties against our insureds. It may also entail the arbitration of uninsured/underinsured motorist claims by insureds. By providing a legal defense of the policyholder faced with a lawsuit, we deliver another very important part of the insurance promise. In California, our house counsel handles over 90% of this litigation. Cases involving conflict or special circumstances may be assigned to outside defense attorneys. Outside counsel is also used in states other than California.

We maintain a Special Investigations Unit (SIU) to investigate claims of a suspicious nature. The SIU is also responsible for providing training to claims and other employees on fraud detection. The SIU works closely with members of law enforcement, the Department of Insurance and the National Insurance Crime Bureau. Our SIU is highly regarded in the insurance industry as being very effective in its efforts to detect and deter fraud.

21st settles many heavily damaged vehicle claims as total losses. As a part of the settlement we may take title to the totaled vehicle and sell it as salvage. An outside salvage company conducts the auction and forwards the proceeds, less their fee, as a recovery for 21st. Vehicles so severely damaged as to have no salvage value are crushed to prevent the vehicle identification number (VIN) from being used for fraudulent purposes.

We have team members who specialize in subrogation, or the recovery of monies we have paid on claims where a third party is legally responsible. We also aim to recover the deductible for our insureds. Some collection efforts, particularly those against uninsured motorists are outsourced to a collection vendor in exchange for a contingency fee upon successful collection.

We understand that the claim experience is a moment of truth for the customer and the customer's decision to continue a relationship with us depends on that experience. We deliver high quality claim service and we continuously seek improvements in our processes.

Unpaid Losses and Loss Adjustment Expenses

The cost to settle a customer's claim includes two major components: losses and loss adjustment expenses ("LAE"). Losses in connection with third party coverages represent damages as a result of an insured's act that results in property damage or bodily injury. First party losses involve damage or injury to the insured's property or person. In either case, the ultimate cost of the loss is not always immediately known and, over time, may be higher or lower than initially estimated. When establishing initial and subsequent estimates, the amount of loss is reduced for salvage (e.g., proceeds from the disposal of the wrecked automobile) and subrogation (e.g., proceeds from another party who is

fully or partially liable, such as the insurer of the driver who caused the accident involving one of our customers).

Loss adjustment expenses represent the costs of adjusting, investigating and settling claims, and are primarily comprised of the cost of our claims department, external inspection services, and internal and external legal counsel. Corporate support areas such as human resources, finance, and information technology provide services to our overall operations, and, accordingly, a portion of their operational costs are also allocated to LAE. The LAE-allocable portion of such corporate support cost is reviewed periodically as changes occur in our organization. Based on these reviews, we modify the allocation percentages as appropriate. Such changes decreased our ratio of overhead LAE to earned premium to 1.6% in 2005, from 1.7% in 2004 and 4.4% in 2003.

Accounting for losses and LAE is highly subjective because these costs must be estimated often weeks, months or even years in advance of when the payments are actually made to claimants, attorneys, claims personnel and others involved in the claims settlement process.

Accounting principles require insurers to record estimates for losses and LAE in the periods in which the insured events, such as automobile accidents, occur. This estimation process requires us to estimate both the number of accidents that have occurred (called "frequency") and the ultimate amount of loss and LAE (called "severity") related to each accident. We employ actuaries who are professionally trained and certified in the process of establishing estimates for frequency and severity. Historically, our actuaries have not projected a range around the carried loss reserves and LAE. Rather, they have used several methods and different underlying assumptions to produce a number of point estimates for the required reserves. Management reviews the assumptions underlying the loss and LAE ratios and selects the carried reserves after carefully reviewing the appropriateness of the underlying assumptions.

Estimating the Frequency of Auto Accidents. By studying the historical lag between the actual date of loss and the date that the accident is reported by the customer to the claims department, our actuaries can make a reasonable, yet never perfect, estimate for the number of claims that ultimately will be reported for a given period. This measurement is referred to as frequency. The difference between the estimated ultimate number of claims that will be made and the number that have actually been reported in any given period is referred to as incurred but not reported ("IBNR") claims.

Estimating the Severity of Auto Claims. For both property damage and injury claims our adjusters determine what exposures exist in open reserves. All property damage reserves and any injury reserves estimated to be less than $15,000 are set at "average amounts" determined by our actuaries. For both bodily injury and uninsured motorist claims estimated to have value in excess of $15,000, adjusters in our claims department establish loss estimates based upon various factors such as the extent of the injuries, property damage sustained, and the age of the claim. Our actuaries review these estimates, giving consideration to the adjusters' historical ability to accurately estimate the ultimate claim and length of time it will take to settle the claim, and provide for development in the adjusters' estimates as applicable. Generally, the longer it takes to settle a claim, the higher the ultimate claim cost. The ultimate amount of the loss is considered the "severity" of the claim. In addition, the actuaries estimate the severity of the IBNR claims.

The severities are estimated by our actuaries each quarter based on historical studies of average claim payments and the patterns of how the claims were paid. Again, the fundamental assumption used in making these estimates is that past events are reliable indicators of future outcomes.

Estimating Losses and LAE for Lines in Runoff. While the personal auto lines represent our core business, we also have losses and LAE relating to development on remaining loss reserves for homeowners and earthquake lines. These lines are said to be "in runoff" because we no longer have policies in force. As discussed in the Notes to Consolidated Financial Statements, we have not written any earthquake policies since 1994 and we ceased writing homeowners coverage at the beginning of 2002. Developing reserve estimates for the earthquake line is particularly subjective because most of the few remaining earthquake claims are in litigation. Our actuaries evaluate the homeowners reserve requirement on a quarterly basis, while personnel in our legal and claims areas prepare quarterly evaluations of the earthquake reserves.

Loss and LAE Reserve Development

Management believes that our reserves are adequate and represent our best estimate based on the information currently available. However, because reserve estimates are necessarily subject to the outcome of future events, changes in estimates are unavoidable in the property and casualty insurance business. These changes sometimes are referred to as "loss development" or "reserve development." See *Critical Accounting Estimates - Losses and Loss Adjustment Expenses* for an explanation of our reserve estimating process.

For the personal auto lines, our actuaries prepare a quarterly evaluation of loss and LAE indications by accident year, and based on these evaluations, we assess whether there is a need to adjust reserve estimates. As claims are reported and settled and as other new information becomes available, changes in estimates are made and are included in earnings of the period of the change.

The changes in prior accident year estimates of losses and LAE incurred that we recorded in each of the past five calendar years, net of reinsurance, are summarized below:

AMOUNTS IN THOUSANDS	*Changes in the Calendar Year of Prior Accident Year Estimates, Net of Reinsurance*				
Years Ended December 31,	**2005**	2004	2003	2002	2001
Personal auto	**$(27,473)**	$(2,936)	$11,159	$16,200	$ 45,742
Homeowner and earthquake[10]	**2,333**	2,831	40,048	56,158	72,265
Total	**$(25,140)**	$ (105)	$51,207	$72,358	$118,007

Positive amounts represent deficiencies in loss and LAE reserves, while negative amounts represent redundancies.

To understand these changes, it is useful to put them in the context of the cumulative reserve development experienced by the Company over a longer time frame. The tables on the following pages present the development of loss and LAE reserves for the personal auto lines (Table 1) and for the homeowner and earthquake lines in runoff (Table 2), for the years 1995 through 2005. The figures in both tables are shown gross of reinsurance.

In Tables 1 and 2 on the following pages, a redundancy (deficiency) exists when the original reserve estimate is greater (less) than the re-estimated reserves. Each amount in the tables includes the effects of all changes in amounts for prior periods. The tables do not present accident year or policy year development data. Conditions and trends that have affected the development of liabilities in the past may not necessarily occur in the future. Therefore, it would not be appropriate to extrapolate future deficiencies or redundancies based on the table. A detailed discussion of loss and LAE reserve development follows the tables.

The top line of each table shows the reserves at the balance sheet date for each of the years indicated. The upper portion of the table indicates the cumulative amounts paid as of subsequent year ends with respect to that reserve liability. The lower portion of the table indicates the re-estimated amount of the previously recorded reserves based on experience as of the end of each succeeding year, including cumulative payments made since the end of the respective year. The estimates change as more information becomes known about the frequency and severity of claims for individual years.

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[10] We no longer have any homeowner policies in force. We ceased writing earthquake coverage in 1994, but we have remaining loss reserves from the 1994 Northridge earthquake. See further discussion in Item 7 under the captions *Results of Operations - Homeowner and Earthquake Lines in Runoff Results, Critical Accounting Estimates - Losses and Loss Adjustment Expenses*, and Note 16 to the Notes to Consolidated Financial Statements.

TABLE 1 - Auto Lines as of December 31, (Amounts in thousands, except claims)	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	20
Reserves for losses and LAE, direct	$ 506,747	$ 468,257	$ 403,263	$ 329,021	$ 261,990	$ 286,057	$ 301,985	$ 333,113	$ 419,913	$ 489,411	$ 52
Paid (cumulative) as of:											
One year later	318,273	260,287	253,528	247,317	242,579	268,515	239,099	249,815	280,534	283,068	
Two years later	392,420	336,538	319,064	307,797	311,659	332,979	312,909	328,951	359,719		
Three years later	416,541	354,854	333,349	324,778	324,740	352,592	333,955	349,763			
Four years later	422,393	357,913	340,907	326,932	327,745	358,806	339,004				
Five years later	423,429	363,068	341,446	327,418	328,557	360,191					
Six years later	427,723	362,824	341,374	327,162	328,359						
Seven years later	427,353	362,508	341,076	326,823							
Eight years later	427,059	362,216	340,772								
Nine years later	426,844	361,959									
Ten years later	426,625										
Reserves re-estimated as of:											
One year later	440,158	365,566	359,262	313,192	309,953	352,709	323,791	348,865	417,225	462,682	
Two years later	424,091	366,858	337,258	321,711	340,914	354,720	338,338	354,784	407,344		
Three years later	425,404	359,925	335,246	341,695	328,190	361,264	339,965	360,308			
Four years later	424,643	357,607	355,605	326,506	329,182	361,068	342,321				
Five years later	422,389	377,414	340,537	326,565	329,318	362,066					
Six years later	442,024	361,980	340,552	327,626	329,042						
Seven years later	426,719	361,865	341,396	327,243							

Eight years later	426,636	362,541	340,967								
Nine years later	427,093	362,042									
Ten years later	426,625										
Redundancy (Deficiency)	$ 80,122	$ 106,215	$ 62,296	$ 1,778	$ (67,052)	$ (76,009)	$ (40,336)	$ (27,195)	$ 12,569	$ 26,729	
Supplemental Auto Claims Data:											
Claims reported during the year for CA only	324,143	294,615	279,211	295,905	307,403	323,395	298,417	293,955	331,734	354,156	39
Claims pending at year end for CA only	63,142	58,172	55,738	56,739	57,134	54,760	50,365	51,488	58,577	59,676	5

See Note 8 of the Notes to Consolidated Financial Statements.

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TABLE 2 - Homeowner and Earthquake Lines in Runoff as of December 31, (Amounts in thousands)	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Reserves for losses and LAE, direct	$ 78,087	$ 75,272	$ 34,624	$ 52,982	$ 14,258	$ 12,379	$ 47,305	$ 50,896	$ 18,410	$ 6,131
Paid (cumulative) as of:										
One year later	55,738	75,100	30,232	48,848	13,103	30,706	58,274	71,147	16,277	6,498
Two years later	119,211	100,296	74,127	58,281	37,404	78,647	125,447	87,343	22,775	
Three years later	139,792	142,850	82,974	81,887	83,985	143,564	140,742	93,828		
Four years later	180,799	151,342	106,274	128,266	147,856	157,792	147,101			
Five years later	188,987	174,513	152,592	192,121	161,560	163,988				
Six years later	211,771	220,805	216,383	205,591	167,615					
Seven years later	257,839	284,455	229,808	211,431						
Eight years later	321,169	297,754	235,648							
Nine years later	334,053	303,591								
Ten years later	339,671									
Reserves re-estimated as of:										
One year later	116,741	101,903	77,445	58,582	18,024	68,245	103,470	89,281	22,406	8,805
Two years later	142,071	145,635	82,716	61,393	72,546	121,176	142,211	93,388	25,081	
Three years later	182,616	150,434	85,519	116,429	125,089	159,331	146,152	96,054		
Four years later	186,631	153,521	140,532	169,157	163,045	162,998	148,850			
Five years later	190,334	208,533	193,375	207,064	166,548	165,593				
Six years later	245,267	261,389	231,217	210,486	168,994					
	298,161	299,109	234,661	212,593						

Seven years later										
Eight years later	335,657	302,550	236,776							
Nine years later	338,735	304,664								
Ten years later	340,622									
Redundancy (Deficiency)	$ (262,535)	$ (229,392)	$ (202,152)	$ (159,611)	$ (154,736)	$ (153,214)	$ (101,545)	$ (45,158)	$ (6,671)	$ (2,674)

See Notes 8 and 16 of the Notes to Consolidated Financial Statements.

Auto Lines Reserve Development. As shown in the ten-year development table, our auto lines historically developed redundancies prior to 1999 and exhibited adverse development for 1999 through 2002. Since 2003, there has been favorable development. The period from 1993 to 1999 was quite unusual in that, during that time, we experienced declining frequencies and declining severities in our auto line. As Table 1 shows, we did not immediately have confidence in these declining trends and did not immediately lower our reserve estimates.

Much of the decline in trend occurred between 1996 and 1998 because of moderation in health care costs due to greater use of HMOs and laws that were enacted in California that limited the ability of uninsured motorists and drunk drivers to collect non-economic damages. During 1999, we assumed that the past trend of declining frequencies and severities would continue. However, in retrospect, it can now be seen that the favorable decline in trends ended and loss costs began to increase. In 2000, we continued to assume lower loss severity primarily because of what then seemed to be an acceleration in the pattern of claims payments and the uncertainty inherent in identifying a change in multi-year patterns. In 2001, we experienced significant, unexpected development in our uninsured motorist coverage while the actuarial indications for most prior accident years were adjusted upward as more data became available. The changes in injury trends affected the entire California market and occurred, to a greater or lesser degree, in virtually every state in the country.

Starting in 2001, we improved the quality and timeliness of the data available to make initial estimates and periodic changes in estimates. We have dedicated more resources to better understand the underlying drivers of the changes in frequency and severity trends as they begin emerging. For example, in the second quarter of 2003 we began making accident month actuarial analyses of our reserves for the auto lines. Our improved methodology is reflected in the small favorable development of $2.9 million recorded in 2004 with respect to 2003 and prior accident years and a larger favorable development of $27.5 million in 2005.

Homeowner and Earthquake Lines in Runoff. In Table 2, substantially all of the development relates to the earthquake line. A major earthquake occurred on January 17, 1994, centered in the San Fernando Valley community of Northridge (the “Northridge earthquake”). Through December 31, 2005, we have settled over 46,000 Northridge earthquake claims (including auto claims) at a total cost (i.e., loss plus LAE) of over $1.2 billion.

The loss development in Table 2 is easiest to understand by dividing it into “pre-SB 1899” and “post-SB 1899” segments. In September 2000, the State of California enacted Senate Bill 1899 (“SB 1899”), which allowed claims from the 1994 Northridge earthquake, barred by contract and the statute of limitations, to be reopened during calendar year 2001. The costs relating to the reopened claims are displayed in the table as a 1994 event (since they all related to the Northridge earthquake), even though the legislation allowing the re-opening of certain claims was not passed until almost seven years later. Before SB 1899 was passed in late 2000, we had only approximately 50 earthquake claims remaining to be resolved out of an initial 35,000 homeowner earthquake claims. Although we settled 98% of the claims within a year of the earthquake, many upward changes in estimates were required in 1994 and beyond as new information emerged on the severity of the damages and as settlements of litigated claims occurred. As a result, we recorded the following upward changes in loss estimates after 1994, but before SB 1899 was adopted: 1995 - $57 million; 1996 - $40 million; 1997 - $24.8 million; 1998 - $40 million; 1999 - $2.5 million; and 2000 - $3.5 million.

Calendar year 2001 was the one-year window SB 1899 permitted for claimants to bring additional insurance claims and legal actions allegedly arising out of the Northridge earthquake. Prior to the enactment of this law, such claims were considered by previously applicable law to be fully barred, or settled and closed. Any additional legal actions with respect to such claims were barred under the policy contracts, settlement agreements, and/or applicable statutes of limitation. As a result of the enactment of this unprecedented legislation, claimants asserted additional claims against the Company allegedly related to damages that occurred in the Northridge earthquake, but which were now being reported seven years later in 2001. Plaintiff attorneys and public adjusters conducted extensive advertising campaigns to solicit claimants. Hundreds of claims were filed in the final days and hours before the December 31, 2001 deadline.

During 2001, the Company recorded an additional $70.0 million of pre-tax losses related to the Northridge earthquake, including $50.0 million in the fourth quarter to cover the indemnity and inspection portion of the claims. In the first two quarters of 2002, we expensed an additional $11.9 million of legal defense costs as they were paid. The Company lacked sufficient information to record a reasonable estimate of the related legal defense costs until the third quarter of 2002, at which time an additional provision of $46.9 million was recorded. Based on subsequent developments, we recorded additional provisions of $0.4 million, $2.2 million, and $37.0 million in the years 2005, 2004, and 2003, respectively. See additional discussion in Note 16 of the Notes to Consolidated Financial Statements.

Quarterly our legal and claims personnel review the adequacy of the remaining SB 1899 reserves based on the most current information available. Based on that review, we believe our remaining earthquake reserves are adequate as of December 31, 2005. More than ninety-nine percent of the claims submitted and litigation brought against the Company as a result of SB 1899 have been resolved. Substantially all of the Company's remaining Northridge earthquake claims are in litigation. No class actions have been certified and the trial court has denied class action status for the two remaining cases seeking class action status. While the reserves established are the Company's current best estimate of the cost of resolving its Northridge earthquake claims, including claims arising as a result of SB 1899, these reserves continue to be highly uncertain because of the difficulty in predicting how the remaining litigated cases will be resolved.

Reinsurance

A reinsurance transaction occurs when an insurer transfers or cedes a portion of its exposure to a reinsurer for a premium. The reinsurance cession does not legally discharge the insurer from its liability for a covered loss, but provides for reimbursement from the reinsurer for the ceded portion of the risk. We monitor the appropriateness of our reinsurance arrangements to determine that our retention levels are reasonable and that our reinsurers are financially sound, able to meet their obligations under the agreements and that the contracts are competitively priced.

The majority of our cessions are with AIG subsidiaries, which have earned A.M. Best's financial rating of A+. The A.M. Best financial ratings of our other reinsurers range from A- to A+. Our reinsurance arrangements are discussed in more detail in Note 10 of the Notes to Consolidated Financial Statements.

Our net retention of insurance risk after reinsurance for 2006 and the preceding five years is summarized below:

	Contracts Incepting During					
	2006	2005	2004	2003	2002	2001
Auto and motorcycle lines	100%	100%	100%	100%	97%[11]	94%
Personal umbrella policies[12]	10	10	10	10	10	16
Homeowner line in runoff	—	—	—	—	—	94

We also have catastrophe reinsurance agreements relating to the auto line, which reinsure any covered events up to $45.0 million in excess of $20.0 million ($30.0 million in excess of $15.0 million prior to January 1, 2004).

State Regulation of Insurance Companies

Insurance companies are subject to regulation and supervision by the insurance departments of the various states. The insurance departments have broad regulatory, supervisory and administrative powers, such as:

- Licensing of insurance companies, claim adjusters, and agents;
- Prior approval, in California and some other jurisdictions, of premium rates;
- Establishment of capital and surplus requirements and standards of solvency;
- Nature of, and limitations on, investments insurers are allowed to hold;
- Periodic examinations of the affairs of insurers;
- Annual and other periodic reports of the financial condition and results of operations of insurers;
- Establishment of statutory accounting rules;
- Issuance of securities by insurers;
- Restrictions on payment of dividends; and
- Restrictions on transactions with affiliates.

Currently, the California Department of Insurance (“CDI”) has primary regulatory jurisdiction over two of our subsidiaries, 21st Century Insurance Company and 21st Century Casualty Company, including prior approval of premium rates. The CDI typically conducts a financial examination of our affairs every three years. The most recently completed triennial examination, for the three years ended December 31, 2002, contained no findings or adjustments. In general, the current regulatory requirements in the other states in which our subsidiaries are licensed insurers are less restrictive than in California. 21st Century Insurance Company of the Southwest (formerly 21st Century Insurance Company of Arizona) changed its state of domicile from Arizona to Texas effective December 31, 2004.

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[11] Effective September 1, 2002, we entered into an agreement to cancel future cessions under our quota share with AIG subsidiaries. The treaty would have ceded 4% of premiums for the auto and motorcycle lines to AIG subsidiaries in the remainder of 2002 and would have declined to 2% in 2003. After September 1, 2002, 100% of auto and motorcycle premiums are retained by the Company.

[12] Personal umbrella coverage is only available to our auto customers. Approximately 2% of auto customers have umbrella coverage.

In addition to regulation by the CDI, the Company and the personal lines insurance business in general are also subject to legislative, judicial and political action in addition to the normal business forces of competition between companies and the choices consumers make based on their preferences.

To our knowledge, no new laws were enacted in 2005 by any state in which we do business that are expected to have a material impact on the auto insurance industry. However, in December 2005, the California Commissioner began a regulatory process that could ultimately result in regulations that would restrict the use of territory in automobile insurance rating. Such regulations, if implemented, could negatively affect our book of business. Also in 2005, a series of workshops were conducted by the CDI that could ultimately result in changes to regulations affecting the expense, investment income and profitability factors used by the CDI in reviewing and approving insurers' rates. Such regulations, if implemented, may also negatively affect our California business.

Holding Company Regulation

We are also subject to regulation by the CDI pursuant to the provisions of the California Insurance Holding Company System Regulatory Act (the "Holding Company Act"). Many transactions defined to be of an "extraordinary" nature may not be effected without the prior approval of the CDI. In addition, the Holding Company Act limits the amount of dividends our insurance subsidiaries may pay. An extraordinary transaction includes a dividend which, together with other dividends or distributions made within the preceding twelve months, exceeds the greater of (i) 10% of the insurance company's policyholders' surplus as of the preceding December 31 or (ii) the insurance company's statutory net income for the preceding calendar year.

The Company's insurance subsidiaries currently have $704.7 million of statutory surplus. Up to $113.0 million of this amount (the 2005 net income of the Company's primary insurance subsidiary) could be paid as dividends to the parent company without prior written approval from insurance regulatory authorities in 2006. Our insurance subsidiaries have not paid any dividends to our holding company since 2001.

Involuntary Business

All 50 states and the District of Columbia have established a mechanism to assure that automobile insurance is available to any consumer that otherwise would not be written voluntarily by the private market; this is called the involuntary or residual market. These organizations are established by the respective state regulators and administered by a governing board represented by insurance companies and other representatives. The involuntary market consists of those consumers who due to a variety of factors such as their driving record or status of first-time drivers represent a high risk. Rates for the involuntary market can be significantly higher than the voluntary market given the cost expectations. The number of private passenger automobiles insured through the involuntary market mechanisms is not distributed evenly among all the states. Depending upon such factors as government regulations, the adequacy of pricing of the involuntary market mechanisms, and industry competition, the size of the involuntary market varies dramatically from one state to another and over time.

Over the 10-year period from 1994 to 2003, the involuntary market has decreased both in absolute and relative terms. The percentage of vehicles insured in the involuntary market is declining in part because of sophisticated pricing models which enable companies to appropriately price for a larger percentage of risks.

The California Automobile Assigned Risk Plan ("CAARP") is the involuntary private passenger automobile market mechanism in California. The number of assignments for each insurer is based on the total applications received by the plan and the insurer's market share. As of December 31, 2005, the number of assigned risk insured vehicles was 1,129 compared to 2,254 at the end of 2004. As of December 31, 2005, this business represented less than 1% of our total direct premiums written. Underwriting profits were $1.0 million in 2005, compared to underwriting losses of $0.9 million and $0.5 million in 2004 and 2003, respectively.

Insurers offering homeowner insurance in California are required to participate in the California FAIR Plan ("FAIR Plan"). FAIR Plan is a state administered pool of difficult-to-insure homeowners. Each participating insurer is allocated a percentage of the total premiums written and losses incurred by the pool according to its share of total homeowner direct premiums written in California. Participation in FAIR Plan operations is based on a company's writings from two years prior. Since 21st ceased writing homeowners business in 2002, the Company no longer receives assignments for plan years beyond 2004, but continues to participate in prior plan year activity, which is in runoff. Our FAIR Plan underwriting results for 2004, 2003, and 2002 were immaterial.

Team Members

The Company employed approximately 2,600 full and part-time team members at December 31, 2005. We provide medical, pension and 401(k) savings plan benefits to eligible team members, according to the provisions of each plan.

Debt Offering

In December 2003, we completed a private offering of $100 million principal amount of 5.9 percent Senior Notes due in December 2013. The effective interest rate on the Senior Notes, when all offering costs are taken into account and amortized over the term of the Senior Notes, is approximately 6 percent per annum. Of the $99.2 million net proceeds from the offering, $85.0 million was used to increase the statutory surplus of our wholly-owned insurance subsidiary, 21st Century Insurance Company, and the balance was retained by our holding company. On July 8, 2004, the Company completed an exchange offer in which all of the private offering notes were exchanged for publicly registered notes having the same terms.

ITEM 1A. RISK FACTORS

Inaccuracies in assumptions used in calculating reserve amounts could have a material adverse impact on our net income.

The reserves for losses and LAE that we have established are estimates of amounts needed to pay reported and unreported claims and related expenses based on facts and circumstances known to us as of the time we established the reserves. Reserves are based on historical claims information, industry statistics and other factors. The establishment of appropriate reserves is an inherently uncertain process. This uncertainty arises from a number of factors, including the difficulty in predicting the number of claims that will ultimately occur, the rate of inflation and the rate and direction of changes in loss payment (severity) trends, interpretation of insurance policy provisions by courts, inconsistent decisions in lawsuits regarding coverage and expanded theories of liability. In addition, changes in claims settlement practices can lead to changes in loss payment patterns, which are used to estimate reserve levels. There can be no assurance that our ultimate liability will not materially exceed our reserves. See further discussion in *Item 1. Business - Loss and Loss Reserve Development*.

Our earnings are influenced by our claims experience, which is subject to significant potential variability due to a number of factors influencing claims costs, which are not necessarily within our ability to control. If our future claims experience does not match our pricing assumptions or past experience, earnings could be materially adversely affected.

Our earnings are significantly influenced by the claims paid under our insurance contracts and will vary from period to period depending upon the amount of claims incurred. In the event our future experience is worse than our pricing assumptions or our past experience, our operating results could be materially adversely affected.

Our core business is in a highly competitive industry.

According to A.M. Best, we were the seventh largest writer of personal automobile insurance in California in 2004, with a 7% share of direct premiums written. By comparison, according to A.M. Best, State Farm Mutual Automobile Insurance Company and Farmers Group, Inc. had shares of direct premiums written of 14% and 10%, respectively, in 2004.

Our business faces strong competition from other insurers. We compete for sales of all our products against larger competitors. Our ability to compete effectively is affected by various factors, including, but not limited to:

- marketing ability;
- perceived financial strength and claims-paying ability;
- ratings;
- investment performance;
- size and strength of the work force capabilities;
- product quality;

- price and features;
- customer service; and
- general reputation.

The level of competition may also increase as a result of the continuing consolidation of the financial services industry. Mergers and acquisitions involving financial services companies could increase, as companies seek to improve their competitive position through increased market share, economies of scale and diversification of products and services.

In addition, the success of our growth strategy is dependent on our ability to compete effectively in the new markets we enter. We may face particular challenges in establishing brand name recognition with consumers in our new markets and we cannot assure you that we will be able to compete successfully.

Changes in interest rates may negatively affect our earnings.

The profitability of our insurance business is sensitive to interest rate changes. In periods of increasing interest rates, our investment income rises, but competitive pressures could contribute to narrower underwriting margins than presently prevail in the California private passenger automobile insurance market. In periods of decreasing interest rates, investment income is diminished; there can be no assurance the California Department of Insurance will grant premium rate increases that may be necessary to maintain rates of return.

We had fixed-income investments with a market value of $1,354.7 million at December 31, 2005, that are subject to the following risks:

- *Bond defaults and impairments.* We are exposed to the risk that issuers of bonds that we hold will not pay principal or interest when due. Increasing credit defaults and impairments may result in write-downs in the value of bonds we hold. Credit rating agencies have downgraded, and may in the future downgrade, certain issuers and fixed-income securities. At December 31, 2005, our bond portfolio, with the exception of a single $2.5 million fair value security that was rated BBB- (from Ford Motor Credit Corporation), consisted of investment grade securities. Widespread deterioration in the credit quality of issuers, changes in interest rate levels, and changes in interest rate spreads between types of investments, could materially impact the value of our invested assets and our earnings.

- *Reinvestment risk.* We are exposed to the risk that investments will be redeemed during a period of declining interest rates and that we will not be able to reinvest the proceeds in a comparable investment that provides a yield equal to or greater than the investment that was redeemed.

- *Interest rate and market risk.* We seek to maintain a proper amount of diversity and liquidity in our investment portfolio; however, we cannot assure you that we will be successful in this regard. If our portfolio were to be impaired by market or issuer-specific conditions to a substantial degree, our liquidity, financial position and financial results could be materially adversely affected. Further, our income from these investments could be materially reduced, and write-downs of the value of certain securities could further reduce our profitability. In addition, a decrease in the value of our investment portfolio could put our subsidiaries at risk of failing to satisfy regulatory capital requirements. If we were not at that time able to supplement our capital by issuing debt or equity securities on acceptable terms, our ability to finance working capital or fund growth could be adversely affected. See further discussion in *Item 7A. Quantitative and Qualitative Disclosures about Market Risk.*

In addition, the assets in our defined benefit pension plan are invested in a combination of high credit quality fixed-income securities and equity securities. Adverse changes in the equity markets, reductions in long-term interest rates and defaults in the bond market could have a significant effect on our earnings through increased pension costs. If the equity and fixed income markets perform poorly, reducing the value of assets in the defined benefit pension plan, we may incur additional funding costs.

A significant ratings downgrade may have a material adverse effect on our business.

Financial strength and claims-paying ability ratings issued by firms such as Standard & Poor’s, Fitch and A.M. Best have become an increasingly important factor in establishing the competitive position of insurance companies. Rating agencies assign ratings based upon their evaluations of an insurance company’s ability to meet its financial obligations.

If our ratings were lowered significantly relative to those of our competitors, our ability to market products to new customers and to renew the policies of current customers could be harmed. A lowering of our ratings could also limit our access to the capital markets or provide us with less than deserved pricing in the capital markets. These events, in turn, could have a material adverse effect on our net income and liquidity.

The insurance industry has been the target of litigation.

In recent years, insurance companies have been named as defendants in lawsuits including class actions, relating to pricing, sales practices and practices in claims handling, among other matters. A number of these lawsuits have resulted in substantial jury awards or settlements involving other insurers. Future litigation relating to these or other business practices may negatively affect us by requiring us to pay substantial awards or settlements, increasing our legal costs, diverting management attention from other business issues or harming our reputation with customers.

Insurance is a regulated industry.

Our insurance subsidiaries are highly regulated and changes in these regulations could negatively affect our business. Our insurance company subsidiaries are subject to government regulation in their states of domicile and also in each of the jurisdictions in which they are licensed or authorized to do business. Governmental agencies have broad administrative power to regulate many aspects of the insurance business, including trade and claim practices, accounting methods, premium rates, marketing practices, advertising, policy forms and capital adequacy. These agencies are concerned primarily with the protection of policyholders rather than shareholders or creditors. Moreover, insurance laws and regulations, among other things:

- establish solvency requirements, including minimum reserves and capital and surplus requirements;
- limit the amount of dividends, intercompany loans and other intercompany payments our insurance company subsidiaries can make without prior regulatory approval;
- impose restrictions on the amounts and types of investments we may hold;
- promote the protection of policyholders rather than security holders;
- controls the amount of losses in Involuntary Markets that companies must bear; and
- require assessments to pay claims of insolvent insurance companies.

Although in the past years we have been successful in gaining regulatory approval for rate increases, there can be no assurance that insurance regulators will grant future rate increases which may be necessary to offset possible future increases in claims cost trends. As a result of such uncertainties, underwriting losses could occur in the future. Further, we could be required to liquidate investments to pay claims, possibly during unfavorable market conditions, which could lead to the realization of losses on sales of investments. Adverse outcomes to any of the foregoing uncertainties would create some degree of downward pressure on the insurance subsidiaries' earnings or cash flows, which in turn could negatively impact our liquidity.

In some states, notably California, the Commissioner of Insurance is an elected official, adding yet an additional source of issues to the regulatory agenda.

In 2002, the California Department of Insurance ("CDI") began hearings for the purpose of implementing generic rating factors in connection with the Commissioner's authority to approve insurance rates. The draft regulations made public by the CDI incredulously focused on restricting an insurer's rate of return rather than on the price charged by the insurer to the consumer. We believe the adoption of such adverse regulations could negatively affect our profitability.

Fluctuations in insurance industry results may affect our business.

The financial results of companies in the insurance industry have historically been subject to significant fluctuations due to competition, economic conditions, interest rates, changes in tort laws, weather, regulatory changes, catastrophes and other factors. Further, differences in the organizational structure of competitors (i.e., public stock companies like Progressive, mutual companies like State Farm, reciprocals like AAA of Southern California, and private stock companies) create different financial objectives and attitudes among competitor managements.

We are primarily a personal automobile insurance carrier, and therefore our business may be adversely affected by conditions in this industry.

As a result of our focus on personal automobile insurance business, negative developments in the economic, competitive or regulatory conditions affecting the personal automobile insurance industry could have a material adverse effect on our results of operations and financial condition. Factors that negatively affect cost trends and our profitability include inflation in automobile repair costs, automobile parts, used car prices and medical care costs. Increased litigation of claims may also adversely affect loss costs. In addition, these developments in the personal

automobile insurance industry would have a disproportionate affect on us, compared to insurers that are more diversified across multiple business lines.

We write a substantial portion of our business in California, and therefore our business may be adversely affected by judicial, legislative, and, regulatory decisions in California, in addition to civil unrest or natural catastrophes.

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Approximately 94% of our direct premiums written for the year ended December 31, 2005, were generated in California. Our revenues and profitability are therefore subject to prevailing regulatory, economic, demographic, competitive and other conditions, including catastrophic events, and adverse judicial and legislative decisions in California. Changes in any of these conditions or adverse legislation or judicial decisions could make it more costly or difficult for us to conduct our business. In addition, these developments would have a disproportionate effect on us, compared to insurers that do not have such a geographic concentration.

We cannot assure you whether our growth strategy will be effective.

Our future financial performance and success are dependent in part upon our ability to successfully implement our growth strategy. Implementation of our growth strategy could be affected by a number of factors beyond our control, such as increased competition, judicial or legislative developments, general economic conditions or increased operating costs. Any failure to successfully implement our growth strategy could materially and adversely affect our financial condition and results of operations. We cannot assure you that we will be able to successfully implement our growth strategy or be able to improve our operating results.

The majority owner of our stock may take actions conflicting with your interests.

The majority owner has a history of being supportive of the Company, making a capital contribution in 1994 that helped the Company recover from the financial impact of the Northridge earthquake and in supporting the Company's development of systems and new markets. However, the majority owner of our common stock can control the outcome of stockholder votes. In addition, three of our ten directors, including our Chairman, are officers and employees of the majority holder or its subsidiaries. Through its majority ownership of our stock, the majority holder can attempt to pursue actions contrary to our interests or your interests as a holder of our stock. The majority holder also may have an interest in pursuing acquisitions, divestitures, financings or other transactions that, in its judgment, could enhance its equity investment, even though such transactions might involve risks to you, as holders of our stock. In addition, subsidiaries of the majority holder sell personal automobile insurance policies in competition with us.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. PROPERTIES

The following table summarizes our properties as of December 31, 2005:

Purpose	Location	Approximate Square Footage	Owned or Leased
Headquarters	Woodland Hills, CA	406,000	Leased
Claims offices	Other Southern California	154,000	Leased
Claims offices	Northern California	25,000	Leased
Claims offices	Phoenix, AZ	8,400	Leased
Office	Las Vegas, NV	1,400	Leased
Service Center	Lewisville, TX	136,000	Owned

We lease office space for our headquarters facilities, which are located in Woodland Hills, California. The lease term expires in February 2015 and the lease may be renewed for two consecutive five-year periods. We also lease office space in 14 other locations, 12 of which are in California primarily for claims-related activities and for Vehicle Inspection Centers. We anticipate no difficulty in extending these leases or obtaining comparable office facilities in

suitable locations and consider our facilities to be adequate for our current needs.

Our newest location is a customer service, sales and claims center in Lewisville, Texas. The Company began leasing this facility in mid-2004. On September 30, 2005, the Company exercised its option under the terms of its lease agreement to purchase the land and building that house this service center. See Note 7 of the Notes to Consolidated Financial Statements for additional information.

ITEM 3. LEGAL PROCEEDINGS

In the normal course of business, the Company is named as a defendant in lawsuits related to claims and insurance policy issues, both on individual policy files and by class actions seeking to attack the Company's business practices. A description of the legal proceedings to which the Company is a party is contained in Note 12 of the Notes to Consolidated Financial Statements.

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

No matters were submitted to a vote of the Company's security holders during the fourth quarter of 2005.

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

(a) Price Range of Common Stock

The Company's common stock is listed on the New York Stock Exchange ("NYSE") under the ticker symbol "TW". The following table sets forth the high and low bid prices on the NYSE for our common stock for the indicated periods.

	2005		2004	
	High	***Low***	*High*	*Low*
Fourth Quarter	**$17.92**	**$14.83**	$13.82	$12.39
Third Quarter	**16.30**	**14.40**	14.15	12.50
Second Quarter	**15.07**	**12.90**	15.35	12.50
First Quarter	**14.35**	**13.00**	14.90	13.19

(b) Holders of Common Stock

The approximate number of holders of record of our common stock on February 3, 2006 was 500.

(c) Dividends

Quarterly dividends of $0.04 per share were declared from the first quarter through the fourth quarter of 2005 and $0.02 per share were declared from the first quarter through the fourth quarter of 2004. The Company's Board of Directors considers a variety of factors in determining the timing and amount of dividends. Accordingly, the Company's past history of dividend payments does not assure that future dividends will be paid.

Our insurance subsidiaries are subject to state laws that restrict their ability to distribute dividends. In 2006, the Company estimates that its largest insurance subsidiary has capacity to pay approximately $113.0 million in dividends to its parent, before the effect of California state income taxes, without prior approval of the California Department of Insurance. See Note 14 of the Notes to Consolidated Financial Statements as well as *Liquidity and Capital Resources* located in *Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations* for additional information.

ITEM 6. SELECTED FINANCIAL DATA

The following selected financial data for each of the years in the five-year period ended December 31, 2005, should be read in conjunction with the Company's consolidated financial statements and the accompanying notes included in Item 8 of this report. All amounts set forth in the following tables are in thousands, except for ratios and per share data.

Years Ended December 31,	**2005**	2004	2003	2002	2001
Personal Auto Lines Data					
Direct premiums written	**$1,346,371**	$1,337,190	$1,223,377	$995,794	$898,862
Ceded premiums written	**(4,952)**	(4,815)	(4,858)	(18,902)	(56,205)
Net premiums written	**1,341,419**	1,332,375	1,218,519	976,892	842,657
Net premiums earned	**1,352,928**	1,313,551	1,172,679	924,559	838,489
Loss and LAE ratio	**73.7%**	75.4%	78.6%	82.9%	88.1%
Underwriting expense ratio	**21.0**	19.7	17.9	15.6	14.9
Combined ratio[13]	**94.7%**	95.1%	96.5%	98.5%	103.0%
All Lines Data					
Direct premiums written	**$1,346,370**	$1,337,198	$1,223,484	$998,248	$929,315
Ceded premiums written	**(4,952)**	(4,814)	(4,854)	(32,949)	(60,359)
Net premiums written	**1,341,418**	1,332,384	1,218,630	965,299	868,956
Net premiums earned	**1,352,937**	1,313,670	1,172,677	924,559	864,145
Total revenues	**1,419,128**	1,383,332	1,246,464	981,295	914,078
Loss and LAE ratio	**73.8%**	75.6%	82.0%	89.4%	96.7%
Underwriting expense ratio	**21.1**	19.7	17.9	15.5	15.0
Combined ratio[14]	**94.9%**	95.3%	99.9%	104.9%	111.7%
Net Income (Loss)	**$ 87,426**	$ 88,225	$ 53,575	$ (12,256)	$ (27,568)
Earnings (Loss) per Share					
Basic and diluted	**$ 1.02**	$ 1.03	$ 0.63	$ (0.14)	$ (0.32)
Dividends declared per Share	**0.16**	0.08	0.08	0.26	0.32

The decrease in premiums ceded from 2001 through 2003 was caused primarily by scheduled decreases in the quota share program with certain AIG subsidiaries, which was terminated effective September 1, 2002. The remainder of our homeowners line was 100% reinsured in 2002. The loss and LAE ratios have decreased since 2001 primarily due to increases in net premiums earned, improvements in our pricing and underwriting methods and the favorable impact of declining frequency trends and moderate claim severity trends. The increase in the 2002 to 2005 expense ratios is primarily due to increased advertising expenditures, increased costs for improving customer service and opening a service center in Texas.

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[13] The combined ratio for the personal auto lines was impacted by the following items: $13.6 million of costs associated with workforce reductions and the settlement of litigation matters in 2001; and (favorable) unfavorable prior accident year loss and LAE development of $(27.5) million, $(2.9) million, $11.2 million, $16.2 million, and $45.7 million in 2005, 2004, 2003, 2002, and 2001, respectively.

[14]

In addition to the effect of the items described in Footnote 13 above, the combined ratio for all lines was impacted by adverse development on remaining loss reserves from the homeowner and earthquake lines, which are in runoff, of $2.3 million in 2005, $2.8 million in 2004, $40.2 million in 2003, $58.8 million in 2002, and $77.6 million in 2001.

Years Ended December 31,	**2005**	2004	2003	2002	2001
Balance Sheet Data:					
Total investments and cash	**$1,470,742**	$1,418,912	$1,284,686	$1,030,478	$ 884,633
Total assets	**1,920,229**	1,864,314	1,738,132	1,470,037	1,354,398
Unpaid losses and LAE	**523,835**	495,542	438,323	384,009	349,290
Unearned premiums	**319,676**	331,036	312,254	266,477	236,473
Debt[15]	**127,972**	138,290	149,686	60,000	—
Total liabilities	**1,090,257**	1,089,913	1,037,442	814,429	695,092
Stockholders' equity	**829,972**	774,401	700,690	655,608	659,306
Book value per common share	**9.66**	9.06	8.20	7.67	7.72
Statutory surplus[16]	**704,671**	614,893	535,026	397,381	393,119
Net premiums written to surplus ratio[17]	**1.9:1**	2.2:1	2.3:1	2.4:1	2.2:1

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Overview

Founded in 1958, 21st Century Insurance Group is a direct-to-consumer provider of personal auto insurance in California, Texas, Illinois and six other states. We also provide motorcycle and personal umbrella insurance in California. We deliver superior policy features and customer service at a competitive price. We began offering personal auto insurance in Illinois, Indiana and Ohio on January 28, 2004, and in Texas on January 3, 2005.

Our long-term financial goals include achieving a 96% or lower combined ratio, 15% annual growth in premiums written, 15% return on stockholders' equity, and strong financial ratings. Please refer to *Item 1. Business* for additional information on the Company's long-term financial goals and a discussion of insurance terminology used throughout this document.

For 2005, our net premiums earned grew 3.0% ($39.2 million) to $1,352.9 million from $1,313.7 million in 2004. California direct premiums written decreased by 2.2% to $1,262.3 million in 2005, compared to $1,290.9 million for the same period in 2004, as a result of the high level of competitor marketing activity in the state. Direct premiums written outside of California increased by 81.6% to $84.1 million in 2005, compared to $46.3 million for the same period in 2004. We plan on expanding into six additional states in 2006 to further our geographic expansion strategy.

Conversion to our new computer platforms, known as APS, occurred as planned. The APS:Claims component has a client-server architecture. The APS:Policy component has a multi-tier system architecture featuring a web client, a middle tier services layer and a real-time relational database back-end. The Claims component began taking 100% of new claims in the third quarter of 2004. Over 90% of the Company's pending claims are now on the new system. We began writing new California 21st Century Insurance Company personal auto policies on the system in the first quarter of 2005 and completed the conversion of these in-force policies in the fourth quarter of 2005. Underwriting expenses have been higher than in prior periods due to costs associated with the conversion process, the training of service staff and the Company's geographic expansion efforts.

See *Results of Operations* for more details as to our overall and personal auto lines results.

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[15] Amount shown for 2002 is a capital lease obligation (see Note 9 of the Notes to Consolidated Financial Statements).
[16]

Amount shown for 2002 would be $343,661 were it not for the sale-leaseback transaction described in Note 9 of the Notes to Consolidated Financial Statements.

[17] Amount shown for 2002 would be 2.8:1 were it not for the sale-leaseback transaction referred to above.

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The remainder of our Management's Discussion and Analysis provides a narrative on the Company's financial condition and performance that should be read in conjunction with the accompanying consolidated financial statements. It includes the following sections:

- Financial Condition
- Liquidity and Capital Resources
- Transactions with Related Parties
- Contractual Obligations and Commitments
- Off Balance Sheet Arrangements
- Results of Operations
- Critical Accounting Estimates
- Recent Accounting Standards
- Forward-Looking Statements

Financial Condition

Stockholders' equity and book value per share increased to $830.0 million and $9.66, respectively, at December 31, 2005, compared to $774.4 million and $9.06 at December 31, 2004. The increase for the year ended December 31, 2005, was primarily due to net income of $87.4 million and $4.7 million of proceeds from exercised stock options, offset by a decrease in accumulated other comprehensive income of $23.1 million (resulting primarily from increases in treasury yields) and dividends to stockholders of $13.7 million.

Investments and cash increased $51.8 million (3.7%) since the prior year primarily due to the $160.3 million of operating cash flow offset by cash outflows of $39.1 million for property and equipment, $35.3 million for net unrealized losses due to changes in interest rates, $13.7 million in shareholder dividends, $12.6 million in debt repayments, and $7.8 million net change in various other accounts.

Of our total investments at December 31, 2005, investments in tax-exempt, fixed-income securities remained constant with December 31, 2004, at 22.3%. At December 31, 2005, investment-grade securities comprised substantially all of the fair value of our investment portfolio. As of December 31, 2005, two investments were rated below investment grade. These securities represent 0.2% of our total investments.

The Company also has unrated, community investments representing 0.2% of total investments. These investments have been made in an effort to provide housing and other services to economically disadvantaged communities. See Note 19 of the Notes to Consolidated Financial Statements for additional information.

Increased advertising, sales and customer service costs through December 31, 2005, contributed to an increase in deferred policy acquisitions costs ("DPAC") of $1.1 million to $59.9 million, compared to $58.8 million at December 31, 2004. The Company's DPAC is estimated to be fully recoverable (see *Critical Accounting Estimates - Deferred Policy Acquisition Costs*).

The following table summarizes unpaid losses and loss adjustment expenses ("LAE"), gross and net of applicable reinsurance, with respect to our lines of business:

AMOUNTS IN THOUSANDS	**2005**		2004	
Years Ended December 31,	**Gross**	**Net**	Gross	Net
Unpaid losses and LAE:				
Personal auto lines	**$521,528**	**$516,849**	$489,411	$485,759
Homeowner and earthquake lines in runoff	**2,307**	**1,368**	6,131	5,138
Total	**$523,835**	**$518,217**	$495,542	$490,897

Gross unpaid losses and LAE increased by $28.3 million in 2005 primarily due to a reserve increase of $32.1 million in the personal auto lines as a result of growth in our customer base. The increase in the personal auto lines was offset by the $3.8 million net decrease in the homeowner and earthquake lines, which are in runoff (see *Critical Accounting Estimates - Losses and Loss Adjustment Expenses* for a description of the Company's reserving process).

Unearned premiums decreased 3.4% to $319.7 million at the end of 2005 compared to $331.0 million at the end of 2004 primarily due to a 2.9% decrease in premiums written in the fourth quarter of 2005 as compared to the same period in 2004.

Debt of $128.0 million consists of $28.1 million of capital lease obligations and $99.9 million senior notes, net of discount (see Note 9 of the Notes to Consolidated Financial Statements). The primary purpose of the capital leases and senior note borrowings was to increase the statutory surplus of 21st Century Insurance Company, our wholly-owned insurance subsidiary, which had significant adverse earthquake and auto reserve development in 2000, 2001, and 2002. The decrease in debt of $10.3 million is primarily attributable to principal payments on the capital leases.

Effective December 4, 2003, we changed our state of incorporation from California to Delaware. In connection with the change, our common stock was assigned a par value of $0.001 per share, resulting in a reclassification of $419.9 million from common stock to additional paid-in capital. There was no change in the location of company operations, location of employees, or the way we do business as a result of the reincorporation.

Liquidity and Capital Resources

21st Century Insurance Group. Our holding company's main sources of liquidity historically have been dividends received from our insurance subsidiaries and proceeds from issuance of debt or equity securities. Apart from the exercise of stock options and restricted stock grants to employees, the effects of which have not been significant, we have not issued any equity securities since 1998 when AIG exercised its warrants to purchase common stock for cash of $145.6 million. Our insurance subsidiaries have not paid any dividends to our holding company since 2001 due to the previous uncertainty surrounding the taxability of dividends received by holding companies from their insurance subsidiaries in California. See further discussion in Note 5 of the Notes to Consolidated Financial Statements.

In December 2003, we completed a private offering of $100 million principal amount of 5.9 percent Senior Notes due in December 2013. The effective interest rate on the Senior Notes, when all offering costs are taken into account and amortized over the term of the Senior Notes, is approximately 6 percent per annum. Of the $99.2 million net proceeds from the offering, $85.0 million was used to increase the statutory surplus of our wholly-owned insurance subsidiary, 21st Century Insurance Company, and the balance was retained by our holding company. On July 8, 2004, the Company completed an exchange offer in which all of the private offering notes were exchanged for publicly registered notes having the same terms.

Effective December 31, 2003, the California Department of Insurance, approved an intercompany lease whereby 21st Century Insurance Company leases certain computer software from our holding company. The monthly lease payment, currently $0.7 million, started in January 2004 and is subject to upward adjustment based on the cost incurred by the holding company to enhance the software. On November 30, 2005, the CDI permitted an amendment to a term loan line that increased the available amount from $40 million to $150 million that our insurance subsidiary, 21st Century Insurance Company, can loan to our holding company. See further information in Note B of the Notes to Condensed Financial Information of Registrant.

Our holding company's significant cash obligations over the next several years, exclusive of any dividends to stockholders that our directors may declare, consist of interest payments on the Senior Notes (approximately $5.9 million annually), ongoing costs to enhance our computer software, and the repayment of the $100 million principal on the Senior Notes due in 2013.

We expect to be able to meet those obligations from sources of cash currently available (i.e., cash and investments at the holding company, which totaled $16.9 million at December 31, 2005, payments received from the intercompany lease, and borrowing from our insurance subsidiary), additional funds obtainable from the capital markets or dividends received from our insurance subsidiaries. The effective California state income tax rate applicable to any such dividends paid from our subsidiaries, if taxable, is approximately 1.8%. Our insurance subsidiaries could pay $113.0

million in 2006 as dividends to the holding company without prior written approval from insurance regulatory authorities.

Insurance Subsidiaries. We have achieved underwriting profits in our core auto insurance operations for the last sixteen quarters and have thereby enhanced our liquidity. Our cash flow from operations and short-term cash position generally are more than sufficient to meet obligations for claim payments, which by the nature of the personal automobile insurance business, tend to have an average duration of less than a year.

In California, where approximately 94% of our premium is written, underwriting profit improved in 2005 without additional rate increases. Effective October 23, 2005, we implemented a class plan revision for our California business. This is a rate neutral change overall, but is intended to improve the accuracy of our pricing.

As of December 31, 2005, our insurance subsidiaries had a combined statutory surplus of $704.7 million compared to $614.9 million at December 31, 2004. The increase in statutory surplus was primarily due to statutory net income of $113.5 million offset by a decrease in net deferred tax assets of $17.2 million, an increase in nonadmitted assets of $5.4 million, and an increase in net unrealized equity investment losses of $1.6 million. The ratio of net premiums written to statutory surplus was 1.9 at December 31, 2005, compared to 2.2 at December 31, 2004.

Transactions with Related Parties

Several subsidiaries of AIG together own approximately 62% of our outstanding common stock and three of the ten members of our Board of Directors are employees of AIG. Since 1995, the Company has entered into transactions with AIG subsidiaries, including reinsurance agreements, insurance coverage contracts, and various services.

Reinsurance agreements - The Company's catastrophe reinsurance agreement for its personal auto lines is provided by three participating entities, two of which are AIG subsidiaries. Together they reinsure any covered event up to $45.0 million in excess of $20.0 million effective January 1, 2004 (up to $30.0 million in excess of $15.0 million in 2003). This coverage was renewed effective January 1, 2005 and 2006 (see Note 10 of the Notes to Consolidated Financial Statements). Total premiums ceded to AIG subsidiaries were $1.0 million, $1.1 million, and $1.2 million for the years ended December 31, 2005, 2004, and 2003, respectively. Total reinsurance recoverables, net of payables, from AIG subsidiaries were $0.6 million and $1.5 million as of December 31, 2005 and 2004, respectively.

Corporate insurance coverage - The Company has obtained the following corporate insurance policies from AIG subsidiaries:

- Workers' compensation insurance
- General liability insurance
- Property insurance
- Umbrella excess insurance
- Fiduciary liability insurance
- Fidelity insurance
- Auto insurance
- Employment practices liability insurance

Errors and omissions insurance was carried with AIG through September 30, 2005.

Insurance expense attributable to AIG corporate insurance coverages was $2.9 million, $3.5 million, and $1.3 million for 2005, 2004, and 2003, respectively.

Investment management and investment accounting - In October 2003, as a result of a competitive bidding process, we entered into an agreement with an AIG subsidiary to provide investment management and investment accounting services to the Company. The fees are determined as a percentage of the average invested asset balance and are classified with net investment income. This agreement was approved by the CDI. Investment management and accounting expense was $0.9 million, $0.9 million, and $0.1 million in 2005, 2004 and 2003, respectively.

Software and data processing - Through December 31, 2004, the Company utilized certain third party software and data processing monitoring tools under an agreement negotiated by AIG. Since January 1, 2005, the Company has negotiated its own contracts, and no longer incurs any software or data processing costs with AIG subsidiaries. Charges by AIG for software and data processing were $0.3 million in 2004 and 2003. There was no expense in 2005.

Contractual Obligations and Commitments

We have various contractual obligations that are recorded as liabilities in our consolidated financial statements. Certain contractual obligations, such as operating lease obligations, are not recognized as liabilities in our consolidated financial statements, but are required to be disclosed.

The following table summarizes our significant contractual obligations and commitments at December 31, 2005 and the future periods in which such obligations are expected to be settled in cash. In addition, the table reflects the timing of principal and interest payments on outstanding senior notes.

		Payments Due by Period			
AMOUNTS IN MILLIONS	**Total**	2006	2007 through 2008	2009 through 2010	Remaining years after 2010
Senior notes	**$147.2**	$ 5.9	$ 11.8	$ 11.8	$117.7
Capital lease obligations	**29.8**	14.8	14.9	0.1	—
Debt	**177.0**	20.7	26.7	11.9	117.7
Operating leases[18]	**165.5**	27.7	37.9	33.0	66.9
Other long-term commitments	**2.1**	0.4	1.2	0.4	0.1
Future pension benefit payments[19]	**68.6**	3.1	7.2	9.1	49.2
Expected loss and LAE payments, net of reinsurance	**518.2**	354.9	148.7	12.5	2.1
Total[20]	**$931.4**	$406.8	$221.7	$ 66.9	$236.0

The table above excludes periodic contributions to pension plans, which are discussed below. The capital lease obligations above resulted from the sale-leaseback transaction discussed earlier and an auto capital lease transaction (see further discussion of these items in Notes 9 and 12 of the Notes to Consolidated Financial Statements). We have no material purchase obligations or other on or off balance sheet long-term liabilities or obligations at December 31, 2005 (see discussion about variable interest entities in Note 19 of the Notes to Consolidated Financial Statements).

Our largest insurance subsidiary is responsible for making payments on both the capital lease obligations and most of the operating lease obligations.

We sponsor defined benefit pension plans that may obligate us to make contributions to the plans from time to time. Total contributions to the plans were $9.0 million, $2.7 million and $7.0 million in 2005, 2004, and 2003, respectively. For the past several years we have followed the practice of contributing sufficient amounts to the qualified defined benefit pension plan to meet or exceed statutory funding requirements, without exceeding the maximum amount that would be deductible for corporate income tax purposes, and while maintaining plan assets at a level at least equal to the actuarial present value of accumulated plan benefits. The amount and timing of future contributions to our qualified defined benefit pension plan depends on a number of unpredictable factors including statutory funding requirements, the market performance of the plan's assets, cash requirements for benefit payments to retirees, and future changes in interest rates that affect the actuarial measurement of the plan's obligations. Contributions to our non-qualified defined benefit pension plan generally are limited to amounts needed to make benefit payments to retirees, which are expected to total approximately $0.9 million in 2006.

Off Balance Sheet Arrangements

We currently have no letters of credit, no trading activities involving non-exchange-traded contracts accounted for at fair value, and no obligations under any derivative financial instruments. In addition, the Company has no material retained interests in assets transferred to any unconsolidated entity (see further discussion in Note 2 of the Notes to Consolidated Financial Statements). However, 21st Century Insurance Group has issued guarantees on behalf of its insurance subsidiaries related to the capital lease obligations described above.

The Board of our Company has made a commitment to invest a portion of policyholder surplus in economically disadvantaged communities. In connection with this commitment, the Company has guaranteed 11.1%, or $19.2 million, of a warehouse financing agreement. The Company has also committed $2.8 million for other community investment purposes. These commitments, which do not significantly impact the Company's liquidity or capital, are

further discussed in Note 19 of the Notes to Consolidated Financial Statements.

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[18] Includes amounts due under long-term software license agreements of approximately $21.2 million.
[19] Includes benefit payments through 2015.
[20] Purchase commitments of $0.2 million were excluded from the summary, as they are not material.

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Results of Operations

Consolidated Results. The following table summarizes the Company's consolidated results of operations for the years ended 2005, 2004, and 2003.

AMOUNTS IN THOUSANDS, EXCEPT SHARE DATA	*Results of Operations*			*Change*	
Years Ended December 31,	**2005**	2004	2003	**2005**	2004
Direct premiums written	**$1,346,370**	$1,337,198	$1,223,484	**0.7%**	9.3%
Net income	**87,426**	88,225	53,575	**(0.9)%**	64.7%
Diluted earnings per share	**1.02**	1.03	0.63	**(1.0)%**	63.5%

The 2005 results include net realized capital losses of $3.3 million compared to net realized capital gains of $10.8 million and $13.2 million for the same period in 2004 and 2003, respectively. The results for 2004 include a $4.9 million increase in income in the third quarter associated with the resolution of California legislation (AB 263) related to holding company taxes on dividends from insurance subsidiaries. The results for 2003 include after-tax charges of $24.1 million in the first quarter to strengthen earthquake reserves and an increase in after-tax net income of $9.6 million in the second quarter, resulting from nonrecurring, nonoperational items and a favorable tax settlement with the IRS.

Personal automobile insurance is our primary line of business. Vehicles insured outside of California accounted for 6.2%, 3.5%, and 2.4% of our direct premiums written in 2005, 2004 and 2003, respectively. This increase is due to our ongoing multi-state expansion program, which includes marketing in non-California states. The Company currently plans to expand into six additional states in 2006 to further its geographic expansion strategy.

Personal Auto Lines Underwriting Results. The following table presents the components of our personal auto lines underwriting profit and the components of the combined ratio for the past three years:

AMOUNTS IN THOUSANDS	*Personal Auto Lines*			*% Change*	*$ Change*	*% Change*	*$ Change*
Years Ended December 31,	**2005**	2004	2003	*'05 vs.'04*	*'05 vs.'04*	*'04 vs.'03*	*'04 vs.'03*
Direct premiums written	**$1,346,371**	$1,337,190	$1,223,377	0.7%	$ 9,181	9.3%	$113,813
Net premiums written	**$1,341,419**	$1,332,375	$1,218,519	0.7%	$ 9,044	9.3%	$113,856
Net premiums earned	**$1,352,928**	$1,313,551	$1,172,679	3.0%	$39,377	12.0%	$140,872
Net losses and LAE	**996,599**	991,008	922,122	0.6	5,591	7.5	68,886
Underwriting expenses	**284,334**	258,571	209,551	10.0	25,763	23.4	