

UNITRIN INC
Form 10-Q
October 31, 2006
Table of Contents

FORM 10-Q

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For Quarterly Period Ended September 30, 2006

OR

Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the Transition Period from _____ to _____

Commission file number 0-18298

Unitrin, Inc.

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of
incorporation or organization)

95-4255452
(I.R.S. Employer
Identification No.)

One East Wacker Drive, Chicago, Illinois
(Address of principal executive offices)

60601
(Zip Code)

(312) 661-4600

(Registrant's telephone number, including area code)

Not Applicable

(Former name, former address and former fiscal year, if changed since last report)

Edgar Filing: UNITRIN INC - Form 10-Q

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

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

Large accelerated filer Accelerated filer Non-accelerated filer

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

67,130,174 shares of common stock, \$0.10 par value, were outstanding as of October 24, 2006.

Table of Contents

UNITRIN, INC.

INDEX

| | Page |
|---|-------------|
| PART I. FINANCIAL INFORMATION. | |
| Item 1. Financial Statements. | |
| <u>Condensed Consolidated Statements of Income for the Nine and Three Months Ended September 30, 2006 and 2005 (Unaudited).</u> | 1 |
| <u>Condensed Consolidated Balance Sheets as of September 30, 2006 (Unaudited) and December 31, 2005.</u> | 2 |
| <u>Condensed Consolidated Statements of Cash Flows for the Nine Months Ended September 30, 2006 and 2005 (Unaudited).</u> | 3 |
| <u>Notes to the Condensed Consolidated Financial Statements (Unaudited).</u> | 4-20 |
| Item 2. <u>Management's Discussion and Analysis of Results of Operations and Financial Condition.</u> | 21-49 |
| Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk.</u> | 49-51 |
| Item 4. <u>Controls and Procedures.</u> | 53 |
| PART II. <u>OTHER INFORMATION.</u> | |
| Item 1. <u>Legal Proceedings.</u> | 53 |
| Item 2. <u>Changes in Securities and Use of Proceeds</u> | 53 |
| Item 6. <u>Exhibits.</u> | 54-55 |
| <u>Signatures</u> | 56 |

Table of Contents**UNITRIN, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF INCOME****(Dollars in millions, except per share amounts)****(Unaudited)**

| | Nine Months Ended | | Three Months Ended | |
|---|--------------------------|------------------|---------------------------|------------------|
| | Sept. 30, | Sept. 30, | Sept. 30, | Sept. 30, |
| | 2006 | 2005 | 2006 | 2005 |
| Revenues: | | | | |
| Earned Premiums | \$ 1,859.8 | \$ 1,858.8 | \$ 622.0 | \$ 620.6 |
| Consumer Finance Revenues | 184.3 | 163.2 | 64.3 | 56.7 |
| Net Investment Income | 229.1 | 209.1 | 77.8 | 67.8 |
| Other Income | 14.7 | 7.6 | 11.7 | 1.2 |
| Net Realized Investment Gains | 23.7 | 53.5 | 3.1 | 7.8 |
| Total Revenues | 2,311.6 | 2,292.2 | 778.9 | 754.1 |
| Expenses: | | | | |
| Policyholders Benefits and Incurred Losses and Loss Adjustment Expenses | 1,208.0 | 1,278.1 | 385.4 | 465.8 |
| Insurance Expenses | 604.8 | 612.2 | 203.2 | 204.1 |
| Consumer Finance Expenses | 146.2 | 125.1 | 53.7 | 43.2 |
| Interest and Other Expenses | 47.2 | 46.7 | 15.5 | 16.4 |
| Total Expenses | 2,006.2 | 2,062.1 | 657.8 | 729.5 |
| Income before Income Taxes and Equity in Net Income of Investee | 305.4 | 230.1 | 121.1 | 24.6 |
| Income Tax Expense | 92.5 | 66.0 | 36.4 | 3.5 |
| Income before Equity in Net Income of Investee | 212.9 | 164.1 | 84.7 | 21.1 |
| Equity in Net Income of Investee | 8.6 | 4.7 | 1.4 | 1.6 |
| Net Income | \$ 221.5 | \$ 168.8 | \$ 86.1 | \$ 22.7 |
| Net Income Per Share | \$ 3.25 | \$ 2.44 | \$ 1.27 | \$ 0.33 |
| Net Income Per Share Assuming Dilution | \$ 3.23 | \$ 2.42 | \$ 1.27 | \$ 0.32 |

The Notes to the Condensed Consolidated Financial Statements are an integral part of these financial statements.

Table of Contents**UNITRIN, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED BALANCE SHEETS****(Dollars in millions, except per share amounts)**

| | September 30, 2006 (Unaudited) | December 31, 2005 |
|---|--------------------------------------|----------------------|
| Investments: | | |
| Fixed Maturities at Fair Value (Amortized Cost: 2006 - \$3,842.5; 2005 - \$3,988.7) | \$ 3,907.9 | \$ 4,086.6 |
| Northrop Grumman Corporation Preferred Stock at Fair Value (Cost: 2006 - \$177.5; 2005 - \$177.5) | 236.0 | 225.7 |
| Northrop Grumman Corporation Common Stock at Fair Value (Cost: 2006 - \$318.8; 2005 - \$330.7) | 503.0 | 460.7 |
| Other Equity Securities at Fair Value (Cost: 2006 - \$384.5; 2005 - \$302.8) | 508.0 | 412.5 |
| Investee (Intermec) at Cost Plus Cumulative Undistributed Earnings (Fair Value: 2006 - \$333.7; 2005 - \$427.8) | 91.4 | 80.4 |
| Short-term Investments at Cost which Approximates Fair Value | 589.9 | 524.5 |
| Other | 565.8 | 484.4 |
| Total Investments | 6,402.0 | 6,274.8 |
| Cash | 43.0 | 44.5 |
| Consumer Finance Receivables at Cost (Fair Value: 2006 - \$1,227.4; 2005 - \$1,112.5) | 1,227.9 | 1,109.5 |
| Other Receivables | 763.7 | 828.0 |
| Deferred Policy Acquisition Costs | 448.3 | 438.2 |
| Goodwill | 344.7 | 344.7 |
| Other Assets | 138.9 | 158.6 |
| Total Assets | \$ 9,368.5 | \$ 9,198.3 |
| Liabilities and Shareholders' Equity: | | |
| Insurance Reserves: | | |
| Life and Health | \$ 2,465.5 | \$ 2,404.9 |
| Property and Casualty | 1,442.9 | 1,531.5 |
| Total Insurance Reserves | 3,908.4 | 3,936.4 |
| Certificates of Deposits at Cost (Fair Value: 2006 - \$1,181.1; 2005 - \$1,070.9) | 1,187.3 | 1,074.3 |
| Unearned Premiums | 815.8 | 810.6 |
| Accrued and Deferred Income Taxes | 287.7 | 272.8 |
| Notes Payable at Amortized Cost (Fair Value: 2006 - \$500.2; 2005 - \$504.3) | 504.3 | 503.6 |
| Accrued Expenses and Other Liabilities | 411.4 | 442.9 |
| Total Liabilities | 7,114.9 | 7,040.6 |
| Shareholders' Equity: | | |
| Common Stock, \$0.10 par value, 100 million Shares Authorized; 67,130,696 Shares Issued and Outstanding at September 30, 2006 and 68,516,167 Shares Issued and Outstanding at December 31, 2005 | 6.7 | 6.9 |
| Paid-in Capital | 726.4 | 711.4 |
| Retained Earnings | 1,241.1 | 1,188.2 |
| Accumulated Other Comprehensive Income | 279.4 | 251.2 |
| Total Shareholders' Equity | 2,253.6 | 2,157.7 |

Edgar Filing: UNITRIN INC - Form 10-Q

| | | |
|--|------------|------------|
| Total Liabilities and Shareholders' Equity | \$ 9,368.5 | \$ 9,198.3 |
|--|------------|------------|

The Notes to the Condensed Consolidated Financial Statements are an integral part of these financial statements.

Table of Contents**UNITRIN, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(Dollars in millions)****(Unaudited)**

| | Nine Months Ended | |
|--|--------------------------|----------------------|
| | September 30, | September 30, |
| | 2006 | 2005 |
| Operating Activities: | | |
| Net Income | \$ 221.5 | \$ 168.8 |
| Adjustments to Reconcile Net Income to Net Cash Provided (Used) by Operating Activities: | | |
| Increase in Deferred Policy Acquisition Costs | (14.4) | (23.4) |
| Equity in Net Income of Investee before Taxes | (13.3) | (7.4) |
| Amortization of Investments | 5.2 | 8.8 |
| (Increase) Decrease in Other Receivables | 64.3 | (55.1) |
| Increase (Decrease) in Insurance Reserves | (31.5) | 172.8 |
| Increase in Unearned Premiums | 5.3 | 35.4 |
| Increase in Accrued and Deferred Income Taxes | | 5.6 |
| Increase (Decrease) in Accrued Expenses and Other Liabilities | (34.0) | 18.1 |
| Net Realized Investment Gains | (23.7) | (53.5) |
| Provision for Loan Losses | 41.9 | 34.9 |
| Other, Net | 18.3 | 32.0 |
| Net Cash Provided by Operating Activities | 239.6 | 337.0 |
| Investing Activities: | | |
| Sales and Maturities of Fixed Maturities | 387.9 | 392.6 |
| Purchases of Fixed Maturities | (245.3) | (448.1) |
| Sales of Northrop Grumman Corporation Common Stock | 17.5 | |
| Sales of Other Equity Securities | 72.7 | 58.9 |
| Purchases of Equity Securities | (135.6) | (40.2) |
| Change in Short-term Investments | (62.5) | (182.0) |
| Acquisition and Improvements of Investment Real Estate | (9.6) | (34.0) |
| Sales of Investment Real Estate | | 41.9 |
| Change in Other Investments | (71.9) | (16.0) |
| Change in Consumer Finance Receivables | (159.5) | (151.7) |
| Other, Net | 5.2 | (14.2) |
| Net Cash Used by Investing Activities | (201.1) | (392.8) |
| Financing Activities: | | |
| Change in Certificates of Deposits | 113.1 | 123.6 |
| Change in Universal Life and Annuity Contracts | 3.5 | 3.0 |
| Notes Payable Proceeds | 20.0 | 20.0 |
| Notes Payable Payments | (20.1) | (20.0) |
| Cash Dividends Paid | (90.3) | (88.2) |
| Common Stock Repurchases | (72.6) | (24.1) |
| Cash Exercise of Stock Options | 4.0 | 15.2 |
| Excess Tax Benefits from Share-based Awards | 2.4 | |

Edgar Filing: UNITRIN INC - Form 10-Q

| | | |
|--|---------|---------|
| Net Cash Provided (Used) by Financing Activities | (40.0) | 29.5 |
| Decrease in Cash | (1.5) | (26.3) |
| Cash, Beginning of Year | 44.5 | 82.1 |
| Cash, End of Period | \$ 43.0 | \$ 55.8 |

The Notes to the Condensed Consolidated Financial Statements are an integral part of these financial statements.

Table of Contents**UNITRIN, INC. AND SUBSIDIARIES****NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited)****Note 1 - Basis of Presentation**

The unaudited Condensed Consolidated Financial Statements included herein have been prepared by Unitrin, Inc. (Unitrin or the Company) pursuant to the rules and regulations of the U.S. Securities and Exchange Commission (the SEC). Certain financial information that is normally included in annual financial statements, including certain financial statement footnote disclosures, prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) is not required by the rules and regulations of the SEC and has been condensed or omitted. In the opinion of the Company s management, the unaudited Condensed Consolidated Financial Statements include all adjustments necessary for a fair presentation. The preparation of interim financial statements relies heavily on estimates. This factor and certain other factors, such as the seasonal nature of some portions of the insurance business, as well as market conditions, call for caution in drawing specific conclusions from interim results. The accompanying unaudited Condensed Consolidated Financial Statements should be read in conjunction with the Consolidated Financial Statements and related notes included in the Company s Annual Report on Form 10-K, filed with the SEC for the year ended December 31, 2005 (the 2005 Annual Report).

Accounting Changes

In December 2004, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 123(R), *Share-Based Payment*. SFAS No. 123(R) replaces SFAS No. 123, *Accounting for Stock- Based Compensation*, and supersedes Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*. SFAS No. 123(R) requires compensation costs related to share-based payment transactions to be recognized in the financial statements over the period that an employee provides service in exchange for the award. The Company has adopted SFAS No. 123(R) using the modified prospective method effective January 1, 2006. Under the modified prospective method, companies record prospectively the compensation cost for new and modified awards, on or after the date of adoption, over the requisite service period of such awards. In addition, companies record compensation cost prospectively for the unvested portion, at the date of adoption, of previously issued and outstanding awards over the remaining requisite service period of such awards. The Company previously adopted SFAS No. 123 in 2003. Accordingly, the incremental effect of adoption of SFAS No. 123(R) was not material.

In 2005, some of the Company s awards under share-based payment arrangements with employees were accounted for under the intrinsic value method of APB Opinion No. 25. The effects on Net Income, Net Income Per Share and Net Income Per Share Assuming Dilution if the fair value based method had been applied to all awards in 2005 are presented below:

| | Nine | Three |
|---|------------------|------------------|
| | Months | Months |
| | Ended | Ended |
| | Sept. 30, | Sept. 30, |
| | 2005 | 2005 |
| (Dollars in Millions, Except Per Share Amounts) | | |
| Net Income, As Reported | \$ 168.8 | \$ 22.7 |
| Add: Stock-Based Compensation Expense Included in Reported Net Income, Net of Related Tax Effects | 6.0 | 2.1 |
| Deduct: Total Stock-Based Employee Compensation Expense Determined under Fair Value Based Method for All Awards, Net of Related Tax Effects | (6.1) | (2.1) |
| Pro Forma Net Income | \$ 168.7 | \$ 22.7 |
| Net Income Per Share: | | |
| As Reported | \$ 2.44 | \$ 0.33 |
| Pro Forma | \$ 2.44 | \$ 0.33 |

Edgar Filing: UNITRIN INC - Form 10-Q

Net Income Per Share Assuming Dilution:

| | | |
|-------------|---------|---------|
| As Reported | \$ 2.42 | \$ 0.32 |
| Pro Forma | \$ 2.42 | \$ 0.32 |

Table of Contents

UNITRIN, INC. AND SUBSIDIARIES

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note 1 - Basis of Presentation (continued)

In June 2006, the FASB issued FASB Interpretation No. (FIN) 48, *Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109*. FIN 48 clarifies the accounting for uncertainty in income taxes recognized under SFAS No. 109, *Accounting for Income Taxes*. FIN 48 prescribes a recognition threshold and measurement attribute for financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return and also provides guidance on various related matters such as derecognition, interest and penalties, and disclosure. FIN 48 is effective with the Company's next fiscal year beginning January 1, 2007. The Company expects that the financial impact, if any, of applying the provisions of FIN 48 to all tax positions will not be material upon the initial adoption of FIN 48.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*. SFAS No. 157 defines fair value, establishes a framework for measuring fair value under GAAP and expands disclosures about fair value measurements. SFAS No. 157 applies to other accounting pronouncements that require or permit fair value measurements, but does not require any new fair value measurements. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. Early application is encouraged, provided that the reporting entity has not yet issued financial statements for an interim period within that fiscal year. The Company estimates that the initial application of SFAS No. 157 will not be material.

In September 2006, the FASB issued SFAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*. SFAS No. 158 amends SFAS No. 87, *Employers' Accounting for Pensions*, SFAS No. 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and Termination Benefits*, SFAS No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, and SFAS No. 132(R), *Employers' Disclosure about Pensions and Other Postretirement Benefits*. SFAS No. 158 requires the recognition of the funded status of a defined benefit postretirement plan (other than a multi-employer plan) as an asset or liability in the statement of financial position and the recognition of changes in the funded status through comprehensive income in the year in which such changes occur. The Company is required to initially apply the recognition provisions of SFAS No. 158 to the funded status of its defined benefit postretirement plans and to provide the required disclosures as of December 31, 2006. The Company has not yet determined the financial impact that the initial recognition of the funded status of its defined benefit postretirement plans will have on its financial position. However, had the Company been required to apply the provisions of SFAS No. 158 to the accounting for its defined benefit postretirement plans at December 31, 2005, it would have recognized a liability of \$35.1 million before tax for the unfunded status of such plans.

In addition, SFAS No. 158 requires that the funded status of a plan be measured as of the date of the year-end statement of financial position, with limited exceptions. The Company currently measures its funded status as of the date of the Company's fiscal year-end statement of financial position. Accordingly, adoption of the measurement provisions of SFAS No. 158 will have no impact on the Company.

Table of Contents**UNITRIN, INC. AND SUBSIDIARIES****NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited)****Note 2 - Catastrophe Reinsurance**

The Company maintains three separate catastrophe reinsurance programs for its property and casualty insurance businesses. Coverage for each reinsurance program is provided in three layers.

The annual program covering the Company's Unitrin Direct, Unitrin Specialty and Unitrin Business Insurance segments provides, effective January 1, 2006, reinsurance coverage of 100% of reinsured catastrophe losses of \$36 million above retention of \$4 million. In 2005, the annual program covering these segments also provided reinsurance coverage of 100% of reinsured catastrophe losses of \$36 million above retention of \$4 million. The aggregate annual premium, excluding reinstatement premium, for the 2006 annual program covering these segments is \$1.9 million, compared to an annual cost of \$1.5 million, excluding reinstatement premium, for the 2005 annual program. Catastrophe reinsurance premiums for this program reduced earned premiums by \$1.4 million for the nine months ended September 30, 2006, compared to \$1.2 million for the same period in 2005, including \$0.1 million of reinstatement premium recorded in the third quarter of 2005.

The annual program covering the property insurance operations of the Company's Life and Health Insurance segment provides, effective January 1, 2006, reinsurance coverage of 100% of reinsured catastrophe losses of \$90 million above retention of \$10 million. In 2005, the annual program covering this segment provided reinsurance coverage of 100% of reinsured catastrophe losses of \$52 million above retention of \$8 million. The aggregate annual premium, excluding reinstatement premium, for the 2006 annual program covering this segment is \$6.1 million, compared to an annual cost of \$2.7 million, excluding reinstatement premium, for the 2005 annual program. Catastrophe reinsurance premiums for this program reduced earned premiums by \$4.5 million for the nine months ended September 30, 2006, including an additional charge of \$0.2 million to reinstate reinsurance coverage due primarily to higher reinsured losses from Hurricane Katrina than previously anticipated. Catastrophe reinsurance premiums for this program reduced earned premiums by \$4.6 million for the nine months ended September 30, 2005, including \$2.6 million of reinstatement premium recorded in the third quarter of 2005.

The Company has renewed, effective July 1, 2006, the annual program covering the Company's Unitrin Kemper Auto and Home segment on terms that are substantially different from the prior annual program. Under Unitrin Kemper Auto and Home's new program, the first layer provides reinsurance coverage of approximately 65% of reinsured catastrophe losses of \$30 million above retention of \$40 million. The second layer provides reinsurance coverage of approximately 88% of reinsured catastrophe losses of \$80 million above retention of \$70 million. The third layer provides reinsurance coverage of approximately 80% of reinsured catastrophe losses of \$100 million above retention of \$150 million. The old program covering this segment, effective from July 1, 2005 to June 30, 2006, provided reinsurance coverage of 100% of reinsured catastrophe losses of \$160 million above retention of \$20 million. The aggregate annual premium, excluding reinstatement premium, for Unitrin Kemper Auto and Home's new annual program is \$19.5 million, compared to an annual cost of \$11.1 million, excluding reinstatement premium, for the old program. Catastrophe reinsurance premiums for these programs reduced earned premiums by \$10.6 million for the nine months ended September 30, 2006, including an additional charge of \$0.3 million to reinstate reinsurance coverage due primarily to higher reinsured losses from Hurricane Katrina than previously anticipated. Catastrophe reinsurance premiums for these programs reduced earned premiums by \$11.3 million for the nine months ended September 30, 2005, including \$3.8 million of reinstatement premium recorded in the third quarter of 2005.

In addition, in the event that the Company's incurred catastrophe losses and loss adjustment expenses (LAE) covered by any of its three catastrophe reinsurance programs exceed the retention for that particular program, each of the programs requires one reinstatement of such coverage. In such an instance, the Company is required to pay a reinstatement premium to the reinsurers to reinstate the full amount of reinsurance available under such program. The reinstatement premium is a percentage of the original premium based on the ratio of the losses exceeding the Company's retention to the reinsurers' coverage limit. In addition to these programs, the Company purchases reinsurance from the Florida Hurricane Catastrophe Fund (the FHCF) for hurricane losses in the state of Florida at retentions lower than those described above. Catastrophe reinsurance premiums for the FHCF reduced earned premiums in the Life and Health Insurance segment by \$0.2 million for the nine months ended September 30, 2006, compared to \$0.1 million for the same period in 2005. Catastrophe reinsurance premiums for the FHCF reduced earned premiums in the Unitrin Kemper Auto and Home segment by \$0.6 million for the nine months ended September 30, 2006, compared to \$0.3 million for the same period in 2005.

Table of Contents**UNITRIN, INC. AND SUBSIDIARIES****NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited)****Note 2 - Catastrophe Reinsurance (continued)**

Total catastrophe losses and LAE (including development), net of reinsurance recoveries, were \$42.9 million and \$8.7 million for the nine and three months ended September 30, 2006, respectively, compared to \$87.7 million and \$70.3 million for the same periods in 2005.

In the third quarter of 2005, two major hurricanes that significantly impacted the Company (Katrina and Rita) made landfall in the United States. A summary of the Company's losses and LAE, net of reinsurance recoveries, from Hurricanes Katrina and Rita initially recorded in the Company's Condensed Consolidated Statements of Income for the nine and three months ended September 30, 2005 by business segment were:

| (Dollars in Millions) | Katrina | Rita | Total |
|---|----------------|----------------|----------------|
| Unitrin Kemper Auto and Home | \$ 20.2 | \$ 20.0 | \$ 40.2 |
| Unitrin Specialty | 2.1 | 0.3 | 2.4 |
| Unitrin Direct | 0.2 | | 0.2 |
| Unitrin Business Insurance | 1.8 | 3.7 | 5.5 |
| Life and Health Insurance | 8.4 | 8.0 | 16.4 |
| Total Loss and LAE, Net of Reinsurance | \$ 32.7 | \$ 32.0 | \$ 64.7 |

As further described below, during the first half of 2006, the Company recorded adverse development of \$3.6 million, net of reinsurance recoveries, due primarily to increases in the Company's estimates of both direct losses and indirect residual market losses for these hurricanes. No development, net of reinsurance recoveries, was recorded for these hurricanes in the third quarter of 2006.

During the first quarter of 2006, the Company significantly increased its estimate of losses and LAE, before reinsurance recoveries, for Hurricane Katrina due primarily to an \$11.5 million increase in the estimate of assessed indirect losses from the Mississippi Windstorm Underwriting Association residual market. In the second quarter of 2006, the Company increased its estimate of losses and LAE, before reinsurance recoveries, for Hurricane Katrina due primarily to a \$3.9 million increase in the Company's estimate of direct losses in its Life and Health Insurance segment. In addition, the Company significantly increased its estimate of losses and LAE, before reinsurance recoveries, in 2006 for Hurricane Rita due primarily to an increase in the estimate of direct losses in the Company's Life and Health Insurance segment. The increase in the Company's estimate of losses and LAE from Hurricane Rita was offset entirely by reinsurance recoveries and, accordingly, had no impact on the Company's reported losses and LAE, net of reinsurance, or on net income for the nine and three months ended September 30, 2006. In addition to the adverse development, the Company also recorded additional reinstatement premiums of \$0.5 million for the nine months ended September 30, 2006.

The Company currently estimates that, as a result of Hurricane Katrina's landfall in Louisiana, Mississippi and Alabama, its Life and Health Insurance segment incurred losses and LAE of \$63.6 million, before reinsurance recoveries, which exceeded its initial retention of \$8 million and reinsurance coverage of \$52 million. The excess of \$3.6 million was recorded as adverse development for the nine months ended September 30, 2006. The process of estimating and establishing reserves for both direct losses and LAE and indirect residual market losses is inherently uncertain and the actual ultimate cost of losses and LAE, before reinsurance recoveries, may vary from the estimated amount reserved. Any further development of direct and indirect losses and LAE from Hurricane Katrina in the Life and Health Insurance segment would have an impact on net income.

The Company currently estimates that, as a result of Hurricane Rita's landfall in Texas and Louisiana, its Life and Health Insurance subsidiaries, together with Capitol County Mutual Fire Insurance Company (Capitol) (see Note 13, Relationships with Mutual Holding Companies and Mutual Insurance Companies, to the Condensed Consolidated Financial Statements), incurred losses and LAE of \$51.7 million, before reinsurance recoveries, or \$43.7 million of losses and LAE in excess of its retention of \$8 million.

Edgar Filing: UNITRIN INC - Form 10-Q

The Company currently estimates that, as a result of Hurricane Katrina's landfall in Louisiana, Mississippi and Alabama, its Unitrin Kemper Auto and Home segment incurred losses and LAE of \$43.4 million, before reinsurance recoveries, or \$23.4 million of losses and LAE in excess of its retention of \$20 million.

Table of Contents**UNITRIN, INC. AND SUBSIDIARIES****NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited)****Note 2 - Catastrophe Reinsurance (continued)**

The Company currently estimates that, as a result of Hurricane Rita's landfall in Texas and Louisiana, its Unitrin Kemper Auto and Home segment incurred losses and LAE of \$19.4 million, or \$0.6 million below its initial retention of \$20 million.

The Company currently estimates that, as a result of Hurricane Katrina's landfall in Louisiana, Mississippi and Alabama, the Unitrin Direct, Unitrin Specialty and Unitrin Business Insurance segments together incurred losses and LAE of \$4.9 million, before reinsurance recoveries, or \$0.9 million of losses and LAE in excess of their retention of \$4 million.

The Company currently estimates that, as a result of Hurricane Rita's landfall in Texas and Louisiana, the Unitrin Direct, Unitrin Specialty and Unitrin Business Insurance segments together incurred losses and LAE of \$4.6 million, before reinsurance recoveries, or \$0.6 million of losses and LAE in excess of their retention of \$4 million.

Note 3 - Notes Payable

Total Debt Outstanding at September 30, 2006 and December 31, 2005 was:

| (Dollars in Millions) | Sept. 30, 2006 | Dec. 31, 2005 |
|--|---------------------------|--------------------------|
| Senior Notes at Amortized Cost: | | |
| 5.75% Senior Notes due July 1, 2007 | \$ 299.5 | \$ 299.0 |
| 4.875% Senior Notes due November 1, 2010 | 198.7 | 198.5 |
| Mortgage Note Payable at Amortized Cost | 6.1 | 6.1 |
| Total Debt Outstanding | \$ 504.3 | \$ 503.6 |

On June 24, 2005, the Company entered into a five-year, \$325 million, unsecured, revolving credit agreement, expiring June 30, 2010, with a group of financial institutions. The agreement provides for fixed and floating rate advances for periods up to one year at various interest rates. The agreement also contains various financial covenants, including limits on total debt to total capitalization and minimum risk-based capital ratios for the Company's largest insurance subsidiaries. The proceeds from advances under the revolving credit facility may be used for general corporate purposes. The new revolving credit agreement replaced the Company's former \$360 million revolving credit agreement which would have expired on August 30, 2005, but was terminated as of June 24, 2005. The Company had no outstanding advances under its unsecured, revolving credit agreements at September 30, 2006 or December 31, 2005. Undrawn letters of credit issued pursuant to the unsecured, revolving credit agreement were \$13.1 million and \$13.4 million at September 30, 2006 and December 31, 2005, respectively. Accordingly, the amounts available for future borrowing were \$311.9 million and \$311.6 million at September 30, 2006 and December 31, 2005, respectively.

Interest Paid, including facility fees, for the nine and three months ended September 30, 2006 and 2005 was:

| (Dollars in Millions) | Nine Months Ended | | Three Months Ended | |
|---|---------------------------|---------------------------|---------------------------|---------------------------|
| | Sept. 30, 2006 | Sept. 30, 2005 | Sept. 30, 2006 | Sept. 30, 2005 |
| Notes Payable under Revolving Credit Agreements | \$ 0.3 | \$ 0.5 | \$ | \$ 0.2 |
| 5.75% Senior Notes due July 1, 2007 | 17.2 | 17.2 | 8.6 | 8.6 |
| 4.875% Senior Notes due November 1, 2010 | 4.9 | 4.9 | | |
| Mortgage Note Payable | 0.3 | 0.3 | 0.1 | 0.1 |

Edgar Filing: UNITRIN INC - Form 10-Q

| | | | | |
|---------------------|---------|---------|--------|--------|
| Total Interest Paid | \$ 22.7 | \$ 22.9 | \$ 8.7 | \$ 8.9 |
|---------------------|---------|---------|--------|--------|

Table of Contents**UNITRIN, INC. AND SUBSIDIARIES****NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited)****Note 3 - Notes Payable (continued)**

Interest Expense, including facility fees and accretion of discount, for the nine and three months ended September 30, 2006 and 2005 was:

| | Nine Months Ended | | Three Months Ended | |
|---|-------------------|----------------|--------------------|---------------|
| | Sept. 30, | Sept. 30, | Sept. 30, | Sept. 30, |
| (Dollars in Millions) | 2006 | 2005 | 2006 | 2005 |
| Notes Payable under Revolving Credit Agreements | \$ 0.3 | \$ 0.4 | \$ | \$ 0.1 |
| 5.75% Senior Notes due July 1, 2007 | 13.5 | 13.4 | 4.6 | 4.5 |
| 4.875% Senior Notes due November 1, 2010 | 7.5 | 7.5 | 2.5 | 2.5 |
| Mortgage Note Payable | 0.3 | 0.3 | 0.1 | 0.1 |
| Total Interest Expense | \$ 21.6 | \$ 21.6 | \$ 7.2 | \$ 7.2 |

Note 4 - Net Income Per Share

Net Income Per Share and Net Income Per Share Assuming Dilution for the nine and three months ended September 30, 2006 and 2005 were as follows:

| | Nine Months Ended | | Three Months Ended | |
|---|-------------------|-----------------|--------------------|----------------|
| | Sept. 30, | Sept. 30, | Sept. 30, | Sept. 30, |
| (Dollars and Shares in Millions, Except Per Share Amounts) | 2006 | 2005 | 2006 | 2005 |
| Net Income | \$ 221.5 | \$ 168.8 | \$ 86.1 | \$ 22.7 |
| Dilutive Effect on Net Income from Investee s Equivalent Shares | (0.2) | (0.1) | | (0.1) |
| Net Income Assuming Dilution | \$ 221.3 | \$ 168.7 | \$ 86.1 | \$ 22.6 |
| Weighted Average Common Shares Outstanding | 68.2 | 69.1 | 67.7 | 69.3 |
| Dilutive Effect of Unitrin Share-based Compensation Plans | 0.3 | 0.6 | 0.2 | 0.6 |
| Weighted Average Common Shares and Equivalent Shares Outstanding Assuming Dilution | 68.5 | 69.7 | 67.9 | 69.9 |
| Net Income Per Share | \$ 3.25 | \$ 2.44 | \$ 1.27 | \$ 0.33 |
| Net Income Per Share Assuming Dilution | \$ 3.23 | \$ 2.42 | \$ 1.27 | \$ 0.32 |

Options outstanding at September 30, 2006 and 2005 to purchase 3.6 million shares and 0.6 million shares, respectively, of Unitrin common stock were excluded from the computation of Net Income Per Share Assuming Dilution for the nine months ended September 30, 2006 and 2005, respectively, because the exercise prices exceeded the average market price.

Table of Contents**UNITRIN, INC. AND SUBSIDIARIES****NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited)****Note 5 - Other Comprehensive Income (Loss)**

Other Comprehensive Income (Loss) for the nine and three months ended September 30, 2006 and 2005 was:

| (Dollars in Millions) | Nine Months Ended | | Three Months Ended | |
|---|--------------------------|------------------|---------------------------|------------------|
| | Sept. 30, | Sept. 30, | Sept. 30, | Sept. 30, |
| | 2006 | 2005 | 2006 | 2005 |
| Gross Unrealized Holding Gains (Losses) Arising During Period from: | | | | |
| Fixed Maturities | \$ (32.8) | \$ (16.1) | \$ 108.8 | \$ (84.8) |
| Northrop Preferred Stock | 10.3 | (19.6) | 11.5 | (7.2) |
| Northrop Common Stock | 59.8 | (0.1) | 29.6 | (7.1) |
| Other Equity Securities | 32.2 | 22.9 | 11.9 | 13.0 |
| Other | (2.4) | 0.5 | 0.6 | (1.6) |
| Gross Unrealized Holding Gains (Losses) Arising During Period | 67.1 | (12.4) | 162.4 | (87.7) |
| Income Tax Benefit (Expense) | (23.5) | 4.4 | (57.0) | 30.8 |
| Unrealized Holding Gains (Losses) Arising During Period, Net | 43.6 | (8.0) | 105.4 | (56.9) |
| Reclassification Adjustment for Gross (Gains) Losses Realized in Net Income: | | | | |
| Fixed Maturities | 0.3 | (0.8) | (2.0) | (0.2) |
| Northrop Common Stock | (5.6) | | | |
| Other Equity Securities | (18.4) | (13.1) | (1.1) | (7.3) |
| Reclassification Adjustment for Gross (Gains) Losses Realized in Net Income | (23.7) | (13.9) | (3.1) | (7.5) |
| Income Tax Expense (Benefit) | 8.3 | 4.9 | 1.1 | 2.6 |
| Reclassification Adjustment for Gross (Gains) Losses Realized in Net Income, Net | (15.4) | (9.0) | (2.0) | (4.9) |
| Other Comprehensive Income (Loss) | \$ 28.2 | \$ (17.0) | \$ 103.4 | \$ (61.8) |

Total Comprehensive Income for the nine months ended September 30, 2006 and 2005 was \$249.7 million and \$151.8 million, respectively. Total Comprehensive Income for the three months ended September 30, 2006 was \$189.5 million. Total Comprehensive Loss for the three months ended September 30, 2005 was \$39.1 million.

Table of Contents**UNITRIN, INC. AND SUBSIDIARIES****NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited)****Note 6 - Income from Investments**

Net Investment Income for the nine and three months ended September 30, 2006 and 2005 was:

| (Dollars in Millions) | Nine Months Ended | | Three Months Ended | |
|--|--------------------------|------------------|---------------------------|------------------|
| | Sept. 30, | Sept. 30, | Sept. 30, | Sept. 30, |
| | 2006 | 2005 | 2006 | 2005 |
| Investment Income: | | | | |
| Interest and Dividends on Fixed Maturities | \$ 158.2 | \$ 156.8 | \$ 53.4 | \$ 52.5 |
| Dividends on Northrop Preferred Stock | 9.3 | 9.3 | 6.2 | 3.1 |
| Dividends on Northrop Common Stock | 6.4 | 5.9 | 2.2 | 2.0 |
| Dividends on Other Equity Securities | 7.9 | 8.8 | 2.6 | 2.8 |
| Short-term Investments | 19.4 | 8.8 | 6.8 | 3.6 |
| Real Estate | 20.7 | 19.0 | 6.9 | 5.8 |
| Other | 23.9 | 15.5 | 5.3 | 2.5 |
| Total Investment Income | 245.8 | 224.1 | 83.4 | 72.3 |
| Real Estate and Other Investment Expenses | 16.7 | 15.0 | 5.6 | 4.5 |
| Net Investment Income | \$ 229.1 | \$ 209.1 | \$ 77.8 | \$ 67.8 |

Dividend income from the Company's investment in Northrop Grumman Corporation (Northrop) preferred stock increased for the three months ended September 30, 2006, compared to the same period in 2005, due to the timing of the ex-dividend date.

The components of Net Realized Investment Gains for the nine and three months ended September 30, 2006 and 2005 were:

| (Dollars in Millions) | Nine Months Ended | | Three Months Ended | |
|--------------------------------------|--------------------------|------------------|---------------------------|------------------|
| | Sept. 30, | Sept. 30, | Sept. 30, | Sept. 30, |
| | 2006 | 2005 | 2006 | 2005 |
| Fixed Maturities: | | | | |
| Gains on Dispositions | \$ 4.1 | \$ 1.2 | \$ 2.1 | \$ 0.2 |
| Losses on Dispositions | (4.4) | (0.4) | | |
| Northrop Common Stock: | | | | |
| Gains on Dispositions | 5.6 | | | |
| Other Equity Securities: | | | | |
| Gains on Dispositions | 21.6 | 21.1 | 1.8 | 9.6 |
| Losses on Dispositions | (1.1) | (1.8) | (0.3) | (1.3) |
| Losses from Write-downs | (2.1) | (6.2) | (0.4) | (1.0) |
| Real Estate: | | | | |
| Gains on Dispositions | | 39.4 | | |
| Losses from Write-downs | (0.1) | | (0.1) | |
| Other Investments: | | | | |
| Gains on Dispositions | 0.4 | 0.6 | 0.1 | 0.3 |
| Losses on Dispositions | (0.3) | (0.4) | (0.1) | |
| Net Realized Investment Gains | \$ 23.7 | \$ 53.5 | \$ 3.1 | \$ 7.8 |

Table of Contents**UNITRIN, INC. AND SUBSIDIARIES****NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited)****Note 7 - Pension Benefits and Postretirement Benefits Other Than Pensions**

The components of Pension Expense for the nine and three months ended September 30, 2006 and 2005 were:

| (Dollars in Millions) | Nine Months Ended | | Three Months Ended | |
|--|-------------------|-------------------|--------------------|-------------------|
| | Sept. 30, 2006 | Sept. 30, 2005 | Sept. 30, 2006 | Sept. 30, 2005 |
| Service Cost Benefits Earned | \$ 10.5 | \$ 9.6 | \$ 3.5 | \$ 3.2 |
| Interest Cost on Projected Benefit Obligations | 14.2 | 13.7 | 4.7 | 4.5 |
| Expected Return on Plan Assets | (17.0) | (15.4) | (5.7) | (5.1) |
| Net Amortization and Deferral | 1.4 | (0.1) | 0.5 | |
| Total Pension Expense | \$ 9.1 | \$ 7.8 | \$ 3.0 | \$ 2.6 |

The components of Postretirement Benefits Other than Pension Expense for the nine and three months ended September 30, 2006 and 2005 were:

| (Dollars in Millions) | Nine Months Ended | | Three Months Ended | |
|---|-------------------|-------------------|--------------------|-------------------|
| | Sept. 30, 2006 | Sept. 30, 2005 | Sept. 30, 2006 | Sept. 30, 2005 |
| Service Cost Benefits Earned | \$ 0.1 | \$ 0.2 | \$ | \$ 0.1 |
| Interest Cost on Projected Benefit Obligations | 1.9 | 2.0 | 0.6 | 0.7 |
| Net Amortization and Deferral | (1.4) | (1.4) | (0.4) | (0.5) |
| Total Postretirement Benefits Other than Pension Expense | \$ 0.6 | \$ 0.8 | \$ 0.2 | \$ 0.3 |

Note 8 - Long-term Equity Compensation Plans

The Company has four stock option plans, all of which have been approved by the Company's shareholders. Stock options to purchase the Company's common stock are granted at prices equal to the fair market value of the Company's common stock on the date of grant to both employees and directors. Employee options generally vest over a period of three and one-half years and expire ten years from the date of grant. Beginning in 2003, options granted to employees were coupled with tandem stock appreciation rights (SAR), settled in Company stock. Options granted to directors are exercisable one year from the date of grant and expire ten years from the date of grant. At September 30, 2006, options to purchase 5,419,249 shares of the Company's common stock were outstanding and options to purchase 2,186,034 shares of the Company's common stock were available for future grants under the Company's four stock option plans.

To encourage stock ownership, the Company's four stock option plans include provisions, subject to certain limitations beginning in 2006 as described below, to automatically grant restorative, or reload stock options (Restorative Options), to replace shares of previously owned Unitrin common stock that an exercising option holder surrenders, either actually or constructively, in order to satisfy the exercise price and/or tax withholding obligations relating to the exercise. Restorative Options are subject to the same terms and conditions as the original options, including the expiration date, except that the exercise price is equal to the fair market value of Unitrin common stock on the date of grant and cannot be exercised until six months after the date of grant.

Table of Contents**UNITRIN, INC. AND SUBSIDIARIES****NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited)****Note 8 - Long-term Equity Compensation Plans (continued)**

For original awards granted beginning in 2006 and Restorative Options granted thereunder, Restorative Options will be granted only if, on the date of exercise of the option giving rise to the Restorative Option, the market price of Unitrin common stock exceeds such option's exercise price by 15%. Further, no Restorative Options will be granted if the option giving rise to the Restorative Option is set to expire within twelve months.

In addition, the Company has a restricted stock plan, which has been approved by the Company's shareholders. Under this plan, restricted stock and restricted stock units may be granted to all eligible employees. Recipients of restricted stock are entitled to full dividend and voting rights and all awards are subject to forfeiture until certain restrictions have lapsed. As of September 30, 2006, 131,150 shares of restricted stock having a weighted-average grant date fair value of \$46.56 have been awarded, of which 1,125 shares were forfeited and 6,558 were tendered to satisfy tax withholding obligations. 876,533 common shares remain available for future grants under the Company's restricted stock plan.

The Company uses the Black-Scholes option pricing model to estimate the fair value of each option on the date of grant. The expected terms of options are developed by considering the Company's historical share option exercise experience, demographic profiles, historical share retention practices of employees and assumptions about their propensity for early exercise in the future. Further, the Company aggregates individual awards into relatively homogenous groups that exhibit similar exercise behavior in order to obtain a more refined estimate of the expected term of options. Expected volatility is estimated using weekly historical volatility. The Company believes that historical volatility is currently the best estimate of expected volatility. The dividend yield is the annualized yield on Unitrin common stock on the date of grant for original grants. For Restorative Options, the annualized yield on Unitrin common stock for the month prior to the grant of the Restorative Option is used. No assumption for any future dividend rate change is included in the current expected dividend yield assumption. The risk free interest rate is the yield on the grant date of U.S. Treasury zero coupon issues with a maturity comparable to the expected term of the option. The assumptions used in the Black-Scholes pricing model for options granted during the nine months ended September 30, 2006 and 2005 were as follows:

| | Nine Months Ended | |
|---------------------------------------|-----------------------|-----------------------|
| | September 30, 2006 | September 30, 2005 |
| Range of Valuation Assumptions | | |
| Expected Volatility | 19.27% - 23.60% | 19.51% - 24.26% |
| Risk Free Interest Rate | 4.30% - 5.14% | 2.90% - 4.21% |
| Expected Dividend Yield | 3.55% - 4.25% | 4.49% - 4.65% |
| Weighted-Average Expected Life | | |
| Employee Grants | 2 - 7 years | 1 - 7 years |
| Director Grants | 4 - 6 years | 8 years |

Table of Contents**UNITRIN, INC. AND SUBSIDIARIES****NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited)****Note 8 - Long-term Equity Compensation Plans (continued)**

Option and SAR activity for the nine months ended September 30, 2006 is presented below:

| | Shares Subject to Options | Weighted- Average Exercise Price Per Share | Weighted- Average Remaining Contractual Life (in Years) | Aggregate Intrinsic Value (\$ in Millions) |
|--------------------------------------|---------------------------------|---|---|---|
| Outstanding at Beginning of the Year | 5,181,175 | \$ 42.61 | | |
| Granted | 1,131,924 | 46.97 | | |
| Exercised | (815,047) | 36.29 | | |
| Forfeited or Expired | (78,803) | 43.27 | | |
| Outstanding at September 30, 2006 | 5,419,249 | \$ 44.47 | 5.76 | \$ 9.2 |
| Exercisable at September 30, 2006 | 4,003,864 | \$ 44.08 | 5.07 | \$ 8.6 |

Activity related to non-vested restricted stock and stock options for the nine months ended September 30, 2006 is presented below:

| | Restricted Shares | Weighted- Average Grant-Date Fair Value Per Share | Stock Options | Weighted- Average Grant-Date Fair Value Per Option |
|--|----------------------|---|------------------|---|
| Nonvested Balance at Beginning of the Year | 750 | \$ 47.06 | 2,187,430 | \$ 5.44 |
| Granted | 130,400 | 46.56 | 1,131,924 | 6.58 |
| Vested | (20,949) | 47.86 | (1,858,582) | 5.06 |
| Forfeited | (1,125) | 47.86 | (45,387) | 6.90 |
| Nonvested Balance at September 30, 2006 | 109,076 | \$ 47.85 | 1,415,385 | \$ 6.82 |

For awards with a graded vesting schedule, the Company recognizes compensation expense on a straight-line basis over the requisite service period for each separately vesting portion of the awards as if each award were, in-substance, multiple awards. Compensation expense is recognized only for those awards expected to vest, with forfeitures estimated at the date of grant based on the Company's historical experience and future expectations. Share-based compensation expense was \$9.4 million and \$2.7 million for the nine and three months ended September 30, 2006, respectively. Share-based compensation expense was \$9.2 million and \$3.3 million for the nine and three months ended September 30, 2005, respectively. Total unamortized compensation expense related to nonvested awards at September 30, 2006 was \$8.5 million, which is expected to be recognized over a weighted-average period of approximately 1.8 years.

Total intrinsic value of stock options exercised was \$8.0 million and \$24.4 million for the nine months ended September 30, 2006 and 2005, respectively. Cash received from option exercises was \$4.0 million and \$15.2 million for the nine months ended September 30, 2006 and 2005, respectively. Total tax benefits realized for tax deductions from option exercises were \$3.0 million and \$8.6 million for the nine months ended September 30, 2006 and 2005, respectively.

Edgar Filing: UNITRIN INC - Form 10-Q

The total fair value of restricted stock that vested during the nine months ended September 30, 2006 was \$0.9 million and the tax benefits for tax deductions realized from the vesting of restricted stock was \$0.3 million.

Table of Contents

UNITRIN, INC. AND SUBSIDIARIES

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note 9 - Income Taxes

At December 31, 2005, the Company had not provided Federal income taxes on \$15 million of income earned prior to 1984 by one of the Company's life insurance subsidiaries (the Pre-1984 Undistributed Income). Under tax laws applicable to years 2004 and prior, such income would not be subject to Federal income taxes under certain circumstances. Federal income taxes could have been incurred on such income if it had been distributed to shareholders or if other limitations were not met. The American Jobs Creation Act of 2004 (AJCA) has effectively suspended the taxation of this income for years 2005 and 2006. Furthermore, to the extent qualifying distributions can be made in 2006 out of the affected life insurance subsidiary, the Company can eliminate any or all of this income that would potentially be subject to tax in years after 2006. The Company's affected life insurance subsidiary made a qualifying distribution during the third quarter of 2006 in order to eliminate all of its remaining Pre-1984 Undistributed Income. The Company currently did not incur income taxes on such qualifying distribution due to the suspension of taxation described above. During 2005, two of the Company's other life insurance subsidiaries made qualifying distributions of their Pre-1984 Undistributed Income and eliminated \$177 million of income that would have been potentially subject to tax in years after 2006. There was no impact on income tax expense in 2005 for these qualifying distributions.

Income taxes paid were \$94.8 million for the nine months ended September 30, 2006, compared to \$62.8 million for the same period in 2005.

Note 10 - Business Segments

The Company is engaged, through its subsidiaries, in the property and casualty insurance, life and health insurance and consumer finance businesses. The Company conducts its operations through six operating segments: Unitrin Kemper Auto and Home, Unitrin Specialty, Unitrin Direct, Unitrin Business Insurance, Life and Health Insurance and Consumer Finance.

The Unitrin Kemper Auto and Home segment provides preferred and standard risk personal automobile and homeowners insurance through networks of independent agents. The Unitrin Specialty segment provides automobile insurance to individuals and businesses in the non-standard and specialty markets through networks of independent agents. The non-standard automobile insurance market consists of individuals and companies that have difficulty obtaining standard or preferred risk insurance, usually because of their driving records. Unitrin Direct markets personal automobile insurance through direct mail, television and the Internet through web insurance portals, click-thrus and its own website. The Unitrin Business Insurance segment provides commercial automobile, general liability, commercial fire, commercial multi-peril and workers' compensation insurance. Its products are designed and priced for those businesses that have demonstrated favorable risk characteristics and loss histories and are sold by independent agents. The Life and Health Insurance segment provides individual life, accident, health and hospitalization insurance. The Company's Life and Health Insurance employee-agents also market property insurance products under common management. The Consumer Finance segment makes consumer loans primarily for the purchase of pre-owned automobiles and offers certificates of deposits.

It is the Company's management practice to allocate certain corporate expenses to its operating units. The Company considers the management of certain investments, Northrop common and preferred stock, Baker Hughes, Inc. common stock and Intermec, Inc. common stock, to be a corporate responsibility. Accordingly, the Company does not allocate income from these investments to its operating segments. The Company does not allocate Net Realized Investment Gains to its operating segments.

Table of Contents**UNITRIN, INC. AND SUBSIDIARIES****NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited)****Note 10 - Business Segments (continued)**

Segment Revenues for the nine and three months ended September 30, 2006 and 2005 were:

| (Dollars in Millions) | Nine Months Ended | | Three Months Ended | |
|---|--------------------------|------------------|---------------------------|------------------|
| | Sept. 30, | Sept. 30, | Sept. 30, | Sept. 30, |
| | 2006 | 2005 | 2006 | 2005 |
| Revenues: | | | | |
| Unitrin Kemper Auto and Home: | | | | |
| Earned Premiums | \$ 708.1 | \$ 705.8 | \$ 237.6 | \$ 235.9 |
| Net Investment Income | 36.7 | 35.0 | 11.5 | 11.4 |
| Other Income | 0.3 | 0.4 | 0.1 | |
| Total Unitrin Kemper Auto and Home | 745.1 | 741.2 | 249.2 | 247.3 |
| Unitrin Specialty: | | | | |
| Earned Premiums | 333.3 | 341.6 | 111.7 | 113.5 |
| Net Investment Income | 16.3 | 15.1 | 5.0 | 4.8 |
| Total Unitrin Specialty | 349.6 | 356.7 | 116.7 | 118.3 |
| Unitrin Direct: | | | | |
| Earned Premiums | 168.9 | 165.3 | 57.7 | 56.4 |
| Net Investment Income | 6.7 | 6.4 | 2.1 | 2.0 |
| Other Income | 0.2 | 0.1 | | |
| Total Unitrin Direct | 175.8 | 171.8 | 59.8 | 58.4 |
| Unitrin Business Insurance: | | | | |
| Earned Premiums | 140.5 | 142.6 | 46.9 | 48.2 |
| Net Investment Income | 21.1 | 21.0 | 6.4 | 6.5 |
| Other Income | 1.3 | | | |
| Total Unitrin Business Insurance | 162.9 | 163.6 | 53.3 | 54.7 |
| Life and Health Insurance: | | | | |
| Earned Premiums | 509.0 | 503.5 | 168.1 | 166.6 |
| Net Investment Income | 132.1 | 116.7 | 43.8 | 37.5 |
| Other Income | 11.0 | 5.2 | 11.0 | 0.5 |
| Total Life and Health Insurance | 652.1 | 625.4 | 222.9 | 204.6 |
| Consumer Finance | 184.3 | 163.2 | 64.3 | 56.7 |
| Total Segment Revenues | 2,269.8 | 2,221.9 | 766.2 | 740.0 |
| Unallocated Dividend Income | 15.9 | 15.6 | 8.5 | 5.3 |

Edgar Filing: UNITRIN INC - Form 10-Q

| | | | | |
|-------------------------------|------------|------------|----------|----------|
| Net Realized Investment Gains | 23.7 | 53.5 | 3.1 | 7.8 |
| Other | 2.2 | 1.2 | 1.1 | 1.0 |
| Total Revenues | \$ 2,311.6 | \$ 2,292.2 | \$ 778.9 | \$ 754.1 |

Table of Contents**UNITRIN, INC. AND SUBSIDIARIES****NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited)****Note 10 - Business Segments (continued)**

Segment Operating Profit for the nine and three months ended September 30, 2006 and 2005 was:

| (Dollars in Millions) | Nine Months Ended | | Three Months Ended | |
|--|--------------------------|------------------|---------------------------|------------------|
| | Sept. 30, | Sept. 30, | Sept. 30, | Sept. 30, |
| | 2006 | 2005 | 2006 | 2005 |
| Segment Operating Profit (Loss): | | | | |
| Unitrin Kemper Auto and Home | \$ 112.7 | \$ 35.6 | \$ 46.4 | \$ (13.9) |
| Unitrin Specialty | 28.3 | 32.2 | 8.9 | 9.6 |
| Unitrin Direct | (5.9) | 1.5 | (3.6) | 0.6 |
| Unitrin Business Insurance | 9.9 | 11.0 | 6.2 | (2.6) |
| Life and Health Insurance | 102.7 | 64.4 | 47.2 | 11.4 |
| Consumer Finance | 38.0 | 38.1 | 10.5 | 13.5 |
| Total Segment Operating Profit | 285.7 | 182.8 | 115.6 | 18.6 |
| Unallocated Dividend Income | 15.9 | 15.6 | 8.5 | 5.3 |
| Net Realized Investment Gains | 23.7 | 53.5 | 3.1 | 7.8 |
| Other Expense, Net | (19.9) | (21.8) | (6.1) | (7.1) |
| Income Before Income Taxes and Equity in Net Income of Investee | \$ 305.4 | \$ 230.1 | \$ 121.1 | \$ 24.6 |

Segment Net Income for the nine and three months ended September 30, 2006 and 2005 was:

| (Dollars in Millions) | Nine Months Ended | | Three Months Ended | |
|---|--------------------------|------------------|---------------------------|------------------|
| | Sept. 30, | Sept. 30, | Sept. 30, | Sept. 30, |
| | 2006 | 2005 | 2006 | 2005 |
| Segment Net Income (Loss): | | | | |
| Unitrin Kemper Auto and Home | \$ 79.6 | \$ 29.4 | \$ 32.3 | \$ (6.9) |
| Unitrin Specialty | 21.3 | 23.6 | 6.8 | 7.1 |
| Unitrin Direct | (2.7) | 2.1 | (2.0) | 0.7 |
| Unitrin Business Insurance | 10.2 | 10.7 | 5.3 | (0.5) |
| Life and Health Insurance | 66.5 | 41.9 | 30.6 | 7.7 |
| Consumer Finance | 22.0 | 22.1 | 5.8 | 7.9 |
| Total Segment Net Income | 196.9 | 129.8 | 78.8 | 16.0 |
| Net Income (Loss) From: | | | | |
| Unallocated Dividend Income | 14.0 | 13.8 | 7.5 | 4.7 |
| Net Realized Investment Gains | 15.4 | 34.7 | 2.0 | 5.0 |
| Other Expense, Net | (13.4) | (14.2) | (3.6) | (4.6) |
| Income Before Equity in Net Income of Investee | 212.9 | 164.1 | 84.7 | 21.1 |
| Equity in Net Income of Investee | 8.6 | 4.7 | 1.4 | 1.6 |
| Net Income | \$ 221.5 | \$ 168.8 | \$ 86.1 | \$ 22.7 |

Table of Contents**UNITRIN, INC. AND SUBSIDIARIES****NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited)****Note 10 - Business Segments (continued)**

Earned Premiums by product line for the nine and three months ended September 30, 2006 and 2005 were:

| (Dollars in Millions) | Nine Months Ended Sept. 30, | | Three Months Ended Sept. 30, | |
|--------------------------------|--------------------------------|------------|---------------------------------|----------|
| | 2006 | 2005 | 2006 | 2005 |
| Life | \$ 301.8 | \$ 304.3 | \$ 99.3 | \$ 101.1 |
| Accident and Health | 119.3 | 120.7 | 39.5 | 40.6 |
| Property and Casualty: | | | | |
| Personal Lines: | | | | |
| Automobile | 872.0 | 884.2 | 294.1 | 295.9 |
| Homeowners | 300.6 | 281.7 | 100.6 | 91.6 |
| Other Personal | 36.3 | 35.0 | 11.7 | 12.1 |
| Total Personal Lines | 1,208.9 | 1,200.9 | 406.4 | 399.6 |
| Commercial Lines: | | | | |
| Automobile | 133.3 | 137.3 | 44.4 | 47.0 |
| Property and Liability | 63.3 | 62.6 | 21.3 | 21.3 |
| Workers Compensation | 14.9 | 16.0 | 4.9 | 5.3 |
| Commercial Reinsurance Program | 18.3 | 17.0 | 6.2 | 5.7 |
| Total Commercial Lines | 229.8 | 232.9 | 76.8 | 79.3 |
| Total Earned Premiums | \$ 1,859.8 | \$ 1,858.8 | \$ 622.0 | \$ 620.6 |

Note 11 - Related Party Transactions

One of Unitrin's directors, Mr. Fayez Sarofim, is the Chairman of the Board, President and the majority shareholder of Fayeze Sarofim & Co. (FS&C), a registered investment advisory firm. Certain of the Company's insurance company subsidiaries and FS&C are parties to agreements under which FS&C provides investment management services. In addition, FS&C provides investment management services with respect to certain funds of the Company's pension plans. The agreements governing these arrangements are terminable by either party at any time upon 30 days advance written notice.

Under these investment advisory arrangements, FS&C is entitled to a fee calculated and payable quarterly based upon the fair market value of the assets under management. At September 30, 2006, the Company's subsidiaries and the Company's pension plans had \$193.5 million and \$86.3 million, respectively, in investments managed by FS&C. During the first nine months of 2006, the Company's subsidiaries and the Company's pension plans paid \$0.5 million in the aggregate to FS&C. During the first nine months of 2005, the Company's subsidiaries and the Company's pension plans paid \$0.5 million in the aggregate to FS&C.

With respect to the Company's 401(k) Savings Plan, one of the investment choices afforded to participants is the Dreyfus Appreciation Fund, an open-end, diversified managed investment fund. FS&C provides investment management services to the Dreyfus Appreciation Fund as a sub-investment advisor. According to published reports filed by FS&C with the SEC, the Dreyfus Appreciation Fund pays monthly fees to FS&C according to a graduated schedule computed at an annual rate based on the value of the Dreyfus Appreciation Fund's average daily net assets. The Company does not compensate FS&C for services provided to the Dreyfus Appreciation Fund. As of September 30, 2006,

Edgar Filing: UNITRIN INC - Form 10-Q

participants in the Company's 401(k) Savings Plan had allocated \$25.8 million for investment in the Dreyfus Appreciation Fund, representing 10% of the total amount invested in the Company's 401(k) Savings Plan.

Table of Contents

UNITRIN, INC. AND SUBSIDIARIES

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note 11 - Related Party Transactions (continued)

The Company believes that the transactions described above have been entered into on terms no less favorable than could have been negotiated with non-affiliated third parties.

As described in Note 13 - Relationships with Mutual Insurance Holding Companies and Mutual Insurance Companies, to the Condensed Consolidated Financial Statements, the Company also has certain relationships with mutual insurance holding companies and mutual insurance companies. Such companies are owned by the policyholders of such companies or their insurance subsidiaries.

Note 12 - Legal Proceedings

In the ordinary course of their businesses, the Company and its subsidiaries are involved in a number of legal proceedings, including lawsuits and regulatory examinations. Some of these proceedings include matters particular to the Company or one or more of its subsidiaries, while other matters pertain to business practices in the industries in which the Company or its subsidiaries operate. Many of these matters raise complicated issues and are subject to uncertainties and difficulties, including but not limited to: (i) the underlying facts of the matter; (ii) unsettled questions of law; (iii) issues unique to the jurisdiction where the matter is pending; (iv) damage claims, including claims for punitive damages, that are disproportionate to the actual economic loss incurred; and (v) the general legal and regulatory environment faced by large corporations generally and the insurance and banking sectors specifically. Additionally, some of the lawsuits seek class action status that, if granted, could expose the Company or its subsidiaries to potentially significant liability by virtue of the size of the putative classes. Accordingly, the outcomes of these matters are difficult to predict, and the amounts or ranges of potential loss at particular points in time are in most cases difficult or impossible to ascertain with any degree of certainty.

The Company believes that resolution of its pending legal proceedings will not have a material adverse effect on the Company's financial position. However, given the unpredictability of the legal process, there can be no assurance that one or more of these matters will not produce a loss which could have a material adverse effect on the Company's financial results for any given period.

Note 13 - Relationships with Mutual Insurance Holding Companies and Mutual Insurance Companies

Unitrin's subsidiary, Trinity Universal Insurance Company (Trinity) and Milwaukee Insurance Company (MIC) are parties to a quota share reinsurance agreement whereby Trinity assumes 95% of the business written or assumed by MIC. MIC is owned by Mutual Insurers Holding Company (MIHC), which in turn is owned by MIC's policyholders. Effective July 1, 2001, MIC and First NonProfit Insurance Company (through its predecessor, First NonProfit Mutual Insurance Company) (FNP) are parties to a quota share reinsurance agreement whereby MIC assumes 80% of certain business written or assumed by FNP. Pursuant to an amendment to the MIC/FNP reinsurance agreement, which became effective January 1, 2003, FNP agrees to arrange for its parent company, First NonProfit Mutual Holding Company (FNMHC), to nominate a simple majority to the FNMHC board of directors selected by MIC. On January 15, 2003, FNMHC elected five employees of the Company, as selected by MIC, to the FNMHC board of directors pursuant to the terms of the amendment. All such employees continued to serve as directors of FNMHC until August 2006, when they resigned from the FNMHC board of directors. FNP is owned by FNMHC, which in turn is owned by FNP's policyholders. Five employees of the Company also serve as directors of MIHC's nine member board of directors. Two employees of the Company also serve as directors of MIC, but together do not constitute a majority of MIC's board of directors. The quota share agreements can be terminated at anytime by any of the parties to the respective agreements, subject to the notice requirements in such agreements.

Table of Contents

UNITRIN, INC. AND SUBSIDIARIES

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note 13 - Relationships with Mutual Insurance Holding Companies and Mutual Insurance Companies (continued)

Trinity and Capitol are parties to a quota share reinsurance agreement whereby, effective August 1, 2005, Trinity assumes 100% of the business written by Capitol. Prior to August 1, 2005, Trinity assumed 95% of the business written by Capitol. Capitol is a mutual insurance company and, accordingly, is owned by its policyholders. Five employees of the Company serve as directors of Capitol's five member board of directors. Nine employees of the Company also serve as directors of Capitol's wholly-owned subsidiary's, Old Reliable Casualty Company's (ORCC), nine member board of directors.

Trinity and ORCC are parties to a quota share reinsurance agreement whereby, effective January 1, 2006, Trinity assumes 100% of the business written by ORCC. Prior to January 1, 2006, Trinity did not assume business written by ORCC.

The Reliable Life Insurance Company (Reliable), a wholly-owned subsidiary of Unitrin, provides certain administrative services to Capitol and its subsidiary, ORCC. In addition, agents appointed by Reliable and employed by Unitrin's subsidiary, United Insurance Company of America, are also appointed by Capitol and ORCC to sell property insurance products. Union National Life Insurance Company, a wholly-owned subsidiary of Unitrin, also provides claims administration services to Capitol and ORCC. The Company also provides certain investment services to Capitol and ORCC.

Table of Contents

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

Summary of Results

Net Income was \$221.5 million (\$3.25 per common share) and \$86.1 million (\$1.27 per common share) for the nine and three months ended September 30, 2006, respectively, compared to \$168.8 million (\$2.44 per common share) and \$22.7 million (\$0.33 per common share) for the same periods in 2005. As discussed throughout this Management's Discussion and Analysis of Results of Operations and Financial Condition, Net Income increased for the nine and three months ended September 30, 2006, due primarily to higher operating results in the Company's operating segments, partially offset by lower Net Realized Investment Gains.

Total Revenues were \$2,311.6 million and \$2,292.2 million for the nine months ended September 30, 2006 and 2005, respectively, an increase of \$19.4 million. Total Revenues were \$778.9 million and \$754.1 million for the three months ended September 30, 2006 and 2005, respectively, an increase of \$24.8 million.

Earned Premiums were \$1,859.8 million and \$1,858.8 million for the nine months ended September 30, 2006 and 2005, respectively, an increase of \$1.0 million. Earned Premiums increased for the nine months ended September 30, 2006 in the Life and Health Insurance segment, the Unitrin Direct segment and the Unitrin Kemper Auto and Home segment, partially offset by decreased Earned Premiums in the Unitrin Specialty segment and the Unitrin Business Insurance segment. Earned Premiums were \$622.0 million and \$620.6 million for the three months ended September 30, 2006 and 2005, respectively, an increase of \$1.4 million. Earned Premiums increased for the three months ended September 30, 2006 in the Unitrin Kemper Auto and Home segment, the Life and Health Insurance segment and the Unitrin Direct segment, partially offset by decreased Earned Premiums in the Unitrin Specialty segment and the Unitrin Business Insurance segment.

Consumer Finance Revenues increased by \$21.1 million and \$7.6 million for the nine and three months ended September 30, 2006, respectively, compared to the same periods in 2005, due primarily to higher levels of loans outstanding, partially offset by lower portfolio interest rates.

Net Investment Income increased by \$20.0 million for the nine months ended September 30, 2006, compared to the same period in 2005, due to higher investment yields and higher levels of investments. Net Investment Income increased by \$10.0 million for the three months ended September 30, 2006, compared to the same period in 2005, due primarily to higher investment yields.

Other Income was \$14.7 million and \$11.7 million for the nine and three months ended September 30, 2006, respectively. Other Income was \$7.6 million and \$1.2 million for the nine and three months ended September 30, 2005, respectively. Other Income increased for both periods in 2006, compared to 2005, due primarily to gains on the sales of certain office buildings used by the Company's Life and Health Insurance segment.

Net Realized Investment Gains were \$23.7 million and \$3.1 million for the nine and three months ended September 30, 2006, respectively, compared to \$53.5 million and \$7.8 million for the same periods in 2005. Net Realized Investment Gains for the nine months ended September 30, 2005 include pretax gains of \$39.4 million from the sales of real estate.

Table of Contents**Critical Accounting Estimates**

The Company's subsidiaries conduct their businesses in three industries: property and casualty insurance, life and health insurance and consumer finance. Accordingly, the Company is subject to several industry-specific accounting principles under accounting principles generally accepted in the United States of America (GAAP). The preparation of financial statements in accordance with GAAP requires the use of estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. The process of estimation is inherently uncertain. Accordingly, actual results could ultimately differ materially from the estimated amounts reported in a company's financial statements. Different assumptions are likely to result in different estimates of reported amounts. The Company's critical accounting policies most sensitive to estimates include the valuation of investments, the valuation of reserves for property and casualty insurance incurred losses and loss adjustment expenses (LAE), the valuation of the reserve for loan losses, the assessment of recoverability of goodwill, and the valuation of postretirement benefit obligations. The Company's critical accounting policies with respect to the valuation of investments, the valuation of reserves for property and casualty insurance incurred losses and LAE, the valuation of the reserve for loan losses, the assessment of recoverability of goodwill, and the valuation of postretirement benefit obligations are described in the Company's Management's Discussion and Analysis of Results of Operations and Financial Condition presented in its Annual Report on Form 10-K filed with the U.S. Securities and Exchange Commission (SEC) for the year ended December 31, 2005. There has been no material change, subsequent to December 31, 2005, to information previously disclosed with respect to the Company's critical accounting policies for the valuation of investments, the valuation of the reserve for loan losses, the assessment of recoverability of goodwill, and the valuation of postretirement benefit obligations. Information regarding the valuation of the Company's reserve for property and casualty insurance incurred losses and LAE follows.

Property and Casualty Insurance Reserves for Losses and Loss Adjustment Expenses

Property and casualty insurance reserves for losses and LAE are reported using the Company's estimate of its ultimate liability for losses and LAE for claims that occurred prior to the end of any given accounting period but have not yet been paid. The Company had \$1,442.9 million and \$1,531.5 million of gross loss and LAE reserves at September 30, 2006 and December 31, 2005, respectively. Property and Casualty Insurance Reserves by business segment at September 30, 2006 and December 31, 2005 were:

| (Dollars in Millions) | Sept. 30, 2006 | Dec. 31, 2005 |
|---|---------------------------|--------------------------|
| Unitrin Kemper Auto and Home | \$ 527.3 | \$ 553.6 |
| Unitrin Specialty | 293.6 | 295.8 |
| Unitrin Direct | 107.2 | 99.4 |
| Unitrin Business Insurance | 401.1 | 419.7 |
| Life and Health Insurance | 7.5 | 31.2 |
| Unallocated Ceded Reserves | 106.2 | 131.8 |
| Total Property and Casualty Insurance Reserves | \$ 1,442.9 | \$ 1,531.5 |

In estimating reserves, the Company's actuaries exercise professional judgment and must consider, and are influenced by, many variables that are difficult to quantify. Accordingly, the process of estimating and establishing reserves for losses and LAE for property and casualty insurance is inherently uncertain and the actual ultimate net cost of a claim may vary materially from the estimated amount reserved. The reserving process is particularly imprecise for claims involving asbestos, environmental matters, construction defect and other emerging and/or long-tailed exposures which may not be discovered or reported until years after the insurance policy period has ended.

Table of Contents**Critical Accounting Estimates (continued)**

The Company's actuaries generally estimate reserves at least quarterly for most product lines and/or coverage levels using accident quarters or accident months spanning 10 or more years depending on the size of the product line and/or coverage level or emerging issues relating to them. The Company's actuaries use a variety of generally accepted actuarial loss reserving estimation methodologies including, but not limited to, the following:

Incurred Loss Development Methodology;

Paid Loss Development Methodology;

Bornhuetter - Ferguson Incurred Loss Methodology;

Bornhuetter - Ferguson Paid Loss Methodology; and

Frequency and Severity Methodology.

The Company's actuaries generally review the results of at least four of these estimation methodologies, two based on paid data and two based on incurred data, to initially estimate loss and LAE reserves and to determine if a change in prior estimates is required. In some cases, the methodologies produce a cluster of estimates with a tight band of indicated possible outcomes. In other cases, however, the methodologies produce conflicting results and wider bands of indicated possible outcomes. However, such bands do not necessarily constitute a range of outcomes, nor does management or the Company's actuaries calculate a range of outcomes.

At a minimum, the Company analyzes 45 product and/or coverage levels, for over 40 separate prior accident quarters for both losses and LAE using many of the loss reserving methodologies identified above. In all, there are over 10,000 combinations of accident quarters, coverage levels, and generally accepted actuarial estimation methodologies used to estimate the Company's unpaid losses and LAE. In some cases, the Company's actuaries make adjustments to these loss reserving methodologies or use additional generally accepted actuarial estimation methodologies to estimate ultimate losses and LAE.

For each accident quarter, the point estimate selected by the Company's actuaries is not necessarily one of the points produced by any particular one of the methodologies utilized, but often is another point that takes into consideration each of the points produced by the several loss methodologies used. In some cases, for a particular product, the current accident quarter may not have enough paid claims data to rely upon, leading the Company's actuaries to conclude that the incurred loss development methodology provides a better estimate than the paid loss development methodology. Therefore, the Company's actuaries may give more weight to the incurred loss methodology for that particular accident quarter. As an accident quarter ages for that same product, the actuary may gain more confidence in the paid loss methodology and begin to give more weight to the paid loss methodology. The Company's actuaries' quarterly selections are summed by product and/or coverage levels to create the actuarial indication of the ultimate losses. More often than not, the actuarial indication for a particular product line and accident quarter is most heavily weighted towards the incurred loss development methodology, particularly for short-tail lines such as personal automobile. Historically, the incurred loss development methodology has been more reliable in predicting ultimate losses for these lines, especially in the more recent accident quarters, when compared with the paid loss development methodology. In the event of a wide variation among results generated by the different projection methodologies, the Company's actuaries further analyze the data using additional techniques.

The final step in the quarterly loss and LAE reserving process involves a comprehensive review of the actuarial indications by the Company's senior actuary and senior management who apply their collective judgment and determine the appropriate estimated level of reserves to record. Numerous factors are considered in this determination process, including, but not limited to, the assessed reliability of key loss trends and assumptions that may be significantly influencing the current actuarial indications, changes in claim handling practices or other changes that affect the timing of payment or development patterns, the maturity of the accident year, pertinent trends observed over the recent past, the level of volatility within a particular line of business, the improvement or deterioration of actuarial indications in the current period as compared to prior periods, and the amount of reserves related to third-party pools for which the Company does not have access to the underlying data and, accordingly, relies on calculations provided by such pools. Total recorded reserves have been consistently higher than the actuarial indication of

Edgar Filing: UNITRIN INC - Form 10-Q

reserves. Total recorded reserves for losses and LAE were 3.9% and 3.7% higher than the actuarial indication of reserves at September 30, 2006 and December 31, 2005, respectively.

Table of Contents**Critical Accounting Estimates (continued)**

The Company's goal is to ensure its total reserves for property and casualty insurance losses and LAE are adequate to cover all costs, while sustaining minimal variation from the time reserves for losses and LAE are initially estimated until losses and LAE are fully developed. Changes in the Company's estimates of these losses and LAE over time, also referred to as development, will occur and may be material. Favorable development is recognized when the Company decreases its estimate of previously reported losses and LAE and results in an increase in net income in the period recognized, whereas adverse development is recognized when the Company increases its estimate of previously reported losses and LAE and results in a decrease in net income. The Company recognized favorable development of \$71.4 million before tax and \$70.6 million before tax for the nine months ended September 30, 2006 and 2005, respectively. The Company recognized favorable development from prior accident years of \$26.5 million before tax and \$27.0 million before tax for the three months ended September 30, 2006 and 2005, respectively.

Development by the Company's business segments was:

| (Dollars in Millions) | Favorable (Adverse) Development Nine Months Ended | | Favorable (Adverse) Development Three Months Ended | |
|----------------------------------|---|-------------------|--|-------------------|
| | Sept. 30, 2006 | Sept. 30, 2005 | Sept. 30, 2006 | Sept. 30, 2005 |
| Unitrin Kemper Auto and Home | \$ 54.4 | \$ 46.8 | \$ 20.5 | \$ 20.9 |
| Unitrin Business Insurance | 18.9 | 10.3 | 8.1 | 2.2 |
| Unitrin Specialty | 6.6 | 12.1 | 0.5 | 3.5 |
| Unitrin Direct | (3.2) | 3.1 | (2.6) | 0.7 |
| Life and Health Insurance | (5.3) | (1.7) | | (0.3) |
| Total Favorable Development, Net | \$ 71.4 | \$ 70.6 | \$ 26.5 | \$ 27.0 |

Development in the Company's Unitrin Kemper Auto and Home segment and Unitrin Business Insurance segment together comprised a substantial portion of the Company's favorable development in 2006 and 2005. Additional information regarding this development follows.

Unitrin Kemper Auto and Home Development

In June of 2002, the Company acquired the personal lines property and casualty insurance business of the Kemper Insurance Companies (KIC) in a renewal rights transaction. Pursuant to the agreements among the parties, KIC retained all liabilities for policies issued by KIC prior to the closing, while the Company is entitled to premiums written for substantially all personal lines property and casualty insurance policies issued or renewed after the closing and is liable for losses and LAE incurred thereon. Accordingly, the results for the Unitrin Kemper Auto and Home segment for 2003 and 2002, including, but not limited to, the earned premiums and losses and LAE, are not necessarily indicative of a full year on a going-forward-basis. The Unitrin Kemper Auto and Home segment did not complete a full calendar year underwriting cycle after the acquisition date until 2004. Accordingly, the Company's results for 2002 and 2003 did not represent 100% of the acquired business. For example, for the 2002 calendar year, the Company's share of earned premiums for the KIC personal lines business was approximately 20% of the entire KIC personal lines business. For the 2003 calendar year, the Company's share of earned premiums was approximately 90% of the entire KIC personal lines business.

Table of Contents**Critical Accounting Estimates (continued)**

The Company's actuaries use various generally accepted actuarial incurred and paid loss development methodologies to estimate unpaid losses and LAE. The key assumption in these estimation methodologies is that patterns observed in prior periods are indicative of how losses and LAE are expected to develop in the future and that such historical data can be used to predict and estimate ultimate losses and LAE. Initially, the Company's actuaries had to rely solely on the historical data of KIC (the KIC Data) to predict how losses for business written by the Company after the acquisition would develop. As Unitrin Kemper Auto and Home continued to renew policies, the paid loss and incurred loss data related to the Company's share of the entire KIC personal lines business gradually increased. Immediately after the acquisition, the Company began accumulating incurred and paid loss and LAE data for its share of the KIC personal lines business (the Unitrin Data). In 2003 and throughout 2004, the Company's actuaries began to review the Unitrin Data and began comparing development factors for it with the development factors for the KIC Data. These initial reviews indicated that the Unitrin Data was producing lower development factors than the factors produced by the KIC Data. However, the amount of Unitrin Data available for analysis was still limited, and the Company's actuaries could not be confident that the observed changes in development were anything but random fluctuations and, therefore, placed less weight on the most recent development patterns.

Since the acquisition, the Company's actuaries have gained increasing confidence that the development patterns from the Unitrin Data were not only different from the KIC Data, but that these patterns were also sustainable. As the Company's actuaries gave more weight, and continued to give more weight each quarter, to the improved development patterns from the Unitrin Data in the selection of their incremental development factors throughout 2004 and 2005 and into 2006, Unitrin Kemper Auto and Home has recognized favorable development each quarter as appropriate.

The lower development factors for the Unitrin Data primarily resulted from improvements in the claim handling procedures on this book of business. In 2002, Unitrin Kemper Auto and Home began to place special emphasis on reporting claims directly to the Company. Prior to that time, a policyholder's agent usually was the primary contact to report a claim. In July of 2002, approximately one-third of all claims were reported directly to Unitrin Kemper Auto and Home compared to approximately two-thirds at the end of 2005. Direct reporting of losses has enabled the Company not only to reduce claim cycle times, but also to better respond to and control loss costs. Unitrin Kemper Auto and Home has also focused on reducing the number of days from when a loss is reported until the related claim is closed, while also controlling the overall loss and LAE costs. Specifically, Unitrin Kemper Auto and Home has implemented several claims handling loss mitigation programs, including:

Increased its utilization of alternative dispute resolution processes, such as mediation and arbitration, to facilitate settlements and reduce defense and legal costs;

Increased its in-house legal expertise to better manage the litigation processes and expenses, including managing the external lawyers with whom Unitrin Kemper Auto and Home contracts to defend claims; and,

Increased its emphasis on attempting to settle third-party claims earlier in the claims process in an effort to reduce the ultimate claim and LAE payout.

Although the Company's actuaries were aware of, and gave consideration to, the changes in the Company's claims handling processes, it takes several years to ascertain whether such changes in claims handling will ultimately result in lower ultimate paid losses and LAE. Accordingly, the improvements have emerged and have been recognized over several quarterly periods as the Company's actuaries have become more convinced that lower losses and LAE have in fact been realized. However, the Company cannot make any assurances that all such improvements have fully emerged or will continue to emerge.

Table of Contents**Critical Accounting Estimates (continued)***Unitrin Business Insurance Development*

The Company attributes favorable development in its Unitrin Business Insurance segment primarily to changes in its claims handling processes and the re-underwriting of its underlying book of business over the past few years. In addition, favorable development for the nine months ended September 30, 2006 includes development of \$2.2 million related to the favorable settlement of three specific claims.

Unitrin Business Insurance improved its claims handling by placing increased emphasis on earlier identification of the full value of a claim, especially case reserves for larger claims. As part of this effort, a large loss unit was created in its home office to handle all significant claims. In addition, Unitrin Business Insurance initiated several claims handling cost cutting measures, such as using third-party analytic software for legal expense and bodily injury review, outsourcing workers' compensation bill review, utilizing preferred vendors for damage repair, and pursuing subrogation more aggressively. The combined effects of these claims handling initiatives were case reserves in the earlier evaluation periods that more closely matched the ultimate payments.

Unitrin Business Insurance began aggressively re-underwriting its book of business in 2002 and substantially completed its re-underwriting activities in the first quarter of 2004. Emphasis was placed on removing highly volatile, unprofitable, and undesirable risks from Unitrin Business Insurance's book of business, which resulted in a significant reduction in the number of policies in force. Improvements in the quality of the book reduced the number and severity of claims in more recent quarters, resulting in better-than-expected development of loss and LAE reserves.

Although the Company's actuaries were aware of, and gave consideration to, the changes in the Company's claims handling processes and the re-underwriting in estimating unpaid losses and LAE for Unitrin Business Insurance, it takes several years to ascertain whether such changes in claims handling and re-underwriting will ultimately result in lower ultimate paid losses and LAE. Accordingly, the improvements have emerged and have been recognized over several quarterly periods as the Company's actuaries have become more convinced that lower losses and LAE have in fact been realized. However, the Company cannot make any assurances that all such improvements have fully emerged or will continue to emerge.

Estimated Variability of Property and Casualty Insurance Reserves

The Company believes that its historical loss and LAE reserve development recognized into income illustrates the potential variability of the Company's estimate of Property and Casualty Insurance Reserves. Based on development recorded in the Company's financial statements through the application of its reserving methodologies over the past four years, the Company estimates that its Property and Casualty Insurance Reserves could vary from the amounts carried on the balance sheet as follows:

| (Dollars in Millions) | Sept. 30, 2006 | Estimated Variability |
|--|---------------------------|----------------------------------|
| Personal Lines | \$ 793.6 | +/- 10% |
| Commercial Lines | 543.1 | +/- 20% |
| Unallocated Ceded Reserves | 106.2 | NA |
| Total Property and Casualty Insurance Reserves | \$ 1,442.9 | +/- 15% |

The estimated variability shown above does not constitute a statistical range of actuarially determined probable outcomes, nor does it constitute a range of all possible outcomes. Rather, it is based solely on the Company's historical experience over the last four full years, which may not necessarily be indicative of future variability due to a number of factors including, but not limited to, changes in claims handling, underwriting, mix of business by class and policy limit, growth in new lines of business or geographical areas, and the legal environment. The impact of changes in these factors is difficult to quantify and predict. Accordingly, the Company's actuaries must exercise considerable professional judgment in making their actuarial indications in light of these factors. Reserves in the Company's Unitrin Kemper Auto and Home and Unitrin Business Insurance segments together account for nearly two-thirds of the Company's reserves for property and casualty insurance losses and LAE. Accordingly, the indicated estimated variability is more likely to result from changes in these businesses.

Table of Contents**Critical Accounting Estimates (continued)**

In particular, the Company's personal lines variability could differ due to the limited history available to the Company related to the Unitrin Kemper Auto and Home segment and the Unitrin Direct segment. As more fully discussed earlier, the Company's actuaries have observed improving loss development factors for the Unitrin Data compared with the KIC Data. While over time the Company's actuaries have been placing more and more confidence in the Unitrin Data, they are still influenced by the KIC Data. If these favorable development patterns continue to emerge favorably compared to the KIC Data, the Company believes that it is reasonable that favorable development could continue to emerge and could be material. If on the other hand, the effects of the changes in claims handling are temporary or do not emerge or even reverse in later development periods, the Company believes that it is reasonable that adverse development could emerge and could be material. Accordingly, until the Unitrin Data is fully developed, the Company's actuaries cannot be certain that the favorable development trends that appear to be resulting from changes in claims handling will continue in subsequent reporting periods or whether such trends could reverse.

Although development will emerge in all of Unitrin's personal lines product lines, development in Unitrin Kemper Auto and Home's personal automobile insurance product line could have the most significant impact. To further illustrate the sensitivity of Unitrin Kemper Auto and Home's reserves for automobile insurance losses and LAE to changes in the cumulative development factors, the Company's actuaries estimated the impact of decreases in the cumulative development factors used in the incurred loss development methodology. For the newest quarterly evaluation period, the Company assumed an average decrease of 12.9% in the cumulative development factor, gradually declining to an average decrease of 3.1% over the next 8 older evaluation quarters, gradually declining to 0.3% over the next 15 older evaluation quarters and then gradually declining to 0% thereafter. Assuming that Unitrin Kemper Auto and Home's automobile insurance loss and LAE reserves were based solely on the incurred loss development methodology and such assumed decreases in the cumulative development factors, the Company estimates that Unitrin Kemper Auto and Home's automobile insurance loss and LAE reserves would have decreased by approximately \$64 million at September 30, 2006 for all accident years combined.

To further illustrate the sensitivity of Unitrin Kemper Auto and Home's reserves for automobile insurance losses and LAE to changes in the cumulative development factors, the Company's actuaries also estimated the impact of increases in the cumulative development factors used in the incurred loss development methodology. For the newest quarterly evaluation period, the Company assumed an average increase of 12.9% in the cumulative development factor, gradually declining to an average increase of 3.1% over the next 8 older evaluation quarters, gradually declining to 0.3% over the next 15 older evaluation quarters and then gradually declining to 0% thereafter. Assuming that Unitrin Kemper Auto and Home's automobile insurance loss and LAE reserves were based solely on the incurred loss development methodology and such assumed increases in the cumulative development factors, the Company estimates that Unitrin Kemper Auto and Home's automobile insurance loss and LAE reserves would have increased by approximately \$64 million at September 30, 2006 for all accident years combined.

The Company's commercial lines include certain long-tail liabilities, which are more difficult to predict. Accordingly, the Company believes that estimated variability for its commercial lines could be greater than for its personal lines. The Company's Unitrin Business Insurance segment has made certain changes in its claims handling processes and re-underwrote its underlying book of business over the past few years. The Company has recognized favorable development in its Unitrin Business Insurance segment over the past two years due primarily to the effects of these changes. If favorable development patterns continue to emerge as a result of these changes, the Company believes that it is reasonable that additional favorable development could continue to emerge in future periods and could be material. If on the other hand, the effects of these changes are temporary or even reverse in later development periods, the Company believes that it is reasonable that unfavorable development could emerge in future periods and could be material. Due to the long-tail nature of some of Unitrin Business Insurance's liabilities, it may take several years to fully determine the impact of these actions.

Table of Contents**Critical Accounting Estimates (continued)**

Although development will emerge in all of Unitrin's commercial product lines, development in Unitrin Business Insurance's product lines, in particular its commercial property and liability and workers' compensation product lines, could have the most significant impact. To further illustrate the sensitivity of the Company's reserves for losses and LAE to changes in the cumulative development factors for these product lines, the Company's actuaries estimated the impact of decreases in the cumulative development factors used in the incurred loss development methodology. For the newest quarterly evaluation period, the Company assumed an average decrease of 26.0% in the cumulative development factor, gradually declining to an average decrease of 5.1% over the next 25 older evaluation quarters, gradually declining to an average decrease of 1.3% over the next 25 older evaluation quarters and then gradually declining to 0% thereafter for commercial property and liability insurance, excluding certain construction defect and asbestos losses and LAE; and an average decrease of 31.1% in the cumulative development factor, gradually declining to an average decrease of 2.6% over the next 30 older evaluation quarters, gradually declining to an average decrease of 0.8% over the next 33 older evaluation quarters and then gradually declining to 0% thereafter for workers' compensation. Assuming that Unitrin Business Insurance's loss and LAE reserves were based solely on the incurred loss development methodology and such assumed decreases in the cumulative development factors, the Company estimates that Unitrin Business Insurance's loss and LAE reserves would have decreased by approximately \$49 million at September 30, 2006 for these product lines and accident years combined.

To further illustrate the sensitivity of these product lines' reserves for losses and LAE to changes in the cumulative development factors, the Company's actuaries also estimated the impact of increases in the cumulative development factors used in the incurred loss development methodology. For the newest quarterly evaluation period, the Company assumed an average increase of 26.0% in the cumulative development factor, gradually declining to an average increase of 5.1% over the next 25 older evaluation quarters, gradually declining to an average increase of 1.3% over the next 25 older evaluation quarters and then gradually declining to 0% thereafter for commercial property and liability insurance, excluding certain construction defect and asbestos losses and LAE; and an average increase of 31.1% in the cumulative development factor, gradually declining to an average increase of 2.6% over the next 30 older evaluation quarters, gradually declining to an average increase of 0.8% over the next 33 older evaluation quarters and then gradually declining to 0% thereafter for workers' compensation. Assuming that Unitrin Business Insurance's loss and LAE reserves were based solely on the incurred loss development methodology and such assumed increases in the cumulative development factors, the Company estimates that Unitrin Business Insurance's loss and LAE reserves would have increased by approximately \$49 million at September 30, 2006 for these product lines and accident years combined.

In addition to the factors described above, other factors may also impact loss reserve development in future periods. These factors include governmental actions, including court decisions interpreting existing laws, regulations or policy provisions, developments related to insurance policy claims and coverage issues, adverse or favorable outcomes in pending claims litigation, the number and severity of insurance claims, the impact of inflation on insurance claims and the impact of residual market assessments. Although the Company's actuaries do not make specific numerical assumptions about these factors, changes in these factors from past patterns will impact historical loss development factors and in turn future loss reserve development. Significant positive changes in one or more factors will lead to positive future loss reserve development, which could result in the actual loss developing closer to, or even below, the lower end of the Company's estimated reserve variability. Significant negative changes in one or more factors will lead to negative loss reserve development, which could result in the actual loss developing closer to, or even above, the higher end of the Company's estimated reserve variability. Accordingly, due to these factors and the other factors enumerated throughout this Management's Discussion and Analysis of Operations and Financial Condition and the inherent limitations of the loss reserving methodologies, the estimated and illustrated reserve variability may not necessarily be indicative of the Company's future reserve variability, which possibly could ultimately be greater than the estimated and illustrated variability. In addition, as previously noted, development will emerge in all of Unitrin's product lines over time. Accordingly, the Company's future reserve variability possibly could ultimately be greater than the illustrated variability.

Certain reserves acquired in connection with a business acquisition from SCOR Reinsurance Company in 2002 (the Unallocated Ceded Reserves) are reinsured by an insurance subsidiary of SCOR (see Note 6, Property and Casualty Insurance Reserves, to the Consolidated Financial Statements in the Company's 2005 Annual Report on Form 10-K). The Company does not anticipate that any variability of these reserves will have a financial impact on the Company's reported results of operations or liquidity and, accordingly, has not estimated any potential variability to these reserves.

Table of Contents**Critical Accounting Estimates (continued)**

Additional information pertaining to the estimation of and development of the Company's Property and Casualty Insurance Reserves for Losses and LAE is contained in Item 1 of Part I of the Company's 2005 Annual Report on Form 10-K under the heading "Property and Casualty Loss and Loss Adjustment Expense Reserves" and in the Company's Management's Discussion and Analysis of Results of Operations and Financial Condition in the Company's 2005 Annual Report on 10-K under the heading "Critical Accounting Estimates."

Catastrophes

The Company maintains three separate catastrophe reinsurance programs for its property and casualty insurance businesses. Coverage for each reinsurance program is provided in three layers.

The annual program covering the Company's Unitrin Direct, Unitrin Specialty and Unitrin Business Insurance segments provides, effective January 1, 2006, reinsurance coverage of 100% of reinsured catastrophe losses of \$36 million above retention of \$4 million. In 2005, the annual program covering these segments also provided reinsurance coverage of 100% of reinsured catastrophe losses of \$36 million above retention of \$4 million. The aggregate annual premium, excluding reinstatement premium, for the 2006 annual program covering these segments is \$1.9 million, compared to an annual cost of \$1.5 million, excluding reinstatement premium, for the 2005 annual program. Catastrophe reinsurance premiums for this program reduced earned premiums by \$1.4 million for the nine months ended September 30, 2006, compared to \$1.2 million for the same period in 2005, including \$0.1 million of reinstatement premium recorded in the third quarter of 2005.

The annual program covering the property insurance operations of the Company's Life and Health Insurance segment provides, effective January 1, 2006, reinsurance coverage of 100% of reinsured catastrophe losses of \$90 million above retention of \$10 million. In 2005, the annual program covering this segment provided reinsurance coverage of 100% of reinsured catastrophe losses of \$52 million above retention of \$8 million. The aggregate annual premium, excluding reinstatement premium, for the 2006 annual program covering this segment is \$6.1 million, compared to an annual cost of \$2.7 million, excluding reinstatement premium, for the 2005 annual program. Catastrophe reinsurance premiums for this program reduced earned premiums by \$4.5 million for the nine months ended September 30, 2006, including an additional charge of \$0.2 million to reinstate reinsurance coverage due primarily to higher reinsured losses from Hurricane Katrina than previously anticipated. Catastrophe reinsurance premiums for this program reduced earned premiums by \$4.6 million for the nine months ended September 30, 2005, including \$2.6 million of reinstatement premium recorded in the third quarter of 2005.

The Company has renewed, effective July 1, 2006, the annual program covering the Company's Unitrin Kemper Auto and Home segment on terms that are substantially different from the prior annual program. Under Unitrin Kemper Auto and Home's new program, the first layer provides reinsurance coverage of approximately 65% of reinsured catastrophe losses of \$30 million above retention of \$40 million. The second layer provides reinsurance coverage of approximately 88% of reinsured catastrophe losses of \$80 million above retention of \$70 million. The third layer provides reinsurance coverage of approximately 80% of reinsured catastrophe losses of \$100 million above retention of \$150 million. The old program covering this segment, effective from July 1, 2005 to June 30, 2006, provided reinsurance coverage of 100% of reinsured catastrophe losses of \$160 million above retention of \$20 million. The aggregate annual premium, excluding reinstatement premium, for Unitrin Kemper Auto and Home's new annual program is \$19.5 million, compared to an annual cost of \$11.1 million, excluding reinstatement premium, for the old program. Catastrophe reinsurance premiums for these programs reduced earned premiums by \$10.6 million for the nine months ended September 30, 2006, including an additional charge of \$0.3 million to reinstate reinsurance coverage due primarily to higher reinsured losses from Hurricane Katrina than previously anticipated. Catastrophe reinsurance premiums for these programs reduced earned premiums by \$11.3 million for the nine months ended September 30, 2005, including \$3.8 million of reinstatement premium recorded in the third quarter of 2005.

In addition, in the event that the Company's incurred catastrophe losses and LAE covered by any of its three catastrophe reinsurance programs exceed the retention for that particular program, each of the programs requires one reinstatement of such coverage. In such an instance, the Company is required to pay a reinstatement premium to the reinsurers to reinstate the full amount of reinsurance available under such program. The reinstatement premium is a percentage of the original premium based on the ratio of the losses exceeding the Company's retention to the reinsurers' coverage limit. In addition to these programs, the Company purchases reinsurance from the Florida Hurricane Catastrophe Fund (the FHCF) for hurricane losses in the state of Florida at retentions lower than those described above. Catastrophe

Table of Contents**Catastrophes (continued)**

reinsurance premiums for the FHCF reduced earned premiums in the Life and Health Insurance segment by \$0.2 million for the nine months ended September 30, 2006, compared to \$0.1 million for the same period in 2005. Catastrophe reinsurance premiums for the FHCF reduced earned premiums in the Unitrin Kemper Auto and Home segment by \$0.6 million for the nine months ended September 30, 2006, compared to \$0.3 million for the same period in 2005.

Total catastrophe losses and LAE (including development), net of reinsurance recoveries, were \$42.9 million and \$8.7 million for the nine and three months ended September 30, 2006, respectively, compared to \$87.7 million and \$70.3 million for the same periods in 2005.

In the third quarter of 2005, two major hurricanes that significantly impacted the Company (Katrina and Rita) made landfall in the United States. A summary of the Company's losses and LAE, net of reinsurance recoveries, from Hurricanes Katrina and Rita initially recorded in the Company's Condensed Consolidated Statements of Income for the nine and three months ended September 30, 2005 by business segment were:

| (Dollars in Millions) | Katrina | Rita | Total |
|--|---------|---------|---------|
| Unitrin Kemper Auto and Home | \$ 20.2 | \$ 20.0 | \$ 40.2 |
| Unitrin Specialty | 2.1 | 0.3 | 2.4 |
| Unitrin Direct | 0.2 | | 0.2 |
| Unitrin Business Insurance | 1.8 | 3.7 | 5.5 |
| Life and Health Insurance | 8.4 | 8.0 | 16.4 |
| Total Loss and LAE, Net of Reinsurance | \$ 32.7 | \$ 32.0 | \$ 64.7 |

As further described below, during the first half of 2006, the Company recorded adverse development of \$3.6 million, net of reinsurance recoveries, due primarily to increases in the Company's estimates of both direct losses and indirect residual market losses for these hurricanes. No development, net of reinsurance recoveries, was recorded for these hurricanes in the third quarter of 2006.

During the first quarter of 2006, the Company significantly increased its estimate of losses and LAE, before reinsurance recoveries, for Hurricane Katrina due primarily to an \$11.5 million increase in the estimate of assessed indirect losses from the Mississippi Windstorm Underwriting Association residual market. In the second quarter of 2006, the Company increased its estimate of losses and LAE, before reinsurance recoveries, for Hurricane Katrina due primarily to a \$3.9 million increase in the Company's estimate of direct losses in its Life and Health Insurance segment. In addition, the Company significantly increased its estimate of losses and LAE, before reinsurance recoveries, in 2006 for Hurricane Rita due primarily to an increase in the estimate of direct losses in the Company's Life and Health Insurance segment. The increase in the Company's estimate of losses and LAE from Hurricane Rita was offset entirely by reinsurance recoveries and, accordingly, had no impact on the Company's reported losses and LAE, net of reinsurance, or on net income for the nine and three months ended September 30, 2006. In addition to the adverse development, the Company also recorded additional reinstatement premiums of \$0.5 million for the nine months ended September 30, 2006.

The Company currently estimates that, as a result of Hurricane Katrina's landfall in Louisiana, Mississippi and Alabama, its Life and Health Insurance segment incurred losses and LAE of \$63.6 million, before reinsurance recoveries, which exceeded its initial retention of \$8 million and reinsurance coverage of \$52 million. The excess of \$3.6 million was recorded as adverse development for the nine months ended September 30, 2006. The process of estimating and establishing reserves for both direct losses and LAE and indirect residual market losses is inherently uncertain and the actual ultimate cost of losses and LAE, before reinsurance recoveries, may vary from the estimated amount reserved. Any further development of direct and indirect losses and LAE from Hurricane Katrina in the Life and Health Insurance segment would have an impact on net income.

The Company currently estimates that, as a result of Hurricane Rita's landfall in Texas and Louisiana, its Life and Health Insurance subsidiaries, together with Capitol County Mutual Fire Insurance Company (Capitol) (see Note 13, Relationships with Mutual Holding Companies and Mutual Insurance Companies, to the Condensed Consolidated Financial Statements), incurred losses and LAE of \$51.7 million, before reinsurance recoveries, or \$43.7 million of losses and LAE in excess of its retention of \$8 million.

Table of Contents**Catastrophes (continued)**

The Company currently estimates that, as a result of Hurricane Katrina's landfall in Louisiana, Mississippi and Alabama, its Unitrin Kemper Auto and Home segment incurred losses and LAE of \$43.4 million, before reinsurance recoveries, or \$23.4 million of losses and LAE in excess of its retention of \$20 million.

The Company currently estimates that, as a result of Hurricane Rita's landfall in Texas and Louisiana, its Unitrin Kemper Auto and Home segment incurred losses and LAE of \$19.4 million, or \$0.6 million below its initial retention of \$20 million.

The Company currently estimates that, as a result of Hurricane Katrina's landfall in Louisiana, Mississippi and Alabama, the Unitrin Direct, Unitrin Specialty and Unitrin Business Insurance segments together incurred losses and LAE of \$4.9 million, before reinsurance recoveries, or \$0.9 million of losses and LAE in excess of their retention of \$4 million.

The Company currently estimates that, as a result of Hurricane Rita's landfall in Texas and Louisiana, the Unitrin Direct, Unitrin Specialty and Unitrin Business Insurance segments together incurred losses and LAE of \$4.6 million, before reinsurance recoveries, or \$0.6 million of losses and LAE in excess of their retention of \$4 million.

Unitrin Kemper Auto and Home

| (Dollars in Millions) | Nine Months Ended | | Three Months Ended | |
|--|-------------------|----------------|--------------------|-----------------|
| | Sept. 30, 2006 | Sept. 30, 2005 | Sept. 30, 2006 | Sept. 30, 2005 |
| Earned Premiums: | | | | |
| Automobile | \$ 459.1 | \$ 467.6 | \$ 154.6 | \$ 157.1 |
| Homeowners | 212.7 | 203.2 | 71.3 | 66.7 |
| Other Personal | 36.3 | 35.0 | 11.7 | 12.1 |
| Total Earned Premiums | 708.1 | 705.8 | 237.6 | 235.9 |
| Net Investment Income | 36.7 | 35.0 | 11.5 | 11.4 |
| Other Income | 0.3 | 0.4 | 0.1 | |
| Total Revenues | 745.1 | 741.2 | 249.2 | 247.3 |
| Incurred Losses and LAE | 424.6 | 488.6 | 131.6 | 188.7 |
| Insurance Expenses | 207.8 | 217.0 | 71.2 | 72.5 |
| Operating Profit (Loss) | 112.7 | 35.6 | 46.4 | (13.9) |
| Income Tax Benefit (Expense) | (33.1) | (6.2) | (14.1) | 7.0 |
| Net Income (Loss) | \$ 79.6 | \$ 29.4 | \$ 32.3 | \$ (6.9) |
| Ratio Based on Earned Premiums | | | | |
| Incurred Loss and LAE Ratio (excluding Catastrophes) | 55.9% | 60.8% | 52.6% | 60.7% |
| Incurred Catastrophe Loss and LAE Ratio | 4.1% | 8.4% | 2.8% | 19.3% |
| Total Incurred Loss and LAE Ratio | 60.0% | 69.2% | 55.4% | 80.0% |
| Incurred Expense Ratio | 29.3% | 30.7% | 30.0% | 30.7% |
| Combined Ratio | 89.3% | 99.9% | 85.4% | 110.7% |

Edgar Filing: UNITRIN INC - Form 10-Q

| (Dollars in Millions) | Sept. 30, 2006 | Dec. 31, 2005 |
|-----------------------|-------------------|------------------|
| Insurance Reserves: | | |
| Personal Automobile | \$ 397.5 | \$ 414.9 |
| Homeowners | 102.7 | 111.3 |
| Other Personal | 27.1 | 27.4 |
| Insurance Reserves | \$ 527.3 | \$ 553.6 |

Table of Contents**Unitrin Kemper Auto and Home (continued)**

| (Dollars in Millions) | Sept. 30, 2006 | Dec. 31, 2005 |
|----------------------------|-------------------|------------------|
| Insurance Reserves: | | |
| Loss Reserves: | | |
| Case | \$ 230.1 | \$ 220.3 |
| Incurred but Not Reported | 200.9 | 230.1 |
| Total Loss Reserves | 431.0 | 450.4 |
| LAE Reserves | 96.3 | 103.2 |
| Insurance Reserves | \$ 527.3 | \$ 553.6 |

| (Dollars in Millions) | Nine Months Ended | | Three Months Ended | |
|--|-------------------|-------------------|--------------------|-------------------|
| | Sept. 30, 2006 | Sept. 30, 2005 | Sept. 30, 2006 | Sept. 30, 2005 |
| Favorable Loss and LAE Reserve Development, Net (excluding Catastrophes) | \$ 54.8 | \$ 46.4 | \$ 20.7 | \$ 19.7 |
| Favorable (Adverse) Catastrophe Loss and LAE Reserve Development, Net | (0.4) | 0.4 | (0.2) | 1.2 |
| Total Favorable Loss and LAE Reserve Development, Net | \$ 54.4 | \$ 46.8 | \$ 20.5 | \$ 20.9 |

| Loss and LAE Reserve Development as a Percentage of Insurance Reserves at Beginning of Year | 9.8% | 9.3% | 3.7% | 4.2% |
|---|------|------|------|------|
| | | | | |

Earned Premiums in the Unitrin Kemper Auto and Home segment increased by \$2.3 million and \$1.7 million for the nine and three months ended September 30, 2006, respectively, compared to the same periods in 2005, due primarily to higher premium rates, partially offset by lower volume. The cost of catastrophe reinsurance coverage was \$11.3 million for the nine months ended September 30, 2006, including an additional charge of \$0.3 million to reinstate reinsurance coverage due primarily to higher reinsured losses from Hurricane Katrina than previously anticipated. The cost of catastrophe reinsurance coverage was \$11.5 million for the nine months ended September 30, 2005, which included a charge of \$3.8 million to reinstate reinsurance coverage following Hurricanes Katrina and Rita (see Management's Discussion and Analysis of Results of Operations and Financial Condition, Catastrophes). The cost of catastrophe reinsurance coverage was \$4.9 million for the three months ended September 30, 2006, compared to \$6.7 million in 2005, which included the charge to reinstate reinsurance coverage. Excluding the effects of the charges to reinstate reinsurance coverage, the cost of catastrophe reinsurance increased for the nine and three months ended September 30, 2006, compared to the same periods in 2005, due primarily to the higher cost of the new catastrophe reinsurance program which became effective on July 1, 2006 (see Management's Discussion and Analysis of Results of Operations and Financial Condition, Catastrophes). Earned premiums on homeowners insurance increased by \$9.5 million for the nine months ended September 30, 2006, compared to the same period in 2005, due primarily to higher premium rates and to a lesser extent higher volume and lower catastrophe reinsurance costs. Earned premiums on homeowners insurance increased by \$4.6 million for the three months ended September 30, 2006, compared to the same period in 2005, due primarily to higher premium rates and lower catastrophe reinsurance costs, partially offset by lower volume. Automobile insurance earned premiums decreased by \$8.5 million and \$2.5 million for the nine and three months ended September 30, 2006, respectively, due primarily to lower volume, partially offset by higher rates. Net Investment Income increased by \$1.7 million for the nine months ended September 30, 2006, compared to the same period in 2005, due to higher levels of investments and higher yields on investments.

Table of Contents**Unitrin Kemper Auto and Home (continued)**

Operating Profit in the Unitrin Kemper Auto and Home segment increased by \$77.1 million for the nine months ended September 30, 2006, compared to the same period in 2005. Operating Profit increased due primarily to lower catastrophe losses and LAE, net of reinsurance recoveries, lower non-catastrophe incurred losses and LAE, lower insurance expenses and higher net investment income. Catastrophe losses and LAE (including development), net of reinsurance recoveries, were \$28.8 million for the nine months ended September 30, 2006, compared to \$59.2 million in 2005. Catastrophe losses and LAE, net of reinsurance recoveries, in 2005 included losses and LAE from Hurricanes Katrina and Rita (see Management's Discussion and Analysis of Results of Operations and Financial Condition, "Catastrophes"). Loss and LAE reserve development had a favorable effect of \$54.4 million for the nine months ended September 30, 2006, compared to a favorable effect of \$46.8 million in 2005. Favorable loss and LAE reserve development on automobile insurance was \$39.7 million for the nine months ended September 30, 2006, compared to \$29.1 million in 2005. Favorable loss and LAE reserve development on homeowners insurance was \$9.7 million for the nine months ended September 30, 2006, compared to \$15.8 million in 2005. Favorable loss and LAE reserve development on other insurance was \$5.0 million for the nine months ended September 30, 2006, compared to \$1.9 million in 2005. Non-catastrophe losses and LAE as a percentage of earned premiums decreased in part due to the effect of placing greater weight on the emerging loss development trends in the current accident year actuarial indications (see Management's Discussion and Analysis of Results of Operations and Financial Condition, "Critical Accounting Estimates").

Insurance Expenses decreased by \$9.2 million for the nine months ended September 30, 2006, compared to the same period in 2005, due primarily to lower restructuring expenses and the realization of additional economies of scale. Restructuring expenses were insignificant in 2006, compared to \$6.0 million for the nine months ended September 30, 2005.

Operating results in the Unitrin Kemper Auto and Home segment increased by \$60.3 million for the three months ended September 30, 2006, compared to the same period in 2005, due primarily to lower catastrophe losses and LAE, net of reinsurance recoveries, and lower non-catastrophe losses and LAE as a percentage of earned premiums. Catastrophe losses and LAE (including development), net of reinsurance recoveries, were \$6.7 million for the three months ended September 30, 2006, compared to \$45.6 million in 2005. Catastrophe losses and LAE, net of reinsurance recoveries, in 2005 included losses and LAE from Hurricanes Katrina and Rita. Non-catastrophe losses and LAE as a percentage of earned premiums decreased in part due to the effect of placing greater weight on the emerging loss development trends in the current accident quarter actuarial indications.

Net Income in the Unitrin Kemper Auto and Home segment increased by \$50.2 million and \$39.2 million for the nine and three months ended September 30, 2006, respectively, compared to the same periods in 2005, due primarily to the changes in Operating Profit. The Unitrin Kemper Auto and Home segment's effective income tax rate differs from the federal statutory income tax rate due primarily to tax-exempt investment income and dividends received deductions. Tax-exempt investment income and dividends received deductions were \$19.0 million and \$6.5 million in the nine and three months ended September 30, 2006, respectively, compared to \$18.2 million and \$6.3 million for the same periods in 2005.

Table of Contents**Unitrin Specialty**

| (Dollars in Millions) | Nine Months Ended | | Three Months Ended | |
|--------------------------------|-------------------|------------------|--------------------|------------------|
| | Sept.30, 2006 | Sept.30, 2005 | Sept.30, 2006 | Sept.30, 2005 |
| Earned Premiums: | | | | |
| Personal Automobile | \$ 244.0 | \$ 251.3 | \$ 81.8 | \$ 82.4 |
| Commercial Automobile | 89.3 | 90.3 | 29.9 | 31.1 |
| Total Earned Premiums | 333.3 | 341.6 | 111.7 | 113.5 |
| Net Investment Income | 16.3 | 15.1 | 5.0 | 4.8 |
| Total Revenues | 349.6 | 356.7 | 116.7 | 118.3 |
| Incurred Losses and LAE | | | | |
| Insurance Expenses | 69.8 | 72.7 | 23.6 | 24.5 |
| Operating Profit | 28.3 | 32.2 | 8.9 | 9.6 |
| Income Tax Expense | 7.0 | 8.6 | 2.1 | 2.5 |
| Net Income | \$ 21.3 | \$ 23.6 | \$ 6.8 | \$ 7.1 |

Ratio Based on Earned Premiums

| | | | | |
|--|--------------|--------------|--------------|--------------|
| Incurred Loss and LAE Ratio (excluding Catastrophes) | 75.2% | 72.6% | 75.3% | 71.9% |
| Incurred Catastrophe Loss and LAE Ratio | 0.3% | 1.1% | 0.1% | 2.3% |
| Total Incurred Loss and LAE Ratio | 75.5% | 73.7% | 75.4% | 74.2% |
| Incurred Expense Ratio | 20.9% | 21.3% | 21.1% | 21.6% |
| Combined Ratio | 96.4% | 95.0% | 96.5% | 95.8% |

| (Dollars in Millions) | Sept. 30, 2006 | Dec. 31, 2005 |
|----------------------------|-------------------|---------------------|
| Insurance Reserves: | | |
| Personal Automobile | \$ 151.6 | \$ 161.7 |
| Commercial Automobile | 124.6 | 116.5 |
| Other | 17.4 | 17.6 |
| Insurance Reserves | \$ 293.6 | \$ 295.8 |

Table of Contents**Unitrin Specialty (continued)**

| (Dollars in Millions) | Sept. 30, 2006 | Dec. 31, 2005 |
|---------------------------|-------------------|------------------|
| Insurance Reserves: | | |
| Loss Reserves: | | |
| Case | \$ 163.1 | \$ 153.2 |
| Incurred but Not Reported | 77.0 | 84.5 |
| Total Loss Reserves | 240.1 | 237.7 |
| LAE Reserves | 53.5 | 58.1 |
| Insurance Reserves | \$ 293.6 | \$ 295.8 |

| (Dollars in Millions) | Nine Months Ended | | Three Months Ended | |
|--|-------------------|-------------------|--------------------|-------------------|
| | Sept. 30, 2006 | Sept. 30, 2005 | Sept. 30, 2006 | Sept. 30, 2005 |
| Favorable Loss and LAE Reserve Development, Net (excluding Catastrophes) | \$ 6.2 | \$ 12.1 | \$ 0.6 | \$ 3.5 |
| Favorable (Adverse) Catastrophe Loss and LAE Reserve Development, Net | 0.4 | | (0.1) | |
| Total Favorable Loss and LAE Reserve Development, Net | \$ 6.6 | \$ 12.1 | \$ 0.5 | \$ 3.5 |

| | | | | |
|---|------|------|------|------|
| Loss and LAE Reserve Development as a Percentage of Insurance Reserves at Beginning of Year | 2.2% | 4.5% | 0.2% | 1.3% |
|---|------|------|------|------|

Earned Premiums in the Unitrin Specialty segment decreased by \$8.3 million and \$1.8 million for the nine and three months ended September 30, 2006, respectively, compared to the same periods in 2005. Personal automobile insurance earned premiums decreased by \$7.3 million and \$0.6 million for the nine and three months ended September 30, 2006, respectively, compared to the same periods in 2005, due primarily to lower personal automobile insurance premium rates and Unitrin Specialty's decision to exit its motorcycle insurance business, partially offset by higher volume of personal automobile insurance. The Unitrin Specialty segment has experienced increased competition from traditional non-standard risk automobile insurance companies as well as standard risk automobile insurance companies. The Unitrin Specialty segment has improved its personal automobile insurance competitive position by reducing personal automobile insurance rates in certain states, where profitability is above the Unitrin Specialty segment's target levels, by changing payment options and by changing its computer applications to make it easier for agents to transact business with Unitrin Specialty. Personal automobile earned premiums for the nine and three months ended September 30, 2005 included \$5.7 million and \$0.9 million, respectively, of motorcycle insurance premiums. Unitrin Specialty exited this line of business during 2005. Commercial automobile insurance earned premiums decreased by \$1.0 million for the nine months ended September 30, 2006, compared to the same period in 2005, due to lower volume of commercial automobile insurance, partially offset by higher commercial automobile insurance rates. Commercial automobile insurance earned premiums decreased by \$1.2 million for the three months ended September 30, 2006, compared to the same period in 2005, due primarily to lower volume of commercial automobile insurance.

Operating Profit in the Unitrin Specialty segment decreased by \$3.9 million and \$0.7 million for the nine and three months ended September 30, 2006, respectively, compared to the same periods in 2005. Incurred losses and LAE as a percentage of earned premiums increased due primarily to lower favorable loss reserve development in 2006 and the lower personal automobile insurance premium rates, partially offset by lower catastrophe losses and LAE, net of reinsurance recoveries. Loss and LAE reserve development had favorable effects of \$6.6 million and \$0.5 million for the nine and three months ended September 30, 2006, respectively, compared to favorable effects of \$12.1 million and \$3.5 million for the same periods in 2005. Catastrophe losses and LAE (including development), net of reinsurance recoveries, were \$0.8 million and \$0.1 million for the nine and three months ended September 30, 2006, respectively, compared to \$3.6 million and \$2.5 million for the same periods in 2005. Catastrophe losses and LAE, net of reinsurance recoveries, in 2005 included losses and LAE from Hurricanes Katrina and Rita (see Management's Discussion and Analysis of Results of Operations and Financial Condition, "Catastrophes").

Table of Contents**Unitrin Specialty (continued)**

Net Income in the Unitrin Specialty segment decreased by \$2.3 million and \$0.3 million for the nine and three months ended September 30, 2006, respectively, compared to the same periods in 2005. The Unitrin Specialty segment's effective tax rate differs from the statutory tax rate due primarily to tax-exempt investment income and dividends received deductions. Tax-exempt investment income and dividends received deductions were \$8.4 million and \$2.8 million for the nine and three months ended September 30, 2006, respectively, compared to \$7.8 million and \$2.6 million for the same periods in 2005.

Unitrin Direct

| (Dollars in Millions) | Nine Months Ended | | Three Months Ended | |
|---|-------------------|-------------------|--------------------|-------------------|
| | Sept. 30, 2006 | Sept. 30, 2005 | Sept. 30, 2006 | Sept. 30, 2005 |
| Earned Premiums | \$ 168.9 | \$ 165.3 | \$ 57.7 | \$ 56.4 |
| Net Investment Income | 6.7 | 6.4 | 2.1 | 2.0 |
| Other Income | 0.2 | 0.1 | | |
| Total Revenues | 175.8 | 171.8 | 59.8 | 58.4 |
| Incurring Losses and LAE | 137.0 | 128.7 | 49.0 | 43.5 |
| Insurance Expenses | 44.7 | 41.6 | 14.4 | 14.3 |
| Operating Profit (Loss) | (5.9) | 1.5 | (3.6) | 0.6 |
| Income Tax Benefit | 3.2 | 0.6 | 1.6 | 0.1 |
| Net Income (Loss) | \$ (2.7) | \$ 2.1 | \$ (2.0) | \$ 0.7 |
| Ratio Based on Earned Premiums | | | | |
| Incurring Loss and LAE Ratio (excluding Catastrophes) | 80.5% | 77.6% | 84.4% | 76.7% |
| Incurring Catastrophe Loss and LAE Ratio | 0.6% | 0.3% | 0.5% | 0.4% |
| Total Incurring Loss and LAE Ratio | 81.1% | 77.9% | 84.9% | 77.1% |
| Incurring Expense Ratio | 26.5% | 25.2% | 25.0% | 25.4% |
| Combined Ratio | 107.6% | 103.1% | 109.9% | 102.5% |

Table of Contents**Unitrin Direct (continued)**

| (Dollars in Millions) | Sept. 30, 2006 | Dec. 31, 2005 |
|---------------------------|-------------------|------------------|
| Insurance Reserves: | | |
| Loss Reserves: | | |
| Case | \$ 74.6 | \$ 70.2 |
| Incurred but Not Reported | 14.0 | 12.2 |
| Total Loss Reserves | 88.6 | 82.4 |
| LAE Reserves | 18.6 | 17.0 |
| Insurance Reserves | \$ 107.2 | \$ 99.4 |

| (Dollars in Millions) | Nine Months Ended | | Three Months Ended | |
|--|-------------------|-------------------|--------------------|-------------------|
| | Sept. 30, 2006 | Sept. 30, 2005 | Sept. 30, 2006 | Sept. 30, 2005 |
| Favorable (Adverse) Loss and LAE Reserve Development, Net (excluding Catastrophes) | \$ (2.9) | \$ 3.1 | \$ (2.5) | \$ 0.7 |
| Adverse Catastrophe Loss and LAE Reserve Development, Net | (0.3) | | (0.1) | |
| Total Favorable (Adverse) Loss and LAE Reserve Development, Net | \$ (3.2) | \$ 3.1 | \$ (2.6) | \$ 0.7 |

| Loss and LAE Reserve Development as a Percentage of Insurance Reserves at Beginning of Year | -3.2% | 3.3% | -2.6% | 0.7% |
|---|-------|------|-------|------|
|---|-------|------|-------|------|

Earned Premiums in the Unitrin Direct segment increased by \$3.6 million and \$1.3 million for the nine and three months ended September 30, 2006, respectively, compared to the same periods in 2005, due to higher premium rates, partially offset by lower volume. Unitrin Direct reduced its writings of new and renewal business in certain states during 2005 while implementing certain product changes and rate increases. Earned premiums in these states decreased by \$13.1 million and \$4.7 million for the nine and three months ended September 30, 2006, respectively, compared to the same periods in 2005. Growth in targeted states did not completely offset the decline in premium volume in the states where writings were reduced. Unitrin Direct has begun to allocate a larger portion of its marketing budget to television and internet advertising. Unitrin Direct began writing premiums in four new states during 2006 and estimates that it currently writes premiums in states comprising approximately 74% of the U. S. personal automobile insurance market. Unitrin Direct anticipates entering six new states, comprising an additional 9% of the U. S. personal automobile insurance market, in 2007.

The Unitrin Direct segment reported an Operating Loss of \$5.9 million and \$3.6 million for the nine and three months ended September 30, 2006, respectively, compared to an Operating Profit of \$1.5 million and \$0.6 million for the same periods in 2005. Operating results decreased due primarily to the effects of loss and LAE reserve development and higher marketing and other policy acquisition expenses. Unitrin Direct recognized adverse loss and LAE reserve development of \$3.2 million and \$2.6 million for the nine and three months ended September 30, 2006, respectively, compared to favorable loss and LAE reserve development of \$3.1 million and \$0.7 million for the same periods in 2005. Marketing and other policy acquisition expenses as a percentage of earned premiums, increased from 7.9% for the nine months ended September 30, 2005 to 9.6% for the same period in 2006, and increased from 8.5% for the three months ended September 30, 2005 to 9.6% for the same period in 2006, respectively, due primarily to increased spending on television and web advertising. Direct marketing initially results in higher expenses as a percentage of earned premiums because up-front marketing costs, to the extent they are not deferrable, are expensed as incurred. Unitrin Direct plans to accelerate its growth with increased direct marketing in both new and existing states. Accordingly, these direct marketing initiatives are expected to result in operating losses in the Unitrin Direct segment in 2007.

Table of Contents**Unitrin Direct (continued)**

Unitrin Direct reported a Net Loss of \$2.7 million and \$2.0 million for the nine and three months ended September 30, 2006, respectively, compared to Net Income of \$2.1 million and \$0.7 million for the same periods in 2005, due primarily to the change in operating results. Unitrin Direct's effective income tax rate differs from the federal statutory income tax rate due primarily to tax-exempt investment income and dividends received deductions. Tax-exempt investment income and dividends received deductions were \$3.5 million and \$1.2 million for the nine and three months ended September 30, 2006, respectively, compared to \$3.3 million and \$1.1 million for the same periods in 2005.

Unitrin Business Insurance

| (Dollars in Millions) | Nine Months Ended | | Three Months Ended | |
|---|-------------------|-------------------|--------------------|-------------------|
| | Sept. 30, 2006 | Sept. 30, 2005 | Sept. 30, 2006 | Sept. 30, 2005 |
| Earned Premiums: | | | | |
| Commercial Automobile | \$ 44.0 | \$ 47.0 | \$ 14.5 | \$ 15.9 |
| Commercial Property and Liability | 63.3 | 62.6 | 21.3 | 21.3 |
| Workers Compensation | 14.9 | 16.0 | 4.9 | 5.3 |
| Commercial Reinsurance Program | 18.3 | 17.0 | 6.2 | 5.7 |
| Total Earned Premiums | 140.5 | 142.6 | 46.9 | 48.2 |
| Net Investment Income | 21.1 | 21.0 | 6.4 | 6.5 |
| Other Income | 1.3 | | | |
| Total Revenues | 162.9 | 163.6 | 53.3 | 54.7 |
| Incurring Losses and LAE | 82.4 | 89.1 | 24.4 | 35.3 |
| Insurance Expenses | 70.6 | 63.5 | 22.7 | 22.0 |
| Operating Profit (Loss) | 9.9 | 11.0 | 6.2 | (2.6) |
| Income Tax Benefit (Expense) | 0.3 | (0.3) | (0.9) | 2.1 |
| Net Income (Loss) | \$ 10.2 | \$ 10.7 | \$ 5.3 | \$ (0.5) |
| Ratio Based on Earned Premiums | | | | |
| Incurring Loss and LAE Ratio (excluding Catastrophes) | 56.9% | 58.8% | 51.1% | 62.8% |
| Incurring Catastrophe Loss and LAE Ratio | 1.7% | 3.7% | 0.9% | 10.4% |
| Total Incurring Loss and LAE Ratio | 58.6% | 62.5% | 52.0% | 73.2% |
| Incurring Expense Ratio | 50.2% | 44.5% | 48.4% | 45.6% |
| Combined Ratio | 108.8% | 107.0% | 100.4% | 118.8% |

| (Dollars in Millions) | Sept. 30, 2006 | Dec. 31, 2005 |
|-----------------------------------|-------------------|------------------|
| Insurance Reserves: | | |
| Commercial Automobile | \$ 70.8 | \$ 79.4 |
| Commercial Property and Liability | 210.2 | 216.4 |
| Workers Compensation | 85.9 | 94.7 |
| Commercial Reinsurance Program | 34.2 | 29.2 |

Insurance Reserves

\$ 401.1 \$ 419.7

Table of Contents**Unitrin Business Insurance (continued)**

| (Dollars in Millions) | Sept. 30, 2006 | Dec. 31, 2005 |
|---------------------------|-------------------|------------------|
| Insurance Reserves: | | |
| Loss Reserves: | | |
| Case | \$ 129.4 | \$ 140.7 |
| Incurred but Not Reported | 178.2 | 182.6 |
| Total Loss Reserves | 307.6 | 323.3 |
| LAE Reserves | 93.5 | 96.4 |
| Insurance Reserves | \$ 401.1 | \$ 419.7 |

| (Dollars in Millions) | Nine Months Ended | | Three Months Ended | |
|--|-------------------|-------------------|----------------------|----------------------|
| | Sept. 30, 2006 | Sept. 30, 2005 | Sept. 30, 2006 | Sept. 30, 2005 |
| Favorable Loss and LAE Reserve Development, Net (excluding Catastrophes) | \$ 19.2 | \$ 9.1 | \$ 8.1 | \$ 1.3 |
| Favorable (Adverse) Catastrophe Loss and LAE Reserve Development, Net | (0.3) | 1.2 | | 0.9 |
| Total Favorable Loss and LAE Reserve Development, Net | \$ 18.9 | \$ 10.3 | \$ 8.1 | \$ 2.2 |

| | | | | |
|---|------|------|------|------|
| Loss and LAE Reserve Development as a Percentage of Insurance Reserves at Beginning of Year | 4.5% | 2.3% | 1.9% | 0.5% |
|---|------|------|------|------|

During 2005, Unitrin Business Insurance re-engineered certain business processes as it began transforming the structure that remained from the former Multi Lines Insurance segment into a structure more suitable and scalable to its future commercial lines insurance strategy. As previously disclosed in the Company's 2005 Annual Report on Form 10-K, the Unitrin Business Insurance segment expected to incur substantial costs in the first half of 2006 related to certain redundant systems and personnel. In the third quarter of 2006, the redundant costs began to decline, and Unitrin Business Insurance expects redundant costs to continue to decline in the fourth quarter of 2006. During the first quarter of 2006, Unitrin Business Insurance substantially completed the migration of its policies to its new policy administration system. Additionally, during the first nine months of 2006, the Unitrin Business Insurance segment completed the closure of three of its full service regional offices and scaled back a fourth office. Restructuring costs recognized in the Unitrin Business Insurance segment were \$0.6 million for the nine months ended September 30, 2006 and insignificant for the three months ended September 30, 2006, compared to \$2.9 million and \$0.9 million for the same periods in 2005. Although the new, scalable structure better matches the current size of the Unitrin Business Insurance segment, the segment will likely not reach adequate economies of scale for several years.

Earned Premiums in the Unitrin Business Insurance segment decreased by \$2.1 million and \$1.3 million for the nine and three months ended September 30, 2006, respectively, compared to the same periods in 2005, due to lower premium rates, partially offset by higher volume of insurance. The Unitrin Business Insurance segment has reduced insurance rates across most product lines due to increased competition in its markets, while at the same time increasing the volume of insurance by focusing on larger accounts written through its account executive distribution network. Business written by the Unitrin Business Insurance segment increased in the third quarter of 2006, but at a slower rate of growth than previously anticipated, due primarily to increased competition and several open account executive positions. Although the Unitrin Business Insurance segment expects to increase business written in the fourth quarter of 2006, earned premiums are expected to remain relatively flat. The Unitrin Business Insurance segment's commercial reinsurance program consists of certain business written and administered by First NonProfit Insurance Company (FNP). FNP specializes in providing various forms of commercial insurance to charitable and other non-profit organizations. The Unitrin Business Insurance segment intends to exit its commercial reinsurance program within the next twelve months. Other Income in the Unitrin Business Insurance segment includes a gain of \$1.3 million on the sale of a regional office building in the second quarter of 2006.

Table of Contents**Unitrin Business Insurance (continued)**

Operating Profit in the Unitrin Business Insurance segment decreased by \$1.1 million for the nine months ended September 30, 2006, compared to the same period in 2005, due primarily to higher insurance expenses, partially the result of the restructuring and system migration initiatives and increased marketing efforts, partially offset by lower incurred losses and LAE and the gain recognized on the sale of the regional office building. Incurred losses and LAE decreased due primarily to higher favorable reserve development and lower catastrophe losses and LAE, partially offset by an abnormal number of large fire losses in 2006. Incurred losses and LAE also increased due to the higher volume of larger general liability insurance accounts, which typically have higher expected losses and LAE as a percentage of earned premiums than certain of Unitrin Business Insurance's other product lines. Losses and LAE on general liability insurance typically are reported and settled over a longer period of time than some of Unitrin Business Insurance's other product lines. Accordingly, the higher losses and LAE typically are offset to some extent by additional investment income during the settlement period. Reserve development, including development of catastrophe losses and LAE, was \$18.9 million favorable for the nine months ended September 30, 2006, compared to \$10.3 million favorable in 2005. Catastrophe losses and LAE were \$2.4 million for the nine months ended September 30, 2006. Catastrophe losses and LAE (including development), net of reinsurance recoveries, were \$5.3 million for the nine months ended September 30, 2005. Catastrophe losses and LAE, net of reinsurance recoveries, in 2005 included losses and LAE from Hurricanes Katrina and Rita (see Management's Discussion and Analysis of Results of Operations and Financial Condition, "Catastrophes"). Catastrophe losses and LAE (including development), net of reinsurance recoveries, for the nine months ended September 30, 2005, included favorable development of \$1.2 million due to higher subrogation recoveries than previously anticipated from an earlier year catastrophe.

Operating Profit in the Unitrin Business Insurance segment increased by \$8.8 million for the three months ended September 30, 2006, compared to the same period in 2005, due primarily to lower incurred losses and LAE. Incurred losses and LAE decreased due primarily to higher favorable reserve development and lower catastrophe losses and LAE, partially offset by the higher volume of larger general liability accounts. Reserve development, including development of catastrophe losses and LAE, was \$8.1 million favorable for the three months ended September 30, 2006, compared to \$2.2 million favorable in 2005. Catastrophe losses and LAE (including development), net of reinsurance recoveries, were \$0.4 million for the three months ended September 30, 2006, compared to \$5.0 million in 2005. Catastrophe losses and LAE, net of reinsurance recoveries, in 2005 included losses and LAE from Hurricanes Katrina and Rita (see Management's Discussion and Analysis of Results of Operations and Financial Condition, "Catastrophes"). Catastrophe losses and LAE (including development), net of reinsurance recoveries, for the three months ended September 30, 2005, included favorable development of \$0.9 million due to higher subrogation recoveries than previously anticipated from an earlier year catastrophe.

For the nine and three months ended September 30, 2006, the Unitrin Business Insurance segment reported Net Income of \$10.2 million and \$5.3 million, respectively, compared to Net Income of \$10.7 million and Net Loss of \$0.5 million for the same periods in 2005. The Unitrin Business Insurance segment's effective income tax rate differs from the federal statutory income tax rate due primarily to tax-exempt investment income and dividends received deductions. Tax-exempt investment income and dividends received deductions were \$10.9 million and \$3.6 million for the nine and three months ended September 30, 2006, respectively. Tax-exempt investment income and dividends received deductions were \$10.0 million and \$3.2 million for the nine and three months ended September 30, 2005, respectively.

Table of Contents**Life and Health Insurance**

| (Dollars in Millions) | Nine Months Ended | | Three Months Ended | |
|--|-------------------|----------------|--------------------|----------------|
| | Sept. 30, 2006 | Sept. 30, 2005 | Sept. 30, 2006 | Sept. 30, 2005 |
| Earned Premiums: | | | | |
| Life | \$ 301.8 | \$ 304.3 | \$ 99.3 | \$ 101.1 |
| Accident and Health | 119.3 | 120.7 | 39.5 | 40.6 |
| Property | 87.9 | 78.5 | 29.3 | 24.9 |
| Total Earned Premiums | 509.0 | 503.5 | 168.1 | 166.6 |
| Net Investment Income | 132.1 | 116.7 | 43.8 | 37.5 |
| Other Income | 11.0 | 5.2 | 11.0 | 0.5 |
| Total Revenues | 652.1 | 625.4 | 222.9 | 204.6 |
| Policyholders Benefits and Incurred Losses and LAE | 312.4 | 319.8 | 96.1 | 114.1 |
| Insurance Expenses | 237.0 | 241.2 | 79.6 | 79.1 |
| Operating Profit | 102.7 | 64.4 | 47.2 | 11.4 |
| Income Tax Expense | 36.2 | 22.5 | 16.6 | 3.7 |
| Net Income | \$ 66.5 | \$ 41.9 | \$ 30.6 | \$ 7.7 |

| (Dollars in Millions) | Sept. 30, 2006 | Dec. 31, 2005 |
|----------------------------|-------------------|-------------------|
| Insurance Reserves: | | |
| Life | \$ 2,373.0 | \$ 2,317.1 |
| Accident and Health | 92.5 | 87.8 |
| Property | 7.5 | 31.2 |
| Insurance Reserves | \$ 2,473.0 | \$ 2,436.1 |

Earned Premiums in the Life and Health Insurance segment increased by \$5.5 million and \$1.5 million for the nine and three months ended September 30, 2006, respectively, compared to the same periods in 2005, due primarily to certain quota share reinsurance transactions with Capitol and its wholly owned subsidiary, Old Reliable Casualty Company (ORCC). Capitol is a mutual insurance company which is owned by its policyholders (see Note 13, Relationships with Mutual Holding Companies and Mutual Insurance Companies, to the Condensed Consolidated Financial Statements). Some of the Life and Health Insurance segment's career agents sell property insurance products for Capitol and ORCC. Effective January 1, 2006, the Company entered into a quota share reinsurance agreement with ORCC whereby the Company assumes 100% of the business written by ORCC. Prior to 2006, the Company did not assume business from ORCC. In the third quarter of 2005, the Company increased the share of business it assumed from Capitol to 100%. Prior to this change, the Company had assumed 95% of the business written by Capitol. The Company estimates that earned premiums increased by \$10.0 million and \$3.1 million for the nine and three months ended September 30, 2006, respectively, compared to the same periods in 2005, due to the impact of these quota share reinsurance transactions.

Excluding the impact of the quota share reinsurance transactions described above, Earned Premiums in the Life and Health Insurance segment decreased by \$4.5 million for the nine months ended September 30, 2006, compared to the same period in 2005, due primarily to lower earned premiums on life insurance and lower earned premiums on accident and health insurance. Earned premiums on life insurance decreased by \$2.5 million for the nine months ended September 30, 2006, compared to the same period in 2005, due primarily to lower volume. Earned premiums on accident and health insurance decreased by \$1.4 million for the nine months ended September 30, 2006, compared to the same period in 2005. Lower volume of accident and health insurance, primarily on limited benefit medical and Medicare supplement products, contributed \$6.2 million to the decrease in accident and health insurance earned premiums, while higher premium rates on those same products accounted for an increase of \$4.8 million. The cost of catastrophe reinsurance coverage was \$4.5 million for the nine months ended September 30, 2006, including a charge of \$0.2 million to reinstate reinsurance due to higher reinsured losses from Hurricane Katrina than previously anticipated. The

Edgar Filing: UNITRIN INC - Form 10-Q

cost of catastrophe reinsurance coverage was \$4.6 million for the nine months ended September 30, 2005, including a charge of \$2.6 million to reinstate reinsurance coverage following Hurricane Katrina. Excluding the effects of the

Table of Contents**Life and Health Insurance (continued)**

charges to reinstate reinsurance coverage, the cost of catastrophe reinsurance increased for the nine months ended September 30, 2006, compared to the same periods in 2005, due primarily to the higher cost of the Life and Health Insurance segment's catastrophe reinsurance program which became effective on January 1, 2006 (see Management's Discussion and Analysis of Results of Operations and Financial Condition, Catastrophes).

Excluding the impact of the quota share reinsurance transactions described above, Earned Premiums in the Life and Health Insurance segment decreased by \$1.6 million for the three months ended September 30, 2006, compared to the same period in 2005, due primarily to lower earned premiums on life insurance and lower earned premiums on accident and health insurance, partially offset by lower catastrophe reinsurance costs. Earned premiums on life insurance decreased by \$1.8 million for the three months ended September 30, 2006, compared to the same period in 2005, due primarily to lower volume. Earned premiums on accident and health insurance decreased by \$1.1 million for the three months ended September 30, 2006, compared to the same period in 2005. Lower volume of accident and health insurance, primarily on limited benefit medical and Medicare supplement products, contributed \$2.6 million to the decrease in accident and health insurance earned premiums, while higher premium rates on those same products accounted for an increase of \$1.5 million. The cost of catastrophe reinsurance coverage was \$1.5 million for the three months ended September 30, 2006, compared to \$3.3 million in 2005, which included a charge of \$2.6 million to reinstate reinsurance coverage following Hurricane Katrina. Excluding the effects of the charges to reinstate reinsurance coverage, the cost of catastrophe reinsurance increased for the three months ended September 30, 2006, compared to the same periods in 2005, due primarily to the higher cost of the Life and Health Insurance segment's catastrophe reinsurance program which became effective on January 1, 2006 (see Management's Discussion and Analysis of Results of Operations and Financial Condition, Catastrophes).

Other Income for the nine and three months ended September 30, 2006, includes a gain of \$9.7 million, net of a deferred gain of \$2.5 million, recognized on the sale and leaseback of Reserve National's home office building and a gain of \$1.3 million recognized on the sale of the Career Agency Group's Louisiana office building. The deferred gain is being amortized over the three-year term of the leaseback. During 2006, the Career Agency Group completed the consolidation of its Louisiana regional office operations into its St. Louis home office. Other Income for the nine months ended September 30, 2005, includes a gain of \$2.4 million recognized on the sale of the Career Agency Group's home office building. Other Income in 2005 also includes service fees charged for certain administrative services provided by the Career Agency Group to ORCC, prior to the effective date of the 100% quota share agreement described above.

Net Investment Income increased by \$15.4 million and \$6.3 million for the nine and three months ended September 30, 2006, respectively, compared to the same periods in 2005, due to higher yields on investments and higher levels of investments.

Operating Profit in the Life and Health Insurance segment increased by \$38.3 million for the nine months ended September 30, 2006, compared to the same period in 2005, due primarily to the higher Net Investment Income and Other Income discussed above, lower catastrophe losses and LAE (including development) on property insurance and lower insurance expenses as a percentage of earned premiums on life and property insurance products sold by the Life and Health Insurance segment's career agents. Operating Profit in the Life and Health Insurance segment increased by \$35.8 million for the three months ended September 30, 2006, compared to the same period in 2005, due primarily to the higher Net Investment Income, the higher Other Income and the reinsurance reinstatement premium discussed above, and lower catastrophe losses and LAE (including development) on property insurance.

Catastrophe losses and LAE (including development), net of reinsurance recoveries, on property insurance sold by the Life and Health Insurance segment's career agents were \$9.9 million and \$1.2 million for the nine and three months ended September 30, 2006, respectively. Catastrophe losses and LAE, for the nine months ended September 30, 2006 included adverse development of \$3.6 million, net of reinsurance recoveries, from Hurricane Katrina (see Management's Discussion and Analysis of Results of Operations and Financial Condition, Catastrophes). Catastrophe losses and LAE (including development), net of reinsurance recoveries, were \$19.1 million and \$16.9 million for the nine and three months ended September 30, 2005, respectively. Catastrophe losses and LAE for the nine and three months ended September 30, 2005 included \$16.4 million, net of reinsurance recoveries, from Hurricanes Katrina and Rita. Property insurance reserves decreased by \$23.7 million during the first nine months of 2006 due primarily to payment of claims related to Hurricanes Katrina and Rita.

Table of Contents**Life and Health Insurance (continued)**

Net Income in the Life and Health Insurance segment increased by \$24.6 million and \$22.9 million for the nine and three months ended September 30, 2006, respectively, compared to the same periods in 2005, due primarily to the higher operating profit.

Consumer Finance

| (Dollars in Millions) | Nine Months Ended | | Three Months Ended | |
|--|-------------------|----------------|--------------------|----------------|
| | Sept. 30, 2006 | Sept. 30, 2005 | Sept. 30, 2006 | Sept. 30, 2005 |
| Interest, Loan Fees and Earned Discount | \$ 176.0 | \$ 155.4 | \$ 61.4 | \$ 54.0 |
| Net Investment Income | 2.8 | 2.6 | 1.0 | 0.9 |
| Other | 5.5 | 5.2 | 1.9 | 1.8 |
| Total Revenues | 184.3 | 163.2 | 64.3 | 56.7 |
| Provision for Loan Losses | 41.9 | 34.9 | 17.8 | 13.1 |
| Interest Expense on Certificates of Deposits | 36.1 | 27.6 | 13.2 | 9.9 |
| General and Administrative Expenses | 68.3 | 62.6 | 22.8 | 20.2 |
| Operating Profit | 38.0 | 38.1 | 10.5 | 13.5 |
| Income Tax Expense | 16.0 | 16.0 | 4.7 | 5.6 |
| Net Income | \$ 22.0 | \$ 22.1 | \$ 5.8 | \$ 7.9 |
| Consumer Finance Loan Originations | \$ 637.7 | \$ 590.0 | \$ 196.4 | \$ 208.6 |

| | Sept. 30, 2006 | Dec. 31, 2005 |
|--|----------------|---------------|
| Percentage of Consumer Finance Receivables Past Due: | | |
| Less than 30 Days | 25.5% | 23.9% |
| 30 Days to 59 Days | 7.9% | 8.3% |
| 60 Days to 89 Days | 2.9% | 2.9% |
| 90 Days and Greater | 1.2% | 1.2% |
| Total Past Due | 37.5% | 36.3% |
| Ratio of Reserve for Loan Losses to Gross Consumer Finance Receivables | 5.3% | 5.3% |
| Weighted-Average Interest Yield on Certificates of Deposits | 4.6% | 4.0% |

| (Dollars in Millions) | Nine Months Ended | | Three Months Ended | |
|---|-------------------|----------------|--------------------|----------------|
| | Sept. 30, 2006 | Sept. 30, 2005 | Sept. 30, 2006 | Sept. 30, 2005 |
| Reserve for Loan Losses - Beginning of Period | \$ 62.6 | \$ 56.6 | \$ 68.6 | \$ 62.3 |
| Provision for Loan Losses | 41.9 | 34.9 | 17.8 | 13.1 |
| Net Charge-off: | | | | |
| Consumer Finance Receivables Charged-off | (73.5) | (57.8) | (30.0) | (21.4) |
| Consumer Finance Receivables Recovered | 37.7 | 31.3 | 12.3 | 11.0 |
| Net Charge-off | (35.8) | (26.5) | (17.7) | (10.4) |

Edgar Filing: UNITRIN INC - Form 10-Q

| | | | | |
|---|---------|---------|---------|---------|
| Reserve for Loan Losses - End of Period | \$ 68.7 | \$ 65.0 | \$ 68.7 | \$ 65.0 |
|---|---------|---------|---------|---------|

Interest, Loan Fees and Earned Discounts in the Consumer Finance segment increased by \$20.6 million and \$7.4 million for the nine and three months ended September 30, 2006, respectively, compared to the same periods in 2005, due primarily to higher levels of loans outstanding, partially offset by lower interest rates.

Table of Contents**Consumer Finance (continued)**

Operating Profit decreased by \$0.1 million and \$3.0 million for the nine and three months ended September 30, 2006, compared to nine and three months ended September 30, 2005, due primarily to higher Provision for Loan Losses and higher Interest Expense on Certificates of Deposits, partially offset by a higher level of loans outstanding. Provision for Loan Losses increased by \$7.0 million and \$4.7 million for the nine and three months ended September 30, 2006, compared to the same periods in 2005, due primarily to a higher level of loans outstanding and higher net charge-off. Interest Expense on Certificates of Deposits increased by \$8.5 million and \$3.3 million for the nine and three months ended September 30, 2006, respectively, compared to the same periods in 2005, due primarily to higher interest rates on Certificates of Deposits and higher levels of deposits. General and Administrative Expenses, as a percentage of Interest, Loan Fees and Earned Discounts, decreased from 40.3% for the nine months ended September 30, 2005, to 38.8% for the nine months ended September 30, 2006, due primarily to higher levels of loans outstanding.

Net Income in the Consumer Finance segment decreased by \$0.1 million and \$2.1 million for the nine and three months ended September 30, 2006, compared to the same period in 2005, due primarily to the lower operating profit.

Equity in Net Income of Investee

Unitrin accounts for its investment in its investee, Intermec, Inc. (Intermec), under the equity method of accounting using the most recent and sufficiently timely publicly-available financial reports and other publicly-available information, which generally results in a three month delay in the inclusion of Intermec's results in Unitrin's consolidated financial statements. Equity in Net Income of Investee was \$8.6 million and \$1.4 million for the nine and three months ended September 30, 2006, respectively. Equity in Net Income of Investee was \$4.7 million and \$1.6 million for the nine and three months ended September 30, 2005, respectively.

The fair value of Unitrin's investment in Intermec exceeded the carrying value of Unitrin's investment in Intermec by \$242.3 million and \$347.4 million at September 30, 2006 and December 31, 2005, respectively. In accordance with applicable accounting standards, such excess is not included in the unaudited Condensed Consolidated Financial Statements.

Corporate Investments

The Company considers the management of certain investments, Northrop Grumman Corporation (Northrop) common and preferred stock, Baker Hughes, Inc. common stock, and its investee, Intermec, to be a corporate responsibility and excludes income from these investments from its operating segments. Dividend income from these investments for the nine and three months ended September 30, 2006 and 2005 was:

| (Dollars in Millions) | Nine Months Ended | | Three Months Ended | |
|-----------------------------------|-------------------|-------------------|----------------------|-------------------|
| | Sept. 30, 2006 | Sept. 30, 2005 | Sept. 30, 2006 | Sept. 30, 2005 |
| Northrop Preferred Stock | \$ 9.3 | \$ 9.3 | \$ 6.2 | \$ 3.1 |
| Northrop Common Stock | 6.4 | 5.9 | 2.2 | 2.0 |
| Baker Hughes Common Stock | 0.2 | 0.4 | 0.1 | 0.2 |
| Total Unallocated Dividend Income | \$ 15.9 | \$ 15.6 | \$ 8.5 | \$ 5.3 |

Dividend income from the Company's investment in Northrop preferred stock increased for the three months ended September 30, 2006, compared to the same period in 2005, due to the timing of the ex-dividend date.

Table of Contents**Corporate Investments (continued)**

The changes in the fair value of Corporate Investments for the nine months ended September 30, 2006 are summarized below:

| (Dollars in Millions) | Fair Value Dec. 31, 2005 | Nine Months Ended September 30, 2006 | | Fair Value Sept. 30, 2006 |
|------------------------------------|--------------------------------|---|------------------|---------------------------------|
| | | Holding Gain (Loss) | Dispositions | |
| Equity Securities: | | | | |
| Northrop Preferred Stock | \$ 225.7 | \$ 10.3 | \$ | \$ 236.0 |
| Northrop Common Stock | 460.7 | 59.8 | (17.5) | 503.0 |
| Baker Hughes Common Stock | 48.7 | 7.7 | (18.8) | 37.6 |
| Investee: | | | | |
| Intermec Common Stock | 427.8 | (94.1) | | 333.7 |
| Total Corporate Investments | \$ 1,162.9 | \$ (16.3) | \$ (36.3) | \$ 1,110.3 |

Net Realized Investment Gains

The components of Net Realized Investment Gains for the nine and three months ended September 30, 2006 and 2005 were:

| (Dollars in Millions) | Nine Months Ended | | Three Months Ended | |
|--------------------------------------|-------------------|-------------------|--------------------|-------------------|
| | Sept. 30, 2006 | Sept. 30, 2005 | Sept. 30, 2006 | Sept. 30, 2005 |
| Fixed Maturities: | | | | |
| Gains on Dispositions | \$ 4.1 | \$ 1.2 | \$ 2.1 | \$ 0.2 |
| Losses on Dispositions | (4.4) | (0.4) | | |
| Northrop Common Stock: | | | | |
| Gains on Dispositions | 5.6 | | | |
| Other Equity Securities: | | | | |
| Gains on Dispositions | 21.6 | 21.1 | 1.8 | 9.6 |
| Losses on Dispositions | (1.1) | (1.8) | (0.3) | (1.3) |
| Losses from Write-downs | (2.1) | (6.2) | (0.4) | (1.0) |
| Real Estate: | | | | |
| Gains on Dispositions | | 39.4 | | |
| Losses from Write-downs | (0.1) | | (0.1) | |
| Other Investments: | | | | |
| Gains on Dispositions | 0.4 | 0.6 | 0.1 | 0.3 |
| Losses on Dispositions | (0.3) | (0.4) | (0.1) | |
| Net Realized Investment Gains | \$ 23.7 | \$ 53.5 | \$ 3.1 | \$ 7.8 |

The Company regularly reviews its investment portfolio for factors that may indicate that a decline in the fair value of an investment is other than temporary. Losses arising from other than temporary declines in fair value are reported in the Condensed Consolidated Statements of Income in the period that the decline was determined to be other than temporary. Net Realized Investment Gains for the nine and three months ended September 30, 2006 includes pretax losses of \$2.2 million and \$0.5 million, respectively, resulting from other than temporary declines in the fair values of investments. Net Realized Investment Gains for the nine and three months ended September 30, 2005 includes pretax losses of \$6.2 million and \$1.0 million, respectively, resulting from other than temporary declines in the fair values of investments. The Company cannot anticipate when or if similar investment losses may occur in the future.

Table of Contents**Liquidity and Capital Resources**

At September 30, 2006, there were approximately 0.8 million shares of the Company's outstanding common stock that could be repurchased under the Company's outstanding repurchase authorization. Common stock may be repurchased in the open market or in privately negotiated transactions from time to time subject to market conditions and other factors. During the first nine months of 2006, the Company repurchased 1,720,600 shares of its common stock at an aggregate cost of \$76.3 million in open market transactions.

The Company has a five-year, \$325 million, unsecured, revolving credit agreement, expiring June 30, 2010, with a group of financial institutions. The agreement provides for fixed and floating rate advances for periods up to one year at various interest rates. The agreement also contains various financial covenants, including limits on total debt to total capitalization and minimum risk-based capital ratios for the Company's largest insurance subsidiaries. The proceeds from advances under the revolving credit facility may be used for general corporate purposes. The Company had no outstanding advances under its unsecured, revolving credit agreement at September 30, 2006 or December 31, 2005. Undrawn letters of credit issued pursuant to the unsecured, revolving credit agreement were \$13.1 million and \$13.4 million at September 30, 2006 and December 31, 2005, respectively. Accordingly, the amounts available for future borrowing were \$311.9 million and \$311.6 million at September 30, 2006 and December 31, 2005, respectively.

At September 30, 2006, the Company had \$300 million of its 5.75% senior notes due July 1, 2007 outstanding and \$200 million of its 4.875% senior notes due November 1, 2010 outstanding. Interest expense on such senior notes was \$21.0 million and \$20.9 million for the nine months ended September 30, 2006 and 2005, respectively.

In August 2005, the Company filed a universal shelf registration statement with the Securities and Exchange Commission for the future sale of up to an aggregate of \$300 million of debt securities, common stock, preferred stock and other securities. The Company's present intention is to utilize the shelf to refinance its \$300 million 5.75% senior notes closer to their maturity.

The Company does not anticipate making significant changes to its capital structure during 2006. The Company's management believes that it has sufficient resources to maintain the payment of dividends to its shareholders at its present level. Sources available for future shareholder dividend payments, the payment of interest on Unitrin's senior notes and the repurchases of the Company's common stock include the receipt of dividends from Unitrin's operating subsidiaries, the receipt of dividends from its investments in Northrop, borrowings under the Company's revolving credit agreement, and monetization of a portion of the Unitrin parent company's Northrop holdings. Various state insurance laws restrict the ability of the Company's insurance subsidiaries to pay dividends without regulatory approval. Such laws generally restrict the amount of dividends paid in an annual period to the greater of statutory net income from the previous year or 10% of statutory capital and surplus. Certain risk-based capital regulations also have the effect of limiting the amount of dividends that may be paid by the Company's consumer finance subsidiary, Fireside Bank. In 2006, the Company estimates that its subsidiaries would be able to pay \$258 million in dividends to the Company without prior regulatory approval. During the first nine months of 2006, three of Unitrin's subsidiaries (Trinity, Union National and Fireside Securities Corporation) paid cash dividends totaling \$59.0 million, \$60.0 million and \$14.3 million, respectively to Unitrin. The Company currently estimates that the Unitrin parent company will receive approximately \$91 million in dividends from its subsidiaries during the remainder of 2006. The Unitrin parent company directly held investments in Northrop preferred and common stock with a market value totaling \$330.5 million and \$321.7 million at September 30, 2006 and December 31, 2005, respectively. In addition to the Unitrin parent company's holdings of Northrop preferred and common stock, Trinity held investments in Northrop common stock with a market value of \$408.5 million and \$364.7 million at September 30, 2006 and December 31, 2005, respectively. During the first nine months of 2006, the Unitrin parent company and Trinity sold a portion of their Northrop common stock, generating gross proceeds of \$12.7 million and \$4.8 million, respectively.

Table of Contents

Liquidity and Capital Resources (continued)

The primary sources of funds for the Company's insurance subsidiaries are premiums and investment income. The primary uses of funds are the payment of policyholder benefits under life insurance contracts and claims under property and casualty insurance contracts and accident and health insurance contracts, the payment of commissions and general expenses and the purchase of investments. Generally, there is a time lag between when premiums are collected and when policyholder benefits and insurance claims are paid. Accordingly, during periods of growth, insurance companies typically experience positive operating cash flows and are able to invest a portion of their operating cash flows to fund future policyholder benefits and claims. During periods in which premium revenues decline, insurance companies may experience negative cash flow from operations and may need to sell investments to fund payments to policyholders and claimants. In addition, if the Company's property and casualty insurance subsidiaries experience several significant catastrophic events over a relatively short period of time, investments may have to be sold in advance of their maturity dates to fund payments, which could either result in investment gains or losses. Management believes that its insurance subsidiaries maintain adequate levels of liquidity and surplus capacity to manage the risks inherent with any differences between the duration of their liabilities and invested assets and to provide adequate liquidity in the event that its property and casualty insurance subsidiaries experience several catastrophic events over a relatively short period of time.

The primary sources of funds for Fireside Bank are customer deposits, repayments of consumer loans, interest on consumer loans and investment income. The primary uses of funds for Fireside Bank are loans made to consumers, repayment of customer deposits, interest paid to depositors and general expenses.

Net Cash Provided by Operating Activities decreased by \$97.4 million for the nine months ended September 30, 2006, compared to the same period in 2005, due primarily to cash outflows related to the payment of insurance claims that were expensed and reserved for in prior years.

Net Cash Used by Investing Activities is largely dependent on Net Cash Provided by Operating Activities and cash flow from Financing Activities. Cash Flow Used by Investing Activities decreased by \$191.7 million for the nine months ended September 30, 2006, compared to the same period in 2005, due primarily to lower levels of cash from Financing and Operating Activities. In addition, the Company significantly reduced its excess cash on hand in 2005 and invested such excess.

Net Cash Provided by Financing Activities decreased by \$69.5 million for the nine months ended September 30, 2006, compared to the same period in 2005. Cash from certificates of deposits issued, net of withdrawals, decreased by \$10.5 million. In addition, the Company used \$72.6 million of cash in the first nine months of 2006 to repurchase shares of its common stock. The Company used \$24.1 million of cash to repurchase shares of its common stock in the corresponding nine month period in 2005.

Interest and Other Expenses

Interest and Other Expenses was \$47.2 million and \$15.5 million for the nine and three months ended September 30, 2006, respectively, compared to \$46.7 million and \$16.4 million for the same periods in 2005. Interest Expense was \$21.6 million and \$7.2 million for the nine and three months ended September 30, 2006, respectively, compared to the same amounts for the same periods in 2005. Other Expenses was \$25.6 million and \$8.3 million for the nine and three months ended September 30, 2006, respectively, compared to \$25.1 million and \$9.2 million for the same periods in 2005.

Table of Contents**Income Taxes**

The Company's effective income tax rate differs from the Federal statutory income tax rate due primarily to the effects tax-exempt investment income and dividends received deductions, partially offset by the net effects of state income taxes. Tax-exempt investment income and dividends received deductions were \$53.4 million and \$20.4 million for the nine and three months ended September 30, 2006, respectively, compared to \$51.0 million and \$17.2 million for the same periods in 2005. Tax-exempt investment income and dividends received deductions increased in 2006 due primarily to higher levels of tax-exempt investments and certain intersegment sales of equity securities resulting from certain tax planning strategies. The Company began implementing these strategies in December 2005 when one of the Company's life insurance subsidiaries sold substantially all of its equity securities to one of the Company's property and casualty insurance subsidiaries. In July 2006, another of the Company's life insurance subsidiaries also sold all of its equity securities to one of the Company's property and casualty insurance subsidiaries as part of these strategies. The net effects of state income taxes were \$3.5 million and \$1.4 million for the nine and three months ended September 30, 2006, respectively, compared to \$3.0 million and \$0.9 million for the same periods in 2005.

Accounting Changes

In December 2004, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 123(R), *Share-Based Payment*. SFAS No. 123(R) replaces SFAS No. 123, *Accounting for Stock-Based Compensation*, and supersedes Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*. SFAS No. 123(R) requires compensation costs related to share-based payment transactions to be recognized in the financial statements over the period that an employee provides service in exchange for the award. The Company has adopted SFAS No. 123(R) using the modified prospective method effective January 1, 2006. Under the modified prospective method, companies record prospectively the compensation cost for new and modified awards, on or after the date of adoption, over the requisite service period of such awards. In addition, companies record compensation cost prospectively for the unvested portion, at the date of adoption, of previously issued and outstanding awards over the remaining requisite service period of such awards. The Company previously adopted SFAS No. 123 in 2003. Accordingly, the incremental effect of adoption of SFAS No. 123(R) was not material.

In June 2006, the FASB issued FASB Interpretation No. (FIN) 48, *Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109*. FIN 48 clarifies the accounting for uncertainty in income taxes recognized under SFAS No. 109, *Accounting for Income Taxes*. FIN 48 prescribes a recognition threshold and measurement attribute for financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return and also provides guidance on various related matters such as derecognition, interest and penalties, and disclosure. FIN 48 is effective with the Company's next fiscal year beginning January 1, 2007. The Company expects that the financial impact, if any, of applying the provisions of FIN 48 to all tax positions will not be material upon the initial adoption of FIN 48.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*. SFAS No. 157 defines fair value, establishes a framework for measuring fair value under GAAP and expands disclosures about fair value measurements. SFAS No. 157 applies to other accounting pronouncements that require or permit fair value measurements, but does not require any new fair value measurements. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. Early application is encouraged, provided that the reporting entity has not yet issued financial statements for an interim period within that fiscal year. The Company estimates that the initial application of SFAS No. 157 will not be material.

Table of Contents**Accounting Changes (continued)**

In September 2006, the FASB issued SFAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*. SFAS No. 158 amends SFAS No. 87, *Employers' Accounting for Pensions*, SFAS No. 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and Termination Benefits*, SFAS No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, and SFAS No. 132(R), *Employers' Disclosure about Pensions and Other Postretirement Benefits*. SFAS No. 158 requires the recognition of the funded status of a defined benefit postretirement plan (other than a multi-employer plan) as an asset or liability in the statement of financial position and the recognition of changes in the funded status through comprehensive income in the year in which such changes occur. The Company is required to initially apply the recognition provisions of SFAS No. 158 to the funded status of its defined benefit postretirement plans and to provide the required disclosures as of December 31, 2006. The Company has not yet determined the financial impact that the initial recognition of the funded status of its defined benefit postretirement plans will have on its financial position. However, had the Company been required to apply the provisions of SFAS No. 158 to the accounting for its defined benefit postretirement plans at December 31, 2005, it would have recognized a liability of \$35.1 million before tax for the unfunded status of such plans.

In addition, SFAS No. 158 requires that the funded status of a plan be measured as of the date of the year-end statement of financial position, with limited exceptions. The Company currently measures its funded status as of the date of the Company's fiscal year-end statement of financial position. Accordingly, adoption of the measurement provisions of SFAS No. 158 will have no impact on the Company.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Pursuant to the rules and regulations of the SEC, the Company is required to provide the following disclosures about Market Risk.

Quantitative Information About Market Risk

The Company's Condensed Consolidated Balance Sheets include five types of financial instruments subject to material market risk disclosures required by the SEC: 1) Investments in Fixed Maturities, 2) Investments in Equity Securities, 3) Consumer Finance Receivables, 4) Certificates of Deposits and 5) Notes Payable. Investments in Fixed Maturities, Consumer Finance Receivables, Certificates of Deposits and Notes Payable are subject to material interest rate risk. The Company's investments in Equity Securities include common and preferred stocks and, accordingly, are subject to material equity price risk and interest rate risk, respectively.

For purposes of this disclosure, market risk sensitive financial instruments are divided into two categories: financial instruments acquired for trading purposes and financial instruments acquired for purposes other than trading. The Company's market risk sensitive financial instruments are classified as held for purposes other than trading. The Company has no significant holdings of financial instruments acquired for trading purposes. The Company has no significant holdings of derivatives.

The Company measures its sensitivity to market risk by evaluating the change in its financial assets and liabilities relative to fluctuations in interest rates and equity prices. The evaluation is made using instantaneous changes in interest rates and equity prices on a static balance sheet to determine the effect such changes would have on the Company's market value at risk and the resulting pre-tax effect on Shareholders' Equity. The changes chosen reflect the Company's view of adverse changes that are reasonably possible over a one-year period. The selection of these changes should not be construed as the Company's prediction of future market events, but rather an illustration of the impact of such events.

Table of Contents**Quantitative Information About Market Risk (continued)**

For the interest rate sensitivity analysis presented below, the Company assumed an adverse and instantaneous increase of 100 basis points in the yield curve at both September 30, 2006 and December 31, 2005, for Investments in Fixed Maturities. Such 100 basis point increase in the yield curve may not necessarily result in a corresponding 100 basis point increase in the interest rate for all investments in fixed maturities. For example, a 100 basis point increase in the yield curve for risk-free, taxable investments in fixed maturities may not result in a 100 basis point increase for tax-exempt investments in fixed maturities. For Investments in Fixed Maturities, the Company also anticipated changes in cash flows due to changes in the likelihood that investments would be called or pre-paid prior to their contractual maturity. All other variables were held constant. For preferred stock equity securities and Consumer Finance Receivables, the Company assumed an adverse and instantaneous increase of 100 basis points in market interest rates from their levels at September 30, 2006 and December 31, 2005, respectively. All other variables were held constant. For Certificates of Deposits and Notes Payable, the Company assumed an adverse and instantaneous decrease of 100 basis points in market interest rates from their levels at September 30, 2006 and December 31, 2005, respectively. All other variables were held constant. The Company measured equity price sensitivity assuming an adverse and instantaneous 10% decrease in the Standard and Poor's Stock Index (the S&P 500) from its levels at September 30, 2006 and December 31, 2005, with all other variables held constant. The Company's investments in common stock equity securities were correlated with the S&P 500 using the portfolio's weighted-average beta of 0.58 and 0.46 at September 30, 2006 and December 31, 2005, respectively. The portfolio's weighted-average beta was calculated using each security's beta for the five-year periods ended September 30, 2006 and December 31, 2005, respectively, and weighted on the fair value of such securities at September 30, 2006 and December 31, 2005, respectively. Beta measures a stock's relative volatility in relation to the rest of the stock market, with the S&P 500 having a beta coefficient of 1.00.

The estimated adverse effects on the market value of the Company's financial instruments using these assumptions were:

| (Dollars in Millions) | Fair Value | Pro Forma Increase (Decrease) | | |
|----------------------------------|------------|-------------------------------|-------------------|-------------------|
| | | Interest Rate Risk | Equity Price Risk | Total Market Risk |
| September 30, 2006 | | | | |
| Assets | | | | |
| Investments in Fixed Maturities | \$ 3,907.9 | \$ (266.0) | \$ | \$ (266.0) |
| Investments in Equity Securities | 1,247.0 | (3.2) | (68.4) | (71.6) |
| Consumer Finance Receivables | 1,227.4 | (16.3) | | (16.3) |
| Liabilities | | | | |
| Certificates of Deposits | \$ 1,181.1 | \$ 22.6 | \$ | \$ 22.6 |
| Notes Payable | 500.2 | 9.4 | | 9.4 |
| December 31, 2005 | | | | |
| Assets | | | | |
| Investments in Fixed Maturities | \$ 4,086.6 | \$ (301.8) | \$ | \$ (301.8) |
| Investments in Equity Securities | 1,098.9 | (4.4) | (47.1) | (51.5) |
| Consumer Finance Receivables | 1,112.5 | (14.8) | | (14.8) |
| Liabilities | | | | |
| Certificates of Deposits | \$ 1,070.9 | \$ 18.6 | \$ | \$ 18.6 |
| Notes Payable | 504.3 | 12.9 | | 12.9 |

Table of Contents**Quantitative Information About Market Risk (continued)**

The market risk sensitivity analysis assumes that the composition of the Company's interest rate sensitive assets and liabilities, including, but not limited to, credit quality, and the equity price sensitive assets existing at the beginning of the period remains constant over the period being measured. It also assumes that a particular change in interest rates is reflected uniformly across the yield curve regardless of the time to maturity. Interest rates on certain types of assets and liabilities may fluctuate in advance of changes in market interest rates, while interest rates on other types may lag behind changes in market rates. Also, any future correlation, either in the near term or the long term, between the Company's common stock equity securities portfolio and the S&P 500 may differ from the historical correlation as represented by the weighted-average historical beta of the common stock equity securities portfolio. Accordingly, the market risk sensitivity analysis may not be indicative of, is not intended to provide, and does not provide, a precise forecast of the effect of changes in market rates on the Company's income or shareholders equity. Further, the computations do not contemplate any actions the Company may undertake in response to changes in interest rates or equity prices.

To the extent that any adverse 100 basis point change occurs in increments over a period of time instead of instantaneously, the adverse impact on fair values would be partially mitigated because some of the underlying financial instruments would have matured. For example, proceeds from any maturing assets could be reinvested and any new liabilities would be incurred at the then current interest rates.

Qualitative Information About Market Risk

Market risk is a broad term related to economic losses due to adverse changes in the fair value of a financial instrument and is inherent to all financial instruments. SEC disclosure rules focus on only one element of market risk - price risk. Price risk relates to changes in the level of prices due to changes in interest rates, equity prices, foreign exchange rates or other factors that relate to market volatility of the rate, index, or price underlying the financial instrument. The Company's primary market risk exposures are to changes in interest rates and equity prices. The Company manages its interest rate exposures with respect to Investments in Fixed Maturities by investing primarily in investment-grade securities of moderate duration. The interest rate risks with respect to the fair value of Consumer Finance Receivables should be partially offset by the impact of interest rate movements on the fair value of Certificates of Deposits which are issued to fund its receivables.

At September 30, 2006 and December 31, 2005, respectively, \$739.0 million and \$686.4 million of the Company's Investments in Equity Securities, which exclude the Company's Investment in Investee, were concentrated in the preferred and common stock of Northrop. Northrop stated in its 2005 Annual Report on Form 10-K that it provides technologically advanced innovative products, services, and solutions in information and services, aerospace, electronics and shipbuilding. Additionally, Northrop stated that As a prime contractor, principal subcontractor, partner, or preferred supplier, it participates in many high-priority defense and non-defense technology programs in the United States and abroad. Accordingly, the Company's Investments in Equity Securities are sensitive to the nature of Northrop's industry segments.

Caution Regarding Forward-Looking Statements

This Quarterly Report on Form 10-Q, including Management's Discussion and Analysis of Results of Operations and Financial Condition, Quantitative and Qualitative Disclosures About Market Risk, the accompanying unaudited Condensed Consolidated Financial Statements (including the notes thereto) and the other Exhibits filed as a part hereof or incorporated by reference may contain or incorporate by reference information that includes or is based upon forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. Forward-looking statements give expectations or forecasts of future events. The reader can identify these statements by the fact that they do not relate strictly to historical or current facts. They use words such as believe(s), goal(s), target(s), estimate(s), anticipate(s), forecast(s), project(s), plan(s), intend(s), expect(s), might, may and other words and terms in connection with a discussion of future operating or financial performance. Forward-looking statements, in particular, include statements relating to future actions, prospective services or products, future performance or results of current and anticipated services or products, sales efforts, expenses, the outcome of contingencies such as legal proceedings, trends in operations and financial results.

Table of Contents

Caution Regarding Forward-Looking Statements (continued)

Any or all forward-looking statements may turn out to be wrong, and, accordingly, readers are cautioned not to place undue reliance on such statements, which speak only as of the date of this Quarterly Report on Form 10-Q. Forward-looking statements can be affected by inaccurate assumptions or by known or unknown risks and uncertainties. Many such factors will be important in determining the Company's actual future results. These statements are based on current expectations and the current economic environment. They involve a number of risks and uncertainties that are difficult to predict. These statements are not guarantees of future performance; actual results could differ materially from those expressed or implied in the forward-looking statements.

Among the general factors that could cause actual results to differ materially from estimated results are:

Changes in general economic conditions, including performance of financial markets, interest rates, unemployment rates and fluctuating values of particular investments held by the Company and its subsidiaries;

Heightened competition, including, with respect to pricing, entry of new competitors and the development of new products by new and existing competitors;

The number and severity of insurance claims (including those associated with catastrophe losses) and their impact on the adequacy of loss reserves;

The impact of inflation on insurance claims, including, but not limited to, the effects attributed to scarcity of resources available to rebuild damaged structures, including labor and materials and the amount of salvage value recovered for damaged property;

Orders, interpretations or other actions by regulators that impact the reporting, adjustment and payment of claims;

Changes in the pricing or availability of reinsurance;

Changes in the financial condition of reinsurers and amounts recoverable therefrom;

Changes in industry trends and significant industry developments;

Regulatory approval of insurance rates, policy forms, license applications and similar matters;

Developments related to insurance policy claims and coverage issues including, but not limited to, interpretations or decisions by courts or regulators that may govern or influence insurance policy coverage issues arising with respect to losses incurred in connection with hurricanes;

Governmental actions, including new laws or regulations or court decisions interpreting existing laws and regulations or policy provisions;

Edgar Filing: UNITRIN INC - Form 10-Q

Adverse outcomes in litigation or other proceedings involving the Company or its subsidiaries;

Regulatory, accounting or tax changes that may affect the cost of, or demand for, the Company's products or services;

The impact of residual market assessments and assessments for insurance industry insolvencies;

Changes in distribution channels, methods or costs resulting from changes in laws or regulations, lawsuits or market forces;

Changes in ratings by credit rating agencies and/or A.M. Best Co., Inc.;

The level of success and costs expended in realizing economies of scale and implementing significant business consolidations and technology initiatives;

Increased costs and risks related to data security;

Absolute and relative performance of the Company's products or services; and

Other risks and uncertainties described from time to time in the Company's filings with the Securities and Exchange Commission (SEC). No assurances can be given that the results contemplated in any forward-looking statements will be achieved or will be achieved in any particular timetable. The Company assumes no obligation to publicly correct or update any forward-looking statements as a result of events or developments subsequent to the date of this Quarterly Report on Form 10-Q. The reader is advised, however, to consult any further disclosures the Company makes on related subjects in filings made with the SEC.

Table of Contents**Item 4. Controls and Procedures**

(a) Evaluation of disclosure controls and procedures.

The Company's management, with the participation of the Company's Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the Company's disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)), as of the end of the period covered by this report. Based on such evaluation, the Company's Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of such period, the Company's disclosure controls and procedures are effective in ensuring that information required to be disclosed by the Company in reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified by the SEC's rules and forms, and accumulated and communicated to the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

(b) Changes in internal controls.

There have not been any changes in the Company's internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the fiscal quarter to which this report relates that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II - OTHER INFORMATION

Items not listed here have been omitted because they are inapplicable or the answer is negative.

Item 1. Legal Proceedings

Information concerning pending legal proceedings is incorporated herein by reference to Note 12 to the Condensed Consolidated Financial Statements (Unaudited) in Part I of this Form 10-Q.

Item 2. Changes in Securities and Use of Proceeds

| Period | Total Number of Shares Purchased (1) | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs |
|----------------------------|--|---------------------------------------|---|--|
| August 1 - August 31 | 700,358 | \$ 42.90 | 693,800 | 1,138,654 |
| September 1 - September 30 | 387,100 | \$ 44.60 | 387,100 | 751,554 |

- (1) This number represents purchases made by the Company under its stock repurchase program, which was first announced on August 8, 1990. The repurchase program was subsequently expanded several times, most recently in November 2000, when the Board of Directors expanded the Company's authority to repurchase the Company's common stock by an aggregate number of 4,000,000 shares (in addition to approximately 860,000 shares remaining under its prior authorization). The repurchase program does not have an expiration date. Total Number of Shares Purchased for the month of August includes 6,558 shares tendered to the Company to satisfy tax withholding obligations relating to the vesting of restricted stock held by employees. This table does not include shares withheld or surrendered, either actually or constructively, to satisfy the exercise price and/or tax withholding obligations relating to the exercise of stock options or stock appreciation rights under the Company's four stock option plans.

Table of Contents

Item 6. Exhibits

- 3.1 Certificate of Incorporation (Incorporated herein by reference to Exhibit 3.1 to the Company's Registration Statement on Form S-3 filed May 9, 2002, Registration No. 333-87866.)
- 3.2 Amended and Restated By-Laws (Incorporated herein by reference to Exhibit 3.2 to the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2004.)
- 4.1 Rights Agreement between Unitrin, Inc. and Computershare Trust Company, N.A. as successor Rights Agent, including the Form of Certificate of Designation, Preferences and Rights of Series A Junior Participating Preferred Stock, the Form of Rights Certificate and the Summary of Rights to Purchase Preferred Stock, dated as of August 4, 2004 and amended May 4, 2006 and October 9, 2006 (Incorporated herein by reference to Exhibit 4.1 to the Company's Current Report on Form 8-K dated August 6, 2004, Exhibits 4.1 and 4.2 to the Company's Registration Statement on Form 8-A/A dated May 4, 2006 and Exhibit 4.1 to the Company's Registration Statement on Form 8-A/A dated October 10, 2006.)
- 4.2 Senior Indenture dated as of June 26, 2002, by and between Unitrin, Inc. and BNY Midwest Trust Company as Trustee (Incorporated herein by reference to Exhibit 4.1 to the Company's Current Report on Form 8-K dated July 1, 2002.)
- 4.3 Form of Subordinated Indenture (Incorporated herein by reference to Exhibit 4.2 to the Company's Registration Statement on Form S-3 filed May 9, 2002, Registration No. 333-87866.)
- 4.4 Officer's Certificate, including form of Senior Note with respect to the Company's 5.75% Senior Notes due July 1, 2007 (Incorporated herein by reference to Exhibit 4.2 to the Company's Current Report on Form 8-K filed July 1, 2002.)
- 4.5 Officer's Certificate, including form of Senior Note with respect to the Company's 4.875% Senior Notes due November 1, 2010 (Incorporated herein by reference to Exhibit 4.2 to the Company's Current Report on Form 8-K filed October 30, 2003.)
- 10.1 Unitrin, Inc. 1990 Stock Option Plan, as amended and restated (Incorporated herein by reference to Exhibit 10.1 to the Company's Annual Report on Form 10-K for the year ended December 31, 2001.)
- 10.2 Unitrin, Inc. 1995 Non-Employee Director Stock Option Plan, as amended and restated (Incorporated herein by reference to Exhibit 10.2 to the Company's Current Report on Form 8-K filed February 6, 2006.)
- 10.3 Unitrin, Inc. 1997 Stock Option Plan, as amended and restated (Incorporated herein by reference to Exhibit 10.3 to the Company's Current Report on Form 8-K filed February 6, 2006.)
- 10.4 Unitrin, Inc. 2002 Stock Option Plan, as amended and restated (Incorporated herein by reference to Exhibit 10.4 to the Company's Current Report on Form 8-K filed February 6, 2006.)
- 10.5 2005 Restricted Stock and Restricted Stock Unit Plan (Incorporated herein by reference to Appendix B to the Company's Proxy Statement, dated March 28, 2005, in connection with the Company's 2005 Annual Meeting of Shareholders.)
- 10.6 Form of Stock Option Agreement under the Unitrin, Inc. 1995 Non-Employee Director Stock Option Plan, as of February 1, 2006 (Incorporated herein by reference to Exhibit 10.6 to the Company's Current Report on Form 8-K filed February 6, 2006.)
- 10.7 Form of Stock Option Agreement (including stock appreciation rights) under the Unitrin, Inc. 1997 Stock Option Plan, as of February 1, 2006 (Incorporated herein by reference to Exhibit 10.7 to the Company's Current Report on Form 8-K filed February 6, 2006.)
- 10.8 Form of Stock Option Agreement (including stock appreciation rights) under the Unitrin, Inc. 2002 Stock Option Plan, as of February 1, 2006 (Incorporated herein by reference to Exhibit 10.8 to the Company's Current Report on Form 8-K filed February 6, 2006.)

Table of Contents

- 10.9 Form of Restricted Stock Agreement under the 2005 Restricted Stock and Restricted Stock Unit Plan.
- 10.10 Unitrin, Inc. Pension Equalization Plan, as amended by First and Second Amendments to the Unitrin, Inc. Pension Equalization Plan (Incorporated herein by reference to Exhibit 10.9 to the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2006.)
- 10.11 Unitrin is a party to individual severance agreements (the form of which is incorporated herein by reference to Exhibit 10.5 to the Company's Annual Report on Form 10-K for the year ended December 31, 2001), with the following executive officers:

Richard C. Vie (Chairman)

Donald G. Southwell (President and Chief Executive Officer)

David F. Bengston (Vice President)

John M. Boschelli (Treasurer)

Eric J. Draut (Executive Vice President and Chief Financial Officer)

Edward J. Konar (Vice President)

Scott Renwick (Senior Vice President, General Counsel and Secretary)

Richard Roeske (Vice President and Chief Accounting Officer)

Each of the foregoing agreements is identical except that the severance compensation multiple is 3.0 for Mr. Vie and 2.0 for the other executive officers.

- 10.12 Unitrin, Inc. Severance Plan (Incorporated herein by reference to Exhibit 10.6 to the Company's Annual Report on Form 10-K for the year ended December 31, 2001.)
- 10.13 Unitrin, Inc. Incentive Bonus Plan, dated February 3, 2004 (Incorporated herein by reference to Appendix A to the Company's Proxy Statement, dated March 29, 2004, in connection with the Company's 2004 Annual Meeting of Shareholders.)
- 10.14 Unitrin, Inc. Non-Qualified Deferred Compensation Plan (Incorporated herein by reference to Exhibit 10.9 to the Company's Annual Report on Form 10-K for the year ended December 31, 2001.)
- 10.15 Summary of Named Executive Officer Compensation, as of September 1, 2006.
- 10.16 Summary of Non-Employee Director Compensation, as of February 1, 2006 (Incorporated herein by reference to Exhibit 10.15 to the Company's Current Report on Form 8-K/A filed February 7, 2006.)
- 10.17 Credit Agreement, dated as of June 24, 2005, by and among Unitrin, Inc., the lenders party thereto, JPMorgan Chase Bank, N.A., individually and as administrative agent, letter of credit issuer and swing line lender, Wells Fargo Bank, National Association, individually and as syndication agent, and Wachovia Bank, N.A., individually and as documentation agent (Incorporated herein by reference to Exhibit 10.1 to Unitrin's Current Report on Form 8-K filed June 27, 2005.)
- 10.18 Registration Rights Agreement, dated as of January 23, 2001, by and among, Northrop Grumman Corporation, NNG, Inc., a direct wholly owned subsidiary of Northrop Grumman Corporation, and Unitrin, Inc. (Incorporated herein by reference to Exhibit 10.17 to the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2006.)
- 31.1 Certification of Chief Executive Officer Pursuant to SEC Rule 13a-14(a).
- 31.2 Certification of Chief Financial Officer Pursuant to SEC Rule 13a-14(a).

Edgar Filing: UNITRIN INC - Form 10-Q

- 32.1 Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (furnished pursuant to Item 601(b)(32) of Regulation S-K.)
- 32.2 Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (furnished pursuant to Item 601(b)(32) of Regulation S-K.)

Table of Contents

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

Unitrin, Inc.

Date: October 31, 2006

/s/ Donald G. Southwell
Donald G. Southwell
President and
Chief Executive Officer

Date: October 31, 2006

/s/ Eric J. Draut
Eric J. Draut
Executive Vice President and
Chief Financial Officer

Date: October 31, 2006

/s/ Richard Roeske
Richard Roeske
Vice President and Chief Accounting Officer

(Principal Accounting Officer)