Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

INTRODUCTION

The purpose of Management's Discussion and Analysis is to provide an understanding of Cincinnati Financial Corporation's consolidated results of operations and financial position. Management's Discussion and Analysis should be read in conjunction with Item 6, Selected Financial Data, Pages 28 and 29, and Item 8, Consolidated Financial Statements and related Notes, beginning on Page 78. We present per share data on a diluted basis unless otherwise noted and we have adjusted those amounts for all stock splits and dividends.

We begin with an executive summary of our results of operations and outlook, as well as details on critical accounting policies and estimates. Periodically, we refer to estimated industry data so that we can give information on our performance versus the overall insurance industry. Unless otherwise noted, the industry data is prepared by A.M. Best, a leading insurance industry statistical, analytical and financial strength rating organization. Information from A.M. Best is presented on a statutory basis. When we provide our results on a comparable statutory basis, we label it as such; all other company data is presented on a GAAP basis.

EXECUTIVE SUMMARY

Cincinnati Financial Corporation is the parent company of the nation's 23rd largest property casualty insurer, based on statutory net written premium volume through the first six months of 2006, the most recent period for which this information is available. We primarily market commercial lines and personal lines property casualty insurance products through a select group of independent insurance agencies in 32 states. As we discussed in the business description in Item 1, we believe three characteristics distinguish our company and allow us to build shareholder value:

- We cultivate relationships with the independent insurance agents who market our policies and we make our decisions at the local level
- We achieve claims excellence, covering the spectrum from our response to reported claims to our approach to establishing reserves for not-yet-paid claims
- We invest for long-term total return, using available cash flow to purchase equity securities after covering insurance liabilities by purchasing fixed-maturity securities

We provide additional detail on these subjects in the Results of Operations and Liquidity and Capital Resources sections of this discussion.

Among the factors that influence the consolidated results of operations and financial position of the company, we consider our relationships with independent insurance agents to be the most significant. We seek to be an indispensable partner in each agency's success. To continue to achieve our performance targets, we must maintain these strong relationships, write a significant portion of each agency's business and attract new agencies.

We believe consistently applying our long-term strategies rather than taking short-term actions will allow us to address these challenges. We seek to meet our agents' needs, with an eye toward solutions and approaches that will give us an advantage for five, 10 or more years. As we appoint new agencies, we are looking to build relationships that will grow as successfully as those we have had for 40 or 50 years.

In 2006, we did not achieve some of our objectives for creating shareholder value. For the year, we reached record levels of new business and total property casualty insurance premiums in the face of growing competition. Business policyholders continued to respond favorably to their local independent agents' presentation of the Cincinnati value proposition. In the second half of the year, agents and personal lines policyholders responded to new pricing for Cincinnati's personal lines products with higher customer retention rates and rising new business. Further, our equity-focused investment strategy led to another year of record investment income and record book value.

However, other factors dampened our enthusiasm for those favorable results. Nine catastrophe events, primarily storms affecting our policyholders in the Midwest, led to a record level of catastrophe losses even as the industry experienced a lighter catastrophe year. Loss severity crept upward. And ongoing investment in our people and our infrastructure, including technology and systems to make it easier for agents to do business with our company, contributed to expenses rising more rapidly than premiums.

Finally, 2006 earnings reflected the adoption of stock option expensing and, as anticipated, savings from favorable development of prior period losses below the unusually high level in 2005.

We look beyond 2006 with a measure of optimism. We remain committed to providing a stable market for our agents' high quality business, underwriting this business carefully and producing steady value for our shareholders, as represented by the board of directors' recent decision to increase our 2007 indicated annual cash dividend by 6 percent, which would mark the 47th consecutive year of increase in that measure. We believe we can achieve above-industry-average growth in written premiums and industry-leading profitability over the long term by building on our proven strategies: strong agency relationships, local underwriting, quality claims service, solid reserves and total return investing.

Over our 56 year history, our growth largely has been driven by increasing our share of the business written by the agencies that market our products, growth of those agencies and, to a lesser extent, appointment of new agencies and our periodic entry into new states. During 2007, we expect to make more than 50 new agency appointments, including our initial appointments in two new states: New Mexico and Washington.

Over the years, we have been able to increase our share of our agencies' business by making available insurance products that meet the needs of the individuals and businesses in their communities. In recent years, our agents have indicated their desire to have Cincinnati available as a market for commercial accounts that require the flexibility of excess and surplus lines coverage.

Generally, excess and surplus lines insurance carriers provide insurance that is unavailable to businesses in the standard market due to market conditions or due to characteristics of the insured that are caused by nature, the insured's history or the nature of their business.

We have studied the option of providing excess and surplus lines coverage for several years and believe it could contribute to our long-term objectives. Among the potential benefits, we could gain opportunities to compete for additional accounts by having more flexibility in pricing and policy terms and conditions.

In 2007, we will take the initial steps necessary to incorporate a new excess and surplus subsidiary and determine its structure. During the year we will appoint a team to begin researching and developing the appropriate terms and conditions, rates and underwriting guidelines. We anticipate little, if any, premium contribution from excess and surplus lines in 2007.

Below we review highlights of our financial results for the past three years and measures of the success of our efforts to create shareholder value. Detailed discussion of these topics appears in Results of Operations, Page 40, and the Liquidity and Capital Resources, Page 59.

CORPORATE FINANCIAL HIGHLIGHTS

Income Statement and Per Share Data

(Dollars in millions except share data)	Twelve months ended December 31,			**2006-2005**	2005-2004
	2006	2005	2004	**Change %**	Change %
Income statement data					
Earned premiums	**$ 3,278**	$ 3,164	$ 3,020	**3.6**	4.8
Investment income, net of expenses	**570**	526	492	**8.4**	6.9
Realized investment gains and losses (pretax)	**684**	61	91	**1,026.1**	(33.1)
Total revenues	**4,550**	3,767	3,614	**20.8**	4.2
Net income	**930**	602	584	**54.5**	3.1
Per share data (diluted)					
Net income	**$ 5.30**	$ 3.40	$ 3.28	**55.9**	3.7
Cash dividends declared	**1.34**	1.205	1.04	**11.2**	16.1
Weighted average shares outstanding	**175,451,341**	177,116,126	178,376,848	**(0.9)**	(0.7)

Revenues rose in 2006 and 2005. The growth in 2006 primarily reflected the sale of our Alltel common stock holdings. In both years, rising pretax investment income offset slowing consolidated property casualty earned premium growth.

Net income and net income per share reached record levels in 2006 and 2005. A number of factors contributed to net income:

- The consolidated property casualty underwriting profit declined in 2006 due to higher catastrophe losses, increased loss severity and less savings from favorable development of prior period losses as well as higher underwriting expenses. Underwriting profitability was healthy in 2005. The factors behind these changes are discussed in the Results of Operations.
- Realized investment gains and losses are integral to our financial results over the long term. We have substantial discretion in the timing of investment sales and, therefore, the gains or losses that will be recognized in any period. That discretion generally is independent of the insurance underwriting process. Also, applicable accounting standards require us to recognize gains and losses from certain changes in fair values of securities and embedded derivatives without actual realization of those gains and losses. Security sales led to realized investment gains in the past three years.
    - ○ 2006 – Raised net income by $434 million, or $2.48 per share. The sale of our Alltel common stock holding contributed $412 million, or $2.35 per share, of the gain.

- 2005 - Raised net income by $40 million, or 23 cents per share.
- 2004 - Raised net income by $60 million, or 34 cents per share.

- Weighted average shares outstanding may fluctuate from period to period because we regularly repurchase shares under board authorizations and we issue shares when associates exercise stock options. At year-end 2006, weighted average shares outstanding on a diluted basis had declined 2 million from year-end 2005.

The board of directors is committed to steadily increasing cash dividends and periodically authorizing stock dividends and splits. Cash dividends declared per share rose 11.2 percent and 16.1 percent in 2006 and 2005.

Balance Sheet Data and Performance Measures

(Dollars in millions except share data)	**At December 31, 2006**	At December 31, 2005	At December 31, 2004
Balance sheet data			
Invested assets	**$ 13,759**	$ 12,702	$ 12,677
Total assets	**17,222**	16,003	16,107
Short-term debt	**49**	0	0
Long-term debt	**791**	791	791
Shareholders' equity	**6,808**	6,086	6,249
Book value per share	**39.38**	34.88	35.60
Debt-to-capital ratio	**11.0 %**	11.5 %	11.2 %

		Years ended December 31,	
	2006	2005	2004
Performance measures			
Comprehensive income	**$ 1,057**	$ 99	$ 287
Return on equity	**14.4 %**	9.8 %	9.4 %
Return on equity based on comprehensive income	**16.4**	1.6	4.6

Invested assets and total assets rose in 2006 on new investments and appreciation in the equity portfolio. Invested assets and total assets were flat in 2005 as strong cash flow for new investments was offset by lower unrealized investment gains.

Comprehensive income is net income plus the year-over-year difference in unrealized gains on investments. In 2006, comprehensive income rose because of higher unrealized gains in the investment portfolio. In 2005 and 2004, comprehensive income was lower because of reduced unrealized gains primarily due to a decline in the market value of our Fifth Third investment.

Return on equity rose in 2006 due to higher realized gains on investments. Return on equity based on comprehensive income grew in 2006 due to the increase in accumulated other comprehensive income.

Our ratio of long-term debt to capital (long-term debt plus shareholders' equity) declined in 2006 due to the increase in shareholders' equity due to higher accumulated other comprehensive income.

Property Casualty Highlights

(Dollars in millions)		Years ended December 31,		**2006-2005**	2005-2004
	2006	2005	2004	**Change %**	Change %
Property casualty highlights					
Written premiums	**$ 3,178**	$ 3,076	$ 2,997	**3.3**	2.6
Earned premiums	**3,164**	3,058	2,919	**3.5**	4.8
Underwriting profit	**181**	330	298	**(45.2)**	10.8
GAAP combined ratio	**94.3 %**	89.2 %	89.8 %		
Statutory combined ratio	**93.9**	89.0	89.4		

The trend in overall written premium growth reflected the competitive and market factors discussed in Item 1, Commercial Lines and Personal Lines Property Casualty Insurance Segments, Page 9 and Page 11. In each of the past three years, our overall written premium growth rate has exceeded that of the industry. Industry net written premiums were estimated to grow 2.6 percent in 2006 and 4.4 percent in 2004, but declined 0.2 percent in 2005. In the past three years, industry premium trends have been obscured by the reinsurance sector, where premiums were estimated to have risen 25.1 percent in 2006 after declining 28.2 percent in 2005.

Our consolidated property casualty insurance underwriting profit declined in 2006 after rising in 2005, matching the trend in our combined ratio. (The combined ratio is the percentage of each premium dollar spent on claims plus all expenses -- the lower the ratio, the better the performance.) 2006 performance was tempered by higher catastrophe losses, increased loss severity and less savings from favorable development on prior period losses as well as higher underwriting expenses.

The estimated industry average statutory combined ratios were 93.3 percent, 100.8 percent and 98.5 percent for 2006, 2005 and 2004, respectively. The 144.9 percent estimated reinsurance sector combined ratio obscured the industry combined ratio in 2005.

We also measure a variety of non-financial metrics for our property casualty operations. For example, we monitor our rank within our reporting agency locations. In 2005, we ranked No. 1 or No. 2 by premium volume in 75 percent of the locations that have marketed our products for more than five years. Other measures include subdivision of territories and new agency appointments. We ended 2006 with 102 field territories, subdividing three new territories and merging one into the surrounding regions. As discussed in Item 1, Growing with Our Agencies, Page 7, we made 55 new agency appointments in 2006, 42 of which were new relationships. These new appointments and other changes in agency structures led to a net increase in reporting agency locations of 37 in 2006.

Agent satisfaction with our technology solutions is, and will continue to be, a requirement for maintaining our strong relationships with these agencies. In 2006, we made additional progress in implementing technology solutions that we believe should make it easier for agencies to do business with us. Among other milestones, we have deployed our new commercial lines policy processing system to agencies in seven states for use in processing new and renewal businessowners policies. We also deployed our personal lines policy processing system in six additional states and continued to make important upgrades and enhancements.

Measuring Our Success in 2007 and Beyond

We use a variety of metrics to measure the success of our strategies:

- Maintaining our strong relationships with our established agencies, writing a significant portion of each agency's business and attracting new agencies – In 2007, we expect to continue to rank No. 1 or No. 2 by premium volume in approximately 75 percent or more of the locations that have marketed our products for more than five years. We expect to improve service to our agencies by subdividing or creating four field territories in 2007. We also expect to appoint another 50 agencies. We are working on plans to enter New Mexico and eastern Washington within the next year and will soon begin the process by preparing policy forms and rates to submit to the departments of insurance in those states.

  In 2007, we expect to make further progress in our efforts to improve service to and communication with our agencies through our expanding portfolio of software. In particular, we will continue to deploy our commercial lines and personal lines quoting and policy processing systems that allow our agencies and our field and headquarters associates to collaborate on new and renewal business more efficiently and give our agencies choice and control. We discuss our technology plans for 2007 in Item 1, Technology Solutions, Page 4.

- Achieving above-industry-average growth in property casualty statutory net written premiums and maintaining industry-leading profitability by leveraging our regional franchise and proven agency-centered business strategy – We believe growth in our consolidated property casualty written premiums may be in the low single digits in 2007 compared with the 3.3 percent increase in 2006.

  Legislative and regulatory developments in early 2007 added to the uncertainty that already existed for the insurance industry in Florida. In February 2007, we asked our agents that they not send us new business submissions. This request, which extends to all lines of insurance and other business areas, may result in lower 2007 premium growth. It does not affect policies in force, which we will continue to support and address at renewal, in line with our current underwriting guidelines and in compliance with Florida rules and regulations. We continue to assess the changing insurance environment in Florida and hope to resume writing policies in the state as the market stabilizes.

  Overall industry premium growth is projected to be 0.1 percent in 2007, which includes an estimated 18.6 percent reinsurance sector growth rate. Net written premiums for the commercial lines industry are expected to be flat in 2007 while the personal lines sector is expected to grow 1.2 percent.

  Our combined ratio estimate for 2007 is 97 percent to 99 percent on either a GAAP or statutory basis compared with 94.3 percent on a GAAP basis in 2006. The year-over-year increase reflects four assumptions:

  - Catastrophe losses should contribute approximately 5.5 percentage points to the combined ratio. We think this is an appropriate estimate based on our reinsurance treaty retention and catastrophe loss experience in recent years.
  - Savings from favorable reserve development in line with our historical norms. Savings from favorable development on prior period reserves averaged about 2 percentage points between 2000 and 2003. Between 2004 and 2006, the average rose to an unusually high level of approximately 5 percentage points.
  - Loss ratio deterioration as pricing becomes even more competitive and loss severity increases.

    - ○ Higher other underwriting expenses as we continue to invest in people and technology. We believe the consolidated property casualty 2007 underwriting expense ratio could be approximately 31.5 percent.

  For these reasons, we may not achieve our objective of an industry-leading combined ratio in 2007. The projected industry average 2007 combined ratio is 96.8 percent.

- Pursuing a total return investment strategy that generates both strong investment income growth and capital appreciation – In 2007, we are estimating pretax investment income growth to be in the range of 6.5 percent to 7.0 percent. This outlook is based on the higher anticipated level of dividend income from equity holdings, the investment of insurance operations cash flow and the current portfolio attributes.

  We do not establish annual capital appreciation targets. Over the long term, our target is to have the equity portfolio outperform the Standard & Poor's 500 Index. In 2006, our compound annual equity portfolio return was 16.1 percent, compared with a compound annual total return of 15.8 percent for the Index. Over the five years ended December 31, 2006, our compound annual equity portfolio return was 2.0 percent compared with a compound annual total return of 6.2 percent for the Index. Our equity portfolio underperformed the market for the five-year period because of the decline in the market value of our holdings of Fifth Third common stock between 2002 and 2005.

- Increasing the total return to shareholders through a combination of higher earnings per share, growth in book value and increasing dividends – We do not announce annual targets for earnings per share or book value. Over the long term, we look for our earnings per share growth to outpace that of a peer group of national and regional property casualty insurance companies. Long-term book value growth should exceed that of our equity portfolio.

  The board of directors is committed to steadily increasing cash dividends and periodically authorizing stock dividends and splits. In February 2007, the board increased the indicated annual dividend rate 6.0 percent, marking the 47th consecutive year of increases in our indicated dividend rate. We believe our record of dividend increases is matched by only 11 other publicly traded corporations.

  Over the long-term, we seek to increase earnings per share, book value and dividends at a rate that would allow long-term total return to our shareholders to exceed that of the Standard & Poor's Composite 1500 Property Casualty Insurance Index. Over the past five years, our total return to shareholders of 49.4 percent was below the 71.4 percent return for that Index.

- Maintaining financial strength by keeping the ratio of debt to capital below 15 percent and purchasing reinsurance to provide investment flexibility – Based on our present capital requirements, we do not anticipate a material increase in debt levels during 2007. As a result, we believe our debt-to-capital ratio will remain approximately 11 percent.

  In December 2006, we finalized our property casualty reinsurance program for 2007, updating it to maintain the balance between the cost of the program and the level of risk we retain. Under the new program, our 2007 reinsurance premiums are expected to be $22 million higher than in 2006.

  We provide more detail on our reinsurance programs in 2007 Reinsurance Programs, Page 69.

Factors supporting our outlook for 2007 are discussed below in the Results of Operations for each of the four business segments.

CRITICAL ACCOUNTING ESTIMATES

Cincinnati Financial Corporation's financial statements are prepared using GAAP. These principles require management to make estimates and assumptions that affect the amounts reported in the Consolidated Financial Statements and accompanying Notes. Actual results could differ materially from those estimates.

The significant accounting policies used in the preparation of the financial statements are discussed in Item 8, Note 1 to the Consolidated Financial Statements, Page 85. In conjunction with that discussion, material implications of uncertainties associated with the methods, assumptions and estimates underlying the company's critical accounting policies are discussed below. The audit committee of the board of directors reviews the annual financial statements with management and the independent registered public accounting firm. These discussions cover the quality of earnings, review of reserves and accruals, reconsideration of the suitability of accounting principles, review of highly judgmental areas including critical accounting policies, audit adjustments and such other inquiries as may be appropriate.

PROPERTY CASUALTY INSURANCE LOSS AND LOSS EXPENSE RESERVES

Overview

Our most significant estimates relate to our reserves for property casualty loss and loss expenses. We believe that the stability of our business makes our historical data the most important source for establishing adequate reserve levels. We base reserve estimates on company experience and information from internal analyses and obtain additional information from the appointed actuary. When reviewing reserves, we analyze historical data and estimate the effect of various loss factors. We believe that the following represent the primary risks to our ability to estimate loss reserves accurately:

- Court decisions or legislation that result in unanticipated coverage expansions on past and existing policies
- Changes in medical inflation and mortality rates that affect workers' compensation claims
- Changes in claim cost trends, including the effects of general economic and tort cost inflation, not reflected in the historical data used to estimate loss reserves
- Changes in reinsurance coverage, not reflected in reserving data, that affect the company's net payments and net case reserves
- Payment and reporting pattern changes attributable to the implementation of a new claims management system and to the use of a claims mediation process that promotes earlier liability settlement resolution
- Reporting pattern changes attributable to case reserving practices, particularly with respect to workers' compensation claims
- Absence of cost-effective methods for accurately assessing asbestos and environmental claim liabilities (see Property Casualty Insurance Reserves, Asbestos and Environmental Reserves, Page 66, for discussion of related reserve levels and trends)

Any of these factors could cause our ultimate loss experience to be better or worse than reserves held, and the difference could be material. To the extent that reserves are inadequate and strengthened, the amount of such increase is treated as a charge in the period that the deficiency is recognized, raising the loss and loss expense ratio and reducing earnings. To the extent that reserves are redundant and released, the amount of the release is a credit in the period that the redundancy is recognized, reducing the loss and loss expense ratio and increasing earnings.

A reserve change of $32 million would have a 1 percentage point effect on the loss and loss expense ratio, based on 2006 earned premiums, a $21 million effect on income and a 12 cent effect on net income per share.

Establishing Reserves

Reserves are established for the total of unpaid loss and loss expenses, including estimates for claims that have been reported, estimates for claims that have been incurred but not yet reported (IBNR) and estimates of loss expenses associated with processing and settling those claims. Reserves are determined for the various lines of business. Loss reserves are reduced by anticipated salvage and subrogation recoveries.

We establish case reserves for claims that have been reported within the parameters of coverage provided in the policy. Individual case reserves greater than $35,000 established by field claims representatives are reviewed by experienced headquarters claims supervisors while case reserves greater than $100,000 also are reviewed by headquarters claims managers. The estimates reflect the informed judgment and experience of our claims associates based on general insurance reserving practices and their experience with the company. Case reserves are reviewed on a 90-day cycle, or more frequently if specific circumstances require, based on events such as the status of ongoing negotiations.

The anticipated effect of inflation is implicitly considered when estimating reserves for loss and loss expenses. While anticipated cost increases due to inflation are considered in estimating ultimate claim costs, increases in average severity of claims are caused by a number of factors that vary by individual type of policy. Average severity projections are based on historical trends adjusted for anticipated changes in underwriting standards, policy provisions and general economic trends. We do not discount any of our property casualty loss and loss expense reserves.

In 2001, we began to establish higher initial case reserves on serious injury claims. The higher reserves reflect experience indicating the likelihood that juries would ignore significant liability issues in cases involving seriously injured claimants.

In 2000, we began using a claims mediation process that promotes earlier liability settlement resolution. By 2004, we had introduced the program into several states, which has provided favorable results.

To review IBNR reserves on an annual basis, we use a variety of tools, including actuarial and statistical methods. These may include but are not limited to:

- The Case Incurred Development Method
- The Paid Development Method
- The Bornhuetter-Ferguson Method
- Probability Trend Family Models

Supplemental statistical information is compiled and reviewed to aid in the application of actuarial methods and models. The supplemental data also is used to evaluate the reasonableness of estimates derived from the actuarial methods and models. This information includes:

- Industry loss frequency and severity and premium trends
- Past, present and anticipated product pricing
- Anticipated premium growth
- Other quantifiable trends
- Projected ultimate loss ratios

We conduct our thorough evaluation of the adequacy of reserves as of the end of the third quarter of each year. As a result, the most significant refinements in reserves historically have been implemented in the fourth quarter. In 2006, we began conducting a detailed supplemental review as of the end of the fourth quarter of each year in parallel with the outside actuarial review. Less detailed, periodic reviews of reserve adequacy are made at the other quarter ends. A loss review committee, including internal actuaries and representatives from management of multiple operating departments, is responsible for the quarterly review process.

The internal actuaries provide a point estimate and a range to summarize their analysis. At year-end 2006 and 2005, IBNR reserves differed from the internal actuarial point estimate by less than 2 percent of our loss and loss expense reserve.

Adjusting Reserves

While we believe that reported reserves provide for all unpaid loss and loss expense obligations, the estimation processes involve a number of variables and assumptions. We believe this uncertainty is mitigated by the historical stability of our book of business and by our periodic reviews of estimates. As loss experience develops and new information becomes known, the reserves are reviewed and adjusted as appropriate. In this process, we monitor trends in the industry, cost trends, relevant court cases, legislative activity and other current events in an effort to ascertain new or additional exposures to loss. If we determine that reserves established in prior years were not sufficient or were excessive, the change is reflected in current-year results.

Actuarial Review

As part of our internal processes, we utilize an appointed actuary to provide management with an opinion regarding an acceptable range for adequate statutory reserves based on generally accepted actuarial guidelines.

Historically, we have established adequate reserves that have fallen in the upper half of the appointed actuary's range. This approach has resulted in recognition of reserve redundancies for the past 10 years, as we discuss in Development of Loss and Loss Expenses, Page 64. Modestly redundant reserves support our business strategy to retain high financial strength ratings and remain a market for agencies' business in all market conditions.

The appointed actuary conducts a thorough evaluation of the adequacy of reserves as of the end of the third quarter of each year and conducts a supplemental review of full-year data at year-end.

ASSET IMPAIRMENT

Fixed-maturity and equity investments are our largest assets. The company's asset impairment committee continually monitors these investments and all other assets for signs of other-than-temporary and/or permanent impairment. The committee monitors significant decreases in the market value of the assets, changes in legal factors or in the business climate, an accumulation of costs in excess of the amount originally expected to acquire or construct an asset, uncollectability of all other assets, or other factors such as bankruptcy, deterioration of creditworthiness, failure to pay interest or dividends or signs indicating that the carrying amount may not be recoverable.

The application of our impairment policy resulted in other-than-temporary impairment charges and write-offs of investments that reduced our income before income taxes by $1 million in both 2006 and 2005 and $6 million in 2004.

Our portfolio managers constantly monitor the status of their assigned portfolios for indications of potential problems that may be possible impairment issues. If a security is trading below book value, the portfolio managers even more closely scrutinize the security. Such declines often occur in conjunction with events taking place in the overall economy and market, combined with events specific to the industry or operations of the issuing corporation. These specific criteria include quantitative measurements such as a declining trend in market value, the extent of the market value decline and the length of time the value of the security has been depressed, as well as qualitative measures such as pending events and issuer liquidity. Generally, these declines in valuation are greater than might be anticipated when viewed in the context of overall economic and market conditions. We provide information regarding valuation of our invested assets in Item 8, Note 2 to the Consolidated Financial Statements, Page 90.

Impairment charges are recorded for other-than-temporary declines in value, if, in the asset impairment committee's judgment, there is little expectation that the value will be recouped in the foreseeable future. A security valued between 90 percent and 100 percent of book value will not be monitored separately by the committee. These assets generally are at this value because of interest rate-driven factors. A security valued below 90 percent of book value is reported to the asset impairment committee. A security valued below 70 percent of book value is defined as distressed.

Distressed securities receive additional scrutiny. Effective January 1, 2006, a security will be written down in the event of a declining market value for four consecutive quarters with quarter-end market value below 70 percent of book value, or when a security's market value is 70 percent below book value for three consecutive quarters. A sudden and severe drop in market value that does not otherwise meet the above criteria is reviewed for possible immediate impairment.

When evaluating other-than-temporary impairments, the committee considers the company's intent and ability to retain a security for a period adequate to recover a significant percentage of cost. Because of the company's investment philosophy and strong capitalization, it can hold securities that have the potential to recover value until their scheduled redemption, when they might otherwise be deemed impaired. In addition to evaluating the security's current valuation, the impairment committee reviews objective evidence that indicates the potential for a recovery in value. Information is evaluated regarding the security, such as financial performance, near term prospects and the financial condition of the region and industry in which the entity operates.

Securities that have already been impaired are evaluated based on their adjusted book value and further written down, if deemed appropriate. The decision to sell or write down a security with impairment indications reflects, at least in part, management's opinion that the security no longer meets the company's investment objectives. We provide detailed information about securities trading in a continuous loss position at year-end 2006 in Item 7A, Unrealized Investment Gains and Losses, Page 75. An other-than-temporary decline in the fair value of a security is recognized in net income as realized investment losses.

Permanent impairment charges (write-offs) are defined as those for which management believes there is little potential for future recovery, for example, following the bankruptcy of the issuing corporation. A permanent decline in the fair value of a security is written off at the time when facts and circumstances indicate such write-down is warranted, and is reflected in realized investment losses.

Other-than-temporary and permanent impairments are distinct from the ordinary fluctuations seen in the value of a security when considered in the context of overall economic and market conditions. Securities considered to have a temporary decline would be expected to recover their market value, which may be at maturity. Under the same accounting treatment as market value gains, temporary declines (changes in the fair value of these securities) are reflected on our balance sheet in accumulated other comprehensive income, net of tax, and have no impact on reported net income.

Life Insurance Policy Reserves

We establish the reserves for traditional life insurance policies based on expected expenses, mortality, morbidity, withdrawal rates and investment yields, including a provision for uncertainty. Once these assumptions are established, they generally are maintained throughout the lives of the contracts. We use both our own experience and industry experience adjusted for historical trends in arriving at our assumptions for expected mortality, morbidity and withdrawal rates. We use our own experience and historical trends for setting our assumptions for expected expenses. We base our assumptions for expected investment income on our own experience adjusted for current economic conditions.

We establish reserves for our universal life, deferred annuity and investment contracts equal to the cumulative account balances, which include premium deposits plus credited interest less charges and withdrawals. Some of our universal life insurance policies contain no-lapse guarantee provisions. For these policies, we establish a reserve in addition to the account balance based on expected no-lapse guarantee benefits and expected policy assessments.

Employee Benefit Pension Plan

We have a defined benefit pension plan covering substantially all employees. Contributions and pension costs are developed from annual actuarial valuations. These valuations involve key assumptions including discount rates and expected return on plan assets, which are updated each year. Any adjustments to these assumptions are based on considerations of current market conditions. Therefore, changes in the related pension costs or credits may occur in the future due to changes in assumptions.

Key assumptions used in developing the 2006 net pension obligation were a 5.75 percent discount rate and rates of compensation increases ranging from 4 percent to 6 percent. Key assumptions used in developing the

2006 net pension expense were a 5.50 percent discount rate, an 8 percent expected return on plan assets and rates of compensation increases ranging from 5 percent to 7 percent.

In 2006, the net pension expense was $19 million. In 2007, we expect a net pension expense of $21 million, primarily as a result of increased service costs, which are expected to more than offset a 0.25 percent reduction in the discount rate.

Holding all other assumptions constant, a 0.5 percentage point decline in the discount rate would lower our 2007 net income before income taxes by $2 million. Likewise, a 0.5 percentage point decline in the expected return on plan assets would lower our 2006 income before income taxes by $1 million.

In addition, the fair value of the plan assets exceeded the accumulated benefit obligation by $8 million at year-end 2006 and $8 million at year-end 2005. The fair value of the plan assets was less than the projected plan benefit obligation by $58 million at year-end 2006 and $62 million at year-end 2005.
The 2005 accumulated benefit obligation and projected benefit obligation amounts were increased by $6 million and $9 million, respectively, to include the company's supplemental retirement plan (SERP).
Market conditions and interest rates significantly affect future assets and liabilities of the pension plan.

DEFERRED ACQUISITION COSTS

We establish a deferred asset for costs that vary with, and are primarily related to, acquiring property casualty and life business. These costs are principally agent commissions, premium taxes and certain underwriting costs, which are deferred and amortized into income as premiums are earned. Deferred acquisition costs track with the change in premiums. Underlying assumptions are updated periodically to reflect actual experience. Changes in the amounts or timing of estimated future profits could result in adjustments to the accumulated amortization of these costs.

For property casualty policies, deferred acquisition costs are amortized over the terms of the policies. For life policies, acquisition costs are amortized into income either over the premium-paying period of the policies or the life of the policy, depending on the policy type.

CONTINGENT COMMISSION ACCRUAL

Another significant estimate relates to our accrual for property casualty contingent (profit-sharing) commissions. We base the contingent commission accrual estimates on property casualty underwriting results and on supplemental information. Contingent commissions are paid to agencies using a formula that takes into account agency profitability and other factors, such as prompt monthly payment of amounts due to the company. Due to the complexity of the calculation and the variety of factors that can affect contingent commissions for an individual agency, the amount accrued can differ from the actual contingent commissions paid. The contingent commission accrual of $95 million in 2006 contributed 3.0 percentage points to the property casualty combined ratio. If contingent commissions paid were to vary from that amount by 5 percent, it would affect 2007 net income by $3 million (after tax), or 2 cents per share, and the combined ratio by approximately 0.1 percentage points.

SEPARATE ACCOUNTS

We issue life contracts, referred to as bank-owned life insurance policies (BOLI). Based on the specific contract provisions, the assets and liabilities for some BOLIs are legally segregated and recorded as assets and liabilities of the separate accounts. Other BOLIs are included in the general account. For separate account BOLIs, minimum investment returns and account values are guaranteed by the company and also include death benefits to beneficiaries of the contract holders.

Separate account assets are carried at fair value. Separate account liabilities primarily represent the contract holders' claims to the related assets and also are carried at the fair value of the assets. Generally, investment income and realized investment gains and losses of the separate accounts accrue directly to the contract holders and, therefore, are not included in our Consolidated Statements of Income. However, each separate account contract includes a negotiated realized gain and loss sharing arrangement with the company.
This share is transferred from the separate account to our general account and is recognized as revenue or expense. In the event that the asset value of contract holders' accounts is projected below the value guaranteed by the company, a liability is established through a charge to our earnings.

For our most significant separate account, written in 1999, realized gains and losses are retained in the separate account and are deferred and amortized to the contract holder over a five-year period, subject to certain limitations. Upon termination or maturity of this separate account contract, any unamortized deferred gains and/or losses will revert to the general account. In the event this separate account holder were to exchange the contract for the policy of another carrier in 2007, the account holder would pay a surrender charge equal to 4 percent of the contract's account value. Since year five, the surrender charge has decreased 2 percent each policy year and will fall to 0 percent in policy year 11.

At year-end 2006, net unamortized realized gains amounted to $2 million. In accordance with this separate account agreement, the investment assets must meet certain criteria established by the regulatory authorities to whose jurisdiction the group contract holder is subject. Therefore, sales of investments may be mandated to maintain compliance with these regulations, possibly requiring gains or losses to be recorded, and charged to the general account. Potentially, losses could be material; however, unrealized losses in the separate account portfolio were less than $6 million at year-end 2006.

RECENT ACCOUNTING PRONOUNCEMENTS

Information regarding recent accounting pronouncements is provided in Item 8, Note 1 to the Consolidated Financial Statements, Page 85. We have determined that recent accounting pronouncements have not had nor are they expected to have any material impact on our consolidated financial statements.

RESULTS OF OPERATIONS

The consolidated results of operations reflect the operating results of each of our four segments along with the parent company and other non-insurance activities. The four segments are:

- Commercial lines property casualty insurance
- Personal lines property casualty insurance
- Life insurance
- Investments operations

We measure profit or loss for our property casualty and life segments based upon underwriting results (profit or loss), which represent net earned premium less loss and loss expenses and underwriting expenses on a pretax basis. We also measure aspects of the performance of our commercial lines and personal lines segments on a combined property casualty insurance operations basis. Underwriting results and segment pretax operating income are not a substitute for net income determined in accordance with GAAP.

For the combined property casualty insurance operations as well as the commercial lines and personal lines segments, statutory accounting data and ratios are key performance indicators that we use to assess business trends and to make comparisons to industry results, since GAAP-based industry data generally is not readily available. We also use statutory accounting data and ratios as key performance indicators for our life insurance operations. We do not believe that inflation has had a material effect on consolidated results of operations, except to the extent that inflation may affect interest rates. We continue to monitor market trends in construction costs that could affect claim payments and headquarters construction costs.

Investments held by the parent company and the investment portfolios for the property casualty and life insurance subsidiaries are managed and reported as the investments segment, separate from the underwriting businesses. Net investment income and net realized investment gains and losses for our investment portfolios are discussed in the Investments Results of Operations.

The calculations of segment data are described in more detail in Item 8, Note 17 of the Consolidated Financial Statements, Page 102. The following sections review results of operations for each of the four segments. Commercial Lines Insurance Results of Operations begins on Page 42, Personal Lines Insurance Results of Operations begins on Page 49, Life Insurance Results of Operations begins on Page 54, and Investments Results of Operations begins on Page 56. We begin with an overview of our consolidated property casualty operations, which is the total of our commercial lines and personal lines segments.

CONSOLIDATED PROPERTY CASUALTY INSURANCE RESULTS OF OPERATIONS

(Dollars in millions)	Years ended December 31, 2006	2005	2004	2006-2005 Change %	2005-2004 Change %
Written premiums	$ **3,178**	$ 3,076	$ 2,997	**3.3**	2.6
Earned premiums	$ **3,164**	$ 3,058	$ 2,919	**3.5**	4.8
Loss and loss expenses excluding catastrophes	**1,833**	1,685	1,605	**8.8**	5.0
Catastrophe loss and loss expenses	**175**	127	148	**37.9**	(14.8)
Commission expenses	**596**	592	583	**0.7**	1.6
Underwriting expenses	**363**	319	274	**13.9**	16.3
Policyholder dividends	**16**	5	11	**208.1**	(52.3)
Underwriting profit	$ **181**	$ 330	$ 298	**(45.2)**	10.8
Ratios as a percent of earned premiums:					
Loss and loss expenses excluding catastrophes	**58.0 %**	55.1 %	55.0 %		
Catastrophe loss and loss expenses	**5.5**	4.1	5.1		
Loss and loss expenses	**63.5**	59.2	60.1		
Commission expenses	**18.8**	19.4	20.0		
Underwriting expenses	**11.5**	10.4	9.4		
Policyholder dividends	**0.5**	0.2	0.3		
Combined ratio	**94.3 %**	89.2 %	89.8 %		

In addition to the factors discussed in Commercial Lines and Personal Lines Insurance Results of Operations, Page 42 and Page 49, growth and profitability for the property casualty insurance operations were affected by:

- New business written directly by agencies – New business written directly by agencies was $357 million, $314 million and $330 million in 2006, 2005 and 2004, respectively. New business levels reflected market conditions for commercial and personal lines as well as the advantages of our agency relationship strategy.
- Savings from favorable development on prior period reserves reduced the combined ratio by 3.7 percentage points in 2006 compared with 5.2 and 6.7 percentage points in 2005 and 2004. The unusually high level of savings in 2004 partially reflected the release of uninsured motorist/underinsured motorist (UM/UIM) reserves following an Ohio Supreme Court decision in late 2003 to limit its 1999 Scott-Pontzer vs. Liberty Mutual decision.
- The adoption of stock option expensing increased the 2006 combined ratio by 0.5 percentage points.
- Catastrophe losses contributed 5.5, 4.1 and 5.1 percentage points to the combined ratio in 2006, 2005 and 2004, respectively. Catastrophe losses in 2006 included wind and hail losses in March, April and October, with incurred losses of $37 million, $37 million and $38 million, respectively. Of the almost 13,000 catastrophe claims reported through January 31, 2007, for all catastrophes in 2006, more than 95 percent are already closed. Our field claims representatives' prompt responses and personal approach reflect positively on our agents, supporting their marketing efforts. The following table shows catastrophe losses incurred, net of reinsurance, for the past three years as well as the effect of loss development on prior period catastrophe events.

  The Cincinnati Insurance Companies do not appoint agencies to actively market property casualty insurance in Louisiana, Mississippi or Texas. Our 2005 Hurricane Katrina and Rita losses included losses associated with commercial accounts written by agents in other states to cover locations and vehicles in multiple states, including Louisiana, Mississippi and Texas.

  Hurricane Katrina losses also included $18 million of assumed losses. The Cincinnati Insurance Company participates in three assumed reinsurance treaties with two reinsurers that spread the risk of very high catastrophe losses among many insurers. The assumed losses from Hurricane Katrina included $16 million under a treaty with the Munich Re Group to assume 2 percent of property losses between $400 million and $1.2 billion from a single event. Munich Re has reserved its Hurricane Katrina losses above $1.2 billion. In 2006, we reduced our participation in the Munich Re assumed reinsurance treaty to 1 percent as discussed in Item 1A, Risk Factors, Page 20.

Catastrophe Losses Incurred

(In millions, net of reinsurance)			Years ended December 31,		
			Commercial	Personal	
Dates	Cause of loss	Region	lines	lines	Total
2006					
Mar. 11-13	Wind, hail	Midwest, Mid-Atlantic	**$ 29**	**$ 8**	**$ 37**
Apr. 2-3	Wind, hail	Midwest	**12**	**5**	**17**
Apr. 6-8	Wind, hail	South	**13**	**24**	**37**
Apr. 13-15	Wind, hail	South	**4**	**6**	**10**
Jun. 18-22	Wind, hail, flood	South	**3**	**2**	**5**
Jul. 19-21	Wind, hail, flood	South	**4**	**1**	**5**
Aug. 23-25	Wind, hail, flood	Midwest	**5**	**2**	**7**
Oct. 2-4	Wind, hail, flood	Midwest	**7**	**31**	**38**
Nov. 30 - Dec. 3	Wind, hail, ice, snow	Midwest, South	**4**	**4**	**8**
Other 2006 catastrophes			**7**	**3**	**10**
Development on 2005 and prior catastrophes			**1**	**0**	**1**
Calendar year incurred total			**$ 89**	**$ 86**	**$ 175**
2005					
Jan. 4-6	Wind, ice, snow	Midwest, Mid-Atlantic	$ 0	$ 1	$ 1
May 6-12	Wind, hail	Midwest	4	8	12
Jul. 9-11	Hurricane Dennis	South	5	2	7
Aug. 25-26	Hurricane Katrina	South	36	11	47
Sep. 20-24	Hurricane Rita	South	3	0	3
Oct. 24	Hurricane Wilma	South	13	12	25
Nov. 6	Wind, hail	Midwest	2	9	11
Nov. 15-16	Wind	Midwest, South	2	10	12
Other 2005 catastrophes			0	0	0
Development on 2004 and prior catastrophes			11	(2)	9
Calendar year incurred total			$ 76	$ 51	$ 127
2004					
May 17-19	Wind, hail	Midwest, Mid-Atlantic	$ 1	$ 9	$ 10
May 21-27	Wind, hail	Midwest, Mid-Atlantic, South	11	20	31
Jul. 12-14	Wind, hail	Midwest, Mid-Atlantic, South	7	5	12
Aug. 13-14	Hurricane Charley	South	16	10	26
Sep. 3-4	Hurricane Frances	South	4	7	11
Sep. 15-21	Hurricane Jeanne	Mid-Atlantic, South	4	2	6
Sep. 25-29	Hurricane Ivan	Midwest, Mid-Atlantic, South	21	18	39
Dec. 22-25	Wind, ice, snow	Midwest, South	5	8	13
Other 2004 catastrophes			3	2	5
Development on 2003 and prior catastrophes			(1)	(4)	(5)
Calendar year incurred total			$ 71	$ 77	$ 148

The discussions of property casualty insurance segments provide additional detail regarding these factors.

COMMERCIAL LINES INSURANCE RESULTS OF OPERATIONS

Overview – Three-year Highlights

Performance highlights for the commercial lines segment include:

- Premiums – Although competition in our commercial markets continued to increase, our written premium growth rate increased in 2006, reflecting our agency relationships, strong new business growth, healthy policy retention rates, more accurate risk classification, insurance-to-value initiatives, higher reinsurance treaty retentions and exposure growth due to the healthy economy. These more than offset our deliberate decisions not to write or renew certain business and the loss of some accounts due to competition. In the more competitive pricing environment we have been careful to maintain our underwriting discipline for both renewal and new business. We believe that our written premium growth rate continues to exceed the average for the overall commercial lines industry, which was estimated at 1.0 percent in 2006 after declining 0.4 percent in 2005. Earned premium growth remained relatively steady over the period.
- Combined ratio – Our commercial lines combined ratio rose to 91.3 percent in 2006 largely because of softer pricing, increasing loss severity, less savings from favorable development on prior period reserves and the adoption of stock option expensing. The combined ratio was very strong in 2005 and 2004.
  We continue to focus on sound underwriting fundamentals and seek to obtain adequate premiums per policy. A single large loss in 2005 increased the ratio in that year by 1.0 percentage point. We discuss large

losses and other factors affecting the combined ratio beginning on Page 44. We discuss the savings from favorable loss reserve development by commercial lines of business on Page 47.

Our commercial lines statutory combined ratio was 90.8 percent in 2006 compared with 87.1 percent in 2005 and 83.7 percent in 2004. By comparison, the estimated industry commercial lines combined ratio was 94.3 percent in 2006, 99.7 percent in 2005 and 102.5 percent in 2004. We believe our results are trending differently than the overall industry because the industry experienced unusually high catastrophe losses in 2004 and 2005 and unusually low catastrophe losses in 2006.

Growth and Profitability

As competition in commercial markets has increased, we have focused on maintaining our pricing discipline for both renewal and new business. Our independent agents continued to report steady pressure on pricing during 2006 and communicated that winning new business and retaining renewals required more pricing flexibility and careful risk selection.

We believe our strong new business growth in 2006 and 2005 primarily was due to the local relationships and efforts of our agents and the field marketing teams that work with them. Our field associates are in our agents' offices emphasizing the Cincinnati value proposition, calling on prospects with those agents, carefully evaluating risk exposure and working up their best quotes for good accounts.

For our renewal business, our headquarters underwriters talk regularly with agents. Our field teams are available to assist the headquarters underwriters by holding renewal review meetings with agency staff to verify that each commercial account retains the characteristics that caused us to write the business initially. For quality risks, our commercial underwriters are offering policyholders the convenience of policy extensions of one and two additional years. Policy extensions provide:

- Retention of the terms and conditions that policyholders originally selected, backed by our superior claims service and our A++ rating from A.M. Best Co.
- Stable rates on some of the shorter-tail coverages within the policies.

We intend to remain a stable market for our agencies' best business, and believe that our case-by-case approach gives us a clear advantage. Our independent agents, field marketing representatives and headquarters underwriters work together to select risks and respond appropriately to local pricing trends. Historically, they have proven capable of balancing risk and price to achieve growth over the longer term.

Staying abreast of evolving market conditions is a critical function, accomplished in both an informal and a formal manner. Informally, our field marketing representatives and underwriters are in constant receipt of market intelligence from the agencies with which they work. Formally, our commercial lines product management group and field marketing associates complete periodic market surveys to obtain competitive intelligence. This market information helps identify the top competitors by line of business or specialty program and also identifies our market strengths and weaknesses. The analysis encompasses pricing, breadth of coverage and underwriting/eligibility issues.

In addition to reviewing our competitive position, our product management group and our underwriting audit group review compliance with our underwriting standards as well as the pricing adequacy of our commercial insurance programs and coverages. Further, our research and development department analyzes opportunities and develops new products, new coverage options and improvements to existing insurance products.

In 2006, strong new business activity, higher policy retention rates and higher premiums per policy led to net written premium growth in all of our commercial lines of business, with commercial auto rising slightly. In 2005, growth largely was driven by higher commercial casualty premiums with commercial auto premiums declining. Commercial auto is one of the first lines to experience pricing pressure because it often represents the largest portion of insurance costs for commercial policyholders. Commercial auto also is one of the larger, annually priced components of our three-year policies.

From 2004 through 2006, we experienced no growth in overall commercial lines policy counts as growth in accounts with premiums above $10,000 offset a decline in the number of smaller accounts. Agency emphasis and technology considerations were the primary reasons for the shift.

For new business, our field marketing associates and agents are working together to select risks and respond appropriately to local pricing trends. New commercial lines business was $324 million in 2006, up from $282 million in both 2005 and 2004.

We discuss growth by commercial lines of business on Page 47.

Commercial Lines Results

(Dollars in millions)	Years ended December 31,			**2006-2005**	2005-2004
	2006	2005	2004	**Change %**	Change %
Written premiums	$ **2,442**	$ 2,290	$ 2,186	**6.7**	4.7
Earned premiums	$ **2,402**	$ 2,254	$ 2,126	**6.6**	6.0
Loss and loss expenses excluding catastrophes	**1,377**	1,222	1,083	**12.7**	12.9
Catastrophe loss and loss expenses	**89**	76	71	**16.6**	6.0
Commission expenses	**444**	438	423	**1.4**	3.6
Underwriting expenses	**268**	228	200	**17.8**	13.5
Policyholder dividends	**16**	5	11	**208.1**	(52.3)
Underwriting profit	$ **208**	$ 285	$ 338	**(27.0)**	(15.6)
Ratios as a percent of earned premiums:					
Loss and loss expenses excluding catastrophes	**57.3** %	54.2 %	50.9 %		
Catastrophe loss and loss expenses	**3.7**	3.4	3.4		
Loss and loss expenses	**61.0**	57.6	54.3		
Commission expenses	**18.5**	19.5	19.9		
Underwriting expenses	**11.1**	10.1	9.4		
Policyholder dividends	**0.7**	0.2	0.5		
Combined ratio	**91.3** %	87.4 %	84.1 %		

Over the past three years, we have continued to focus on seeking and maintaining adequate premium per exposure as well as pursuing non-pricing means of enhancing longer-term profitability. These have included identifying the exposures we have for each risk and making sure we offer appropriate coverages, terms and conditions and limits of insurance. We continue to adhere to our underwriting guidelines, to re-underwrite books of business with selected agencies and to update policy terms and conditions, where necessary. In addition, we continue to leverage our strong local presence. Our field marketing representatives meet with local agencies to reaffirm agreements on the extent of frontline renewal underwriting they will perform. Loss control, machinery and equipment and field claims representatives continue to conduct on-site inspections. Field claims representatives prepare full risk reports on any account reporting a loss above $100,000 or on any risk of concern. These actions have helped to mitigate rising loss severity.

We describe the significant cost components for the commercial lines segment below.

Loss and Loss Expenses (excluding catastrophe losses)

Loss and loss expenses include both net paid losses and reserve changes for unpaid losses as well as the associated loss expenses. We believe more competitive market conditions and softer pricing contributed to the rise in the loss and loss expense ratio excluding catastrophe losses between 2004 and 2006. In addition, 2005 results include a single large loss that was insufficiently covered through our facultative reinsurance programs, which increased 2005 loss and loss expenses by $22 million, net of reinsurance, or 1.0 percentage points. Savings from favorable loss reserve development moved lower over the three years, which we discuss by commercial lines of business on Page 47.

Re-underwriting our commercial lines book of business in the early 2000s has had a positive impact on loss cost trends such as frequency of loss, resulting in significant savings from favorable reserve development. The favorable development in 2005 and 2004 also was due to a headquarters claims department initiative, begun in 2001, to establish higher initial case reserves on severe injury claims. The higher reserves reflect our experience that juries often ignore significant liability issues in cases involving seriously injured claimants as well as trends in medical cost inflation and life expectancies. These higher initial amounts produce case reserves that reflect our full exposure more accurately. But some claims settle before reaching a jury and some juries make awards that are less than the “worst-case” scenario.

Another factor in the rise in the loss and loss expense ratio excluding catastrophe losses in 2006 was increasing loss severity, reflected primarily by an increase in new losses and case reserve increases greater than $250,000. In total, commercial lines new losses and reserve increases greater than $250,000 rose to 21.3 percent of annual earned premiums in 2006 from 16.8 percent in 2005 and 14.9 percent in 2004. Those amounts included an increase in new losses greater than $1 million. Our analysis indicated no unexpected concentration of these losses and reserve increases by risk category, geographic region, policy inception, agency or field marketing territory. We believe loss severity generally is rising, but we cannot predict the magnitude of future increases. Severe injury was frequently the cause for new losses greater than $1 million. We continue to analyze factors that could be contributing to a rise in severe injuries.

Commercial Lines Losses by Size

(Dollars in millions)	Years ended December 31,			2006-2005	2005-2004
	2006	2005	2004	**Change %**	Change %
Losses $1 million or more	**$ 180**	$ 124	$ 80	**45.3**	54.3
Losses $250 thousand to $1 million	**139**	105	103	**32.3**	1.2
Development and case reserve increases of $250 thousand or more	**193**	149	133	**29.5**	12.7
Other losses excluding catastrophes	**561**	596	536	**(5.7)**	11.1
Total losses incurred excluding catastrophe losses	**1,073**	974	852	**10.3**	14.2
Catastrophe losses	**89**	76	71	**16.6**	6.0
Total losses incurred	**$ 1,162**	$ 1,050	$ 923	**10.7**	13.6
Ratios as a percent of earned premiums:					
Losses $1 million or more	**7.5 %**	5.5 %	3.8 %		
Losses $250 thousand to $1 million	**5.8**	4.7	4.9		
Development and case reserve increases of $250 thousand or more	**8.0**	6.6	6.2		
Other losses excluding catastrophes	**23.4**	26.4	25.1		
Loss ratio excluding catastrophe losses	**44.7**	43.2	40.0		
Catastrophe losses	**3.7**	3.4	3.4		
Total loss ratio	**48.4 %**	46.6 %	43.4 %		

Catastrophe Loss and Loss Expenses

Commercial lines catastrophe losses have been relatively stable as a percentage of net earned premiums over the past three years.

Commission Expenses

Commercial lines commission expense as a percent of earned premium declined by 1.0 and 0.4 percentage points in 2006 and 2005, respectively, primarily due to lower profit-sharing commissions on lower overall underwriting profits. Profit-sharing, or contingent, commissions are calculated on the profitability of an agency's aggregate book of business, taking into account longer-term profit, with a percentage for prompt payment of premiums and other criteria, and reward the agencies' efforts. These profit-based commissions generally fluctuate with our loss and loss expenses.

A refinement and subsequent release of a contingent commission over accrual from 2004 in the first three months of 2005 was responsible for 0.3 percentage points of the decline in 2005. The refinement reflected the use of final 2004 financial data to calculate the contingent commissions paid in 2005. Our 2006 contingent commission accrual reflected our estimate of the profit-sharing commissions that will be paid to our agencies in early 2007.

Underwriting Expenses

Non-commission underwriting expenses rose to 11.1 percent of earned premiums in 2006 from 10.1 percent in 2005 and 9.4 percent in 2004. We continue to invest in our associates and technology, which is contributing to an increase in other underwriting expenses. Higher technology expense contributed 0.3 and 0.1 percentage points to the increase in 2006 and 2005. Higher staffing expense contributed 0.9 percentage points to the increase in 2006, with stock option expense accounting for 0.5 percentage points of that amount.

Policyholder Dividends

Policyholder dividend expense was 0.7 percent of earned premium in 2006 compared with 0.2 percent in 2005 and 0.5 percent in 2004. The increase in 2006 was a result of higher paid dividends and increased accrual for future dividends. The increased accrual reflects the improved profitability of workers' compensation policies with respect to recent policy years.

Line of Business Analysis

Approximately 95 percent of our commercial lines premiums relate to accounts with coverages from more than one of our business lines. As a result, we believe that commercial lines is best measured and evaluated on a segment basis. However, we provide the line of business data to summarize growth and profitability trends separately for our business lines.

(Dollars in millions)	Years ended December 31,			2006-2005	2005-2004
	2006	2005	2004	**Change %**	Change %
Commercial casualty:					
Written premiums	**$ 838**	$ 779	$ 708	**7.7**	10.0
Earned premiums	**831**	759	686	**9.5**	10.7
Loss and loss expenses incurred	**440**	302	321	**45.8**	(5.9)
Loss and loss expense ratio	**53.0 %**	39.8 %	46.8 %		
Loss and loss expense ratio excluding catastrophes	**53.0**	39.8	46.8		
Commercial property:					
Written premiums	**$ 505**	$ 476	$ 455	**6.1**	4.5
Earned premiums	**491**	467	440	**5.1**	6.0
Loss and loss expenses incurred	**282**	300	240	**(5.9)**	24.9
Loss and loss expense ratio	**57.5 %**	64.2 %	54.5 %		
Loss and loss expense ratio excluding catastrophes	**43.6**	49.3	42.1		
Commercial auto:					
Written premiums	**$ 450**	$ 448	$ 458	**0.3**	(2.2)
Earned premiums	**453**	457	450	**(0.9)**	1.5
Loss and loss expenses incurred	**278**	274	236	**1.5**	16.3
Loss and loss expense ratio	**61.5 %**	60.1 %	52.4 %		
Loss and loss expense ratio excluding catastrophes	**60.6**	60.0	52.1		
Workers' compensation:					
Written premiums	**$ 379**	$ 338	$ 320	**12.1**	5.4
Earned premiums	**366**	328	313	**11.4**	5.1
Loss and loss expenses incurred	**313**	299	251	**4.7**	18.9
Loss and loss expense ratio	**85.4 %**	90.9 %	80.3 %		
Loss and loss expense ratio excluding catastrophes	**85.4**	90.9	80.3		
Specialty packages:					
Written premiums	**$ 144**	$ 138	$ 135	**4.6**	2.1
Earned premiums	**141**	137	133	**3.2**	2.5
Loss and loss expenses incurred	**94**	92	80	**2.1**	14.6
Loss and loss expense ratio	**66.3 %**	67.0 %	59.9 %		
Loss and loss expense ratio excluding catastrophes	**54.9**	61.8	47.4		
Surety and executive risk:					
Written premiums	**$ 97**	$ 85	$ 85	**15.3**	(0.1)
Earned premiums	**93**	80	80	**16.3**	(0.8)
Loss and loss expenses incurred	**47**	27	21	**72.2**	27.9
Loss and loss expense ratio	**50.7 %**	34.2 %	26.6 %		
Loss and loss expense ratio excluding catastrophes	**50.7**	34.2	26.6		
Machinery and equipment:					
Written premiums	**$ 29**	$ 26	$ 25	**8.7**	6.8
Earned premiums	**27**	26	24	**5.8**	8.0
Loss and loss expenses incurred	**12**	6	5	**98.7**	17.1
Loss and loss expense ratio	**42.0 %**	22.4 %	20.6 %		
Loss and loss expense ratio excluding catastrophes	**41.6**	22.5	20.2		

The accident year loss data provides current estimates of incurred loss and loss expenses for the past three accident years. Accident year data classifies losses according to the year in which the corresponding loss event occurred, regardless of when the losses are actually reported, booked or paid.

(Dollars in millions)	Accident year		
	2006	2005	2004
Loss and loss expenses incurred:			
Commercial casualty	$ 540	$ 420	$ 359
Commercial property	278	300	261
Commercial auto	300	281	269
Workers' compensation	303	254	250
Specialty packages	91	80	82
Surety and executive risk	41	39	29
Machinery and equipment	11	7	4
Loss and loss expenses ratio:			
Commercial casualty	64.9 %	55.4 %	52.4 %
Commercial property	56.6	64.2	59.3
Commercial auto	66.1	61.4	59.8
Workers' compensation	82.8	77.4	79.8
Specialty packages	64.7	58.6	61.2
Surety and executive risk	44.4	48.3	36.2
Machinery and equipment	39.2	28.6	18.6

Over the past three years, results for the business lines within the commercial lines segment have reflected our emphasis on underwriting and obtaining adequate pricing for covered risks, as discussed above.

Commercial Casualty

Commercial casualty is our largest business line. Commercial casualty net written premium growth slowed in 2006, but remained above the overall growth rate for commercial lines. While casualty pricing continues to become more competitive, new business is strong. We also are seeing a boost from the healthy business economy over the past several years as well as related exposure growth.

The commercial casualty loss and loss expense ratio rose in 2006 after improving in 2005, but remained within the range we consider appropriate. In each of the last three calendar years, activity in the reserves for prior period losses has been the primary reason for the fluctuations in the loss and loss expense ratio.

- 2006 – Favorable development lowered the loss and loss expense ratio by 12.0 percentage points.
- 2005 – Favorable development lowered the loss and loss expense ratio by 22.5 percentage points.
- 2004 – Favorable development lowered the loss and loss expense ratio by 20.0 percentage points.

Over the three years, flat commercial umbrella loss costs helped produce savings through favorable development on prior period reserves. Factors that contributed to the flat loss cost trend included commercial lines re-underwriting efforts, Ohio judicial decisions regarding underinsured/uninsured motorist claims and a claims mediation process that promoted earlier liability settlement resolution, which also contributed to lower loss cost trends for our other general liability coverages. Once these commercial lines and claims initiatives are fully implemented, loss cost trends could be expected to return to normal levels.

Another factor that helped produce savings through favorable development was the headquarters claims department initiative to establish higher initial case reserves on serious injury claims. The higher reserves reflect our experience indicating the likelihood that juries would ignore significant liability issues in cases involving seriously injured claimants as well as trends in medical cost inflation and life expectancies.

In large part because this business line also includes umbrella coverages, the accident year loss and loss expense ratio can fluctuate significantly on a year-over-year basis.

Commercial Property

Commercial property is our second largest business line. Commercial property net written premiums rose in 2006 and 2005. The primary reason for the more rapid growth in 2006 was a $5 million ceded reinsurance reinstatement premium in 2005 to restore affected layers of our property catastrophe reinsurance program following Hurricane Katrina. This added 1.2 percentage points to the 2006 growth rate.

The commercial property loss and loss expense ratio excluding catastrophe losses improved in 2006 after rising in 2005 and remained within the range we consider appropriate. In each of the last three calendar years, activity in the reserves for prior period losses contributed to the changes in the loss and loss expense ratio.

- 2006 – Reserve strengthening raised the loss and loss expense ratio by 0.9 percentage points.
- 2005 – Reserve strengthening raised the loss and loss expense ratio by 3.5 percentage points.
- 2004 – Reserve strengthening raised the loss and loss expense ratio by 0.3 percentage points.

In addition, the large loss discussed on Page 42 added 5.0 percentage points to the 2005 ratio.

Commercial Auto

Commercial auto net written premiums rose slightly in 2006 after declining 2.2 percent in 2005. We are beginning to see the impact of the downward pressure on pricing on underwriting results. Commercial auto is one of the business lines that we renew and price annually, so market trends may be reflected here more quickly than in other lines. Commercial auto also is generally one of the larger components of the typical package.

As a result of our underwriting activities and moderating industrywide severity and frequency trends, the loss and loss expense ratio for commercial auto remained at an acceptable level in 2006 and 2005 despite increasing due to pricing pressures. The increase in the loss and loss expense ratio in 2006 also reflected a 2.9 percentage point rise in the ratio of $1 million plus losses to commercial auto earned premiums.

In each of the last three calendar years, favorable development on prior period losses, due to commercial lines re-underwriting efforts and favorable frequency and severity trends, contributed to the changes in the loss and loss expense ratio.

- 2006 – Favorable development lowered the loss and loss expense ratio by 4.6 percentage points.
- 2005 – Favorable development lowered the loss and loss expense ratio by 5.0 percentage points.
- 2004 – Favorable development lowered the loss and loss expense ratio by 10.5 percentage points, including 4.6 percentage points due to the release of UM/UIM reserves.

Workers' Compensation

In 2006 and 2005, workers' compensation written premiums rose more rapidly than our total commercial lines written premiums. Workers' compensation premiums are benefiting from the healthy business economy and related payroll growth. Premiums also are benefiting from initiatives to modestly expand our workers' compensation business in selected states. We cannot offer workers' compensation coverage in Ohio, our highest volume state, because it is provided solely by the state instead of private insurers.

We pay a lower commission rate on workers' compensation business, which means this line has a higher loss and loss expense breakeven point than our other commercial business lines.

The workers' compensation loss and loss expense ratio rose in 2005 after remaining steady for several years and remained above our target levels in 2006. The 2005 rise largely was due to a higher level of reserve strengthening for older accident years. The ratio remained above our target level in 2006 because of modest reserve strengthening and seven new losses greater than $1 million, primarily in the second half of the year. The seven losses in 2006 totaled $18 million and added 4.9 percentage points to the workers' compensation loss and loss expense ratio. There was only one similarly sized loss, for $1.6 million, in 2005 and none in 2004.

Our philosophy is to establish case reserves when we learn of a loss to reflect our best estimate of ultimate payouts. The higher initial reserves established in 2006 for newly reported claims demonstrate our commitment to applying our claims reserving philosophy to this business line.

In 2006, we also reviewed each of our established workers' compensation case reserves above $100,000 in light of current trends in medical cost inflation and estimated payout periods. The review led to the allocation of approximately $60 million to case reserves held for specific claims from accident years going back as much as 20 years. Reductions to IBNR reserves offset approximately $44 million of those reserve increases. We had raised workers' compensation IBNR reserves in 2005, in light of the trends identified in the workers' compensation market. However, small shifts in medical cost inflation and payout periods could have a significant effect on our potential future liability compared with our current projections.

Activity in the reserves for prior period losses in the past three years included:

- 2006 – Reserve strengthening raised the loss and loss expense ratio by 2.6 percentage points, as discussed above.
- 2005 – Reserve strengthening raised the loss and loss expense ratio by 12.9 percentage points. The reserve strengthening primarily was due to medical cost inflation and longer estimated payout periods compared with our original projections.
- 2004 – Reserve strengthening raised the loss and loss expense ratio by 4.9 percentage points, which also was due to medical cost inflation.

Specialty Packages

Specialty packages net written premiums rose in 2006 and 2005. The rollout we have begun of our commercial lines policy processing system should help us meet changing agency needs and address pricing, technology and service systems other carriers have introduced for similar products in recent years.

The loss and loss expense ratio excluding catastrophe losses improved in 2006 after rising in 2005, but remained within the range we consider appropriate. In each of the last three calendar years, activity in the reserves for prior period losses contributed to the fluctuations in the loss and loss expense ratio.

- 2006 – Reserve strengthening raised the loss and loss expense ratio by 1.6 percentage points.
- 2005 – Reserve strengthening raised the loss and loss expense ratio by 10.9 percentage points.
- 2004 – Reserve strengthening raised the loss and loss expense ratio by 3.7 percentage points.

Surety and Executive Risk

Surety and executive risk net written premiums rose in 2006 and were unchanged in 2005. Healthy economic activity drove the 2006 growth.

The loss and loss expense ratio rose in 2006 and 2005; however, surety and executive risk losses can fluctuate significantly, and we do not believe that the increases indicate any new trend or risk.

Director and officer liability coverage accounted for 59.0 percent of surety and executive risk premiums in 2006 compared with 61.7 percent in 2005 and 65.7 percent in 2004. Our director and officer liability policies are offered primarily to nonprofit organizations, reducing the risk associated with this line of business. As of December 31, 2006, two of our in-force director and officer liability policies covered Fortune 500 companies, 36 covered publicly traded companies (excluding banks and savings and loans) and 57 covered banks and savings and loans with more than $500 million in assets.

In each of the last three calendar years, activity in the reserves for prior period losses contributed to the changes in the loss and loss expense ratio.

- 2006 – Reserve strengthening raised the loss and loss expense ratio by 21.1 percentage points due to case reserves additions for director and officer liability claims.
- 2005 – Favorable development lowered the loss and loss expense ratio by 5.4 percentage points.
- 2004 – Favorable development lowered the loss and loss expense ratio by 9.3 percentage points.

Machinery and Equipment

Machinery and equipment net written premiums rose in 2006 and 2005. Marketing by machinery and equipment and field marketing representatives contributed to the 2006 growth.

The loss and loss expense ratio rose in 2006; however, machinery and equipment losses can fluctuate significantly, and we do not believe that the increase indicates any new trend or risk.

In each of the last three calendar years, activity in the reserves for prior period losses contributed to the changes in the loss and loss expense ratio.

- 2006 – Reserve strengthening raised the loss and loss expense ratio by 0.8 percentage points.
- 2005 – Favorable development lowered the loss and loss expense ratio by 3.7 percentage points.
- 2004 – Favorable development lowered the loss and loss expense ratio by 1.3 percentage points.

Commercial Lines Insurance Outlook

Industrywide commercial lines written premiums are expected to decline approximately 1.0 percent in 2007. During 2006, agents again reported that renewal pricing pressure had risen and new business pricing was requiring even more flexibility and more careful risk selection. During 2006, we continued to need to use credits more frequently to retain renewals of quality business – the larger the account, the higher the credits, with variations by geographic region and class of business. By year-end 2006, our field marketing representatives reported pricing down about 10 percent to 15 percent on average to write the same piece of new business we would have quoted in 2005. By comparison, 5 percent to 10 percent rate declines seem to be typical for renewal business.

We intend to continue to market our products to a broad range of business classes, price our products adequately and take a package approach. We intend to maintain our underwriting selectivity and carefully manage our rate levels as well as our programs that seek to accurately match exposures with appropriate premiums. We will continue to evaluate each risk individually and to make decisions regarding rates, the use of three-year commercial policies and other policy terms on a case-by-case basis, even in lines and classes of business that are under competitive pressure. New marketing territories created over the past several years and new agency appointments will contribute to commercial lines growth.

We believe our approach should allow us to continue to underwrite commercial lines business profitably in 2007, but we do not believe favorable reserve development will contribute to underwriting profits as much in 2007 as in the past three years. In addition, underwriting expenses are rising. We discuss our overall outlook for our property casualty insurance operations in Measuring Our Success in 2007 and Beyond, Page 34.

PERSONAL LINES INSURANCE RESULTS OF OPERATIONS

Overview – Three-year Highlights

Performance highlights for the personal lines segment include:

- Premiums – As competition in our personal lines markets continued to increase and we continued to work to generate consistent profitability in our personal lines market, our written premiums declined again in 2006, reflecting lower new business and policy retention rates through the first half of the year and lower pricing in the second half of the year. Industry average written premium growth was estimated at 2.0 percent for 2006, 3.7 percent for 2005 and 6.6 percent for 2004.

  Personal lines new business premiums written directly by agencies increased 1.6 percent to $33 million in 2006 after declining 33.9 percent to $32 million in 2005 and 19.9 percent to $48 million in 2004.
- Combined ratio – After improving substantially in 2005, the combined ratio increased in 2006 due to higher catastrophe losses, less savings from favorable development on prior period reserves, an increase in loss severity and higher expenses. Lower earned premiums exacerbated the year-over-year comparisons. Our personal lines statutory combined ratio was 103.6 percent in 2006 compared with 94.3 percent in 2005 and 104.6 percent in 2004. By comparison, the estimated industry personal lines combined ratio was 92.0 percent in 2006, 97.6 percent in 2005 and 94.9 percent in 2004. We believe our results are trending differently than the overall industry because of the competitive and pricing factors discussed below.

Growth and Profitability

Personal lines insurance is a strategic component of our overall relationship with many of our agencies and an important component of agency relationships with their clients. We believe agents recommend Cincinnati personal insurance products for their value-oriented clients who seek to balance quality and price and are attracted by Cincinnati's superior claims service and the benefits of our package approach.

In late 2004, price competition returned to the personal lines market as insurers leveraged the higher profitability and stronger financial positions that were the outcome of industrywide increases in homeowner rates and stricter enforcement of underwriting standards between 2000 and 2003.

When price competition emerged in 2004, we were in the early stages of a program to improve profitability for our homeowner line by raising rates and making changes to our policy terms and conditions. We raised our personal lines rates in some territories too high to allow our agents to market the benefits of a Cincinnati policy, leading to declines in our policy retention rates and lower new business levels between 2002 and 2005.

We opted to delay certain rate changes to address the competitive situation until mid-2005 because we felt it was more important to fully commit our programming resources to completing necessary modifications and upgrades to our then-new Diamond policy processing system. During that time period, other carriers began making more aggressive use of segmented pricing models, offering lower rates for higher quality accounts.

When some important system modifications were completed in mid-2005, we began filing rate and credit changes to better position our products in the market, but written premiums, new business and retention rates continued to decline.

During the 2003 to 2005 period, we also were introducing Diamond in our higher volume states, which may have contributed to lower growth rates. The focus required by our agencies to convert to our newer technology and make the necessary adaptations to their work flows may have diverted their resources from new business efforts. Diamond gives agencies additional choices to consider for their business operations and for policyholders. Agents are growing more familiar with the new options and work flow, and many now are seeing benefits from efficiencies as they renew business through the system.

During 2005 and 2006, we increased the system's processing power and availability and offered additional functionality requested by agency staff. For example, we began offering convenient account billing to direct bill customers, invoicing for multiple policies at one time, and electronic funds transfer, which accommodates new monthly payment plans. We continue to respond to agency requests for enhancements as we prepare Diamond for additional states.

In mid-2006, we introduced a limited program of policy credits to incorporate insurance scores into homeowner and personal auto pricing. These were intended to improve our ability to compete for our agents' highest quality personal lines accounts, increasing the opportunity for our agents to market the advantages of our personal lines products and services to their clients.

The policy credits contributed to increases in new business for both personal auto and homeowner for the first time in several years. The new credit structure also led to improved retention of current business. However, new business did not rise sufficiently to offset the lower prices that our current personal lines policyholders received at renewal with these policy credits. As a result, total net written premiums continued to decline in the second half of 2006. To build on the new business and retention trends of the second half of 2006, we will need to monitor the competitiveness of our personal auto and homeowner rates on an ongoing basis and make refinements as necessary.

Strategies to accelerate our personal lines growth are discussed in Personal Lines Outlook, Page 54. We discuss premium trends by personal lines of business on Page 53.

Personal Lines Results

(Dollars in millions)	Years ended December 31,			2006-2005	2005-2004
	2006	2005	2004	**Change %**	Change %
Written premiums	$ **736**	$ 786	$ 811	**(6.4)**	(3.0)
Earned premiums	$ **762**	$ 804	$ 793	**(5.3)**	1.4
Loss and loss expenses excluding catastrophes	**456**	463	522	**(1.5)**	(11.3)
Catastrophe loss and loss expenses	**86**	51	77	**69.8**	(34.2)
Commission expenses	**152**	154	160	**(1.6)**	(3.6)
Underwriting expenses	**95**	91	74	**4.2**	24.0
Underwriting profit (loss)	$ **(27)**	$ 45	$ (40)	**(160.0)**	214.0
Ratios as a percent of earned premiums:					
Loss and loss expenses excluding catastrophes	**59.9 %**	57.6 %	65.9 %		
Catastrophe loss and loss expenses	**11.3**	6.3	9.7		
Loss and loss expenses	**71.2**	63.9	75.6		
Commission expenses	**19.9**	19.2	20.1		
Underwriting expenses	**12.5**	11.3	9.3		
Combined ratio	**103.6 %**	94.4 %	105.0 %		

In 2006, we did not achieve the profit levels we had hoped to realize, following the improvement of the personal lines combined ratio in 2005. Instead, higher catastrophe losses and other factors caused the 2006 combined ratio to rise.

We describe the significant cost components for the personal lines segment below.

Loss and Loss Expenses (excluding catastrophe losses)

Loss and loss expenses include both net paid losses and reserve changes for unpaid losses as well as the associated loss expenses. The change in the loss and loss expense ratio excluding catastrophe losses between 2004 and 2006 largely was due to pricing and loss cost trends. Increased loss severity was seen primarily in higher new losses and case reserve increases greater than $250,000. In total, personal lines new losses and case reserve increases greater than $250,000 were 11.1 percent of annual earned premiums in 2006 compared with 8.2 percent in 2005 and 10.2 percent in 2004. Personal lines new losses and case reserve increases declined as a percent of earned premiums in 2005, in part because of higher rates per exposure. Our analysis indicated no unexpected concentration of these losses and case reserve increases by risk category, geographic region, policy inception, agency or field marketing territory. In 2006, homeowner fires, which spiked in the third quarter, were the most frequent cause for new losses greater than $1 million. We believe loss severity generally is rising, but we cannot predict the magnitude of future increases.

Savings from favorable loss reserve development moved lower over the three years, which we discuss by personal lines of business on Page 53.

Personal Lines Losses by Size

(Dollars in millions)	Years ended December 31,			2006-2005	2005-2004
	2006	2005	2004	**Change %**	Change %
Losses $1 million or more	$ **23**	$ 13	$ 17	**79.1**	(26.0)
Losses $250 thousand to $1 million	**39**	34	43	**14.5**	(19.9)
Development and case reserve increases of $250 thousand or more	**22**	19	21	**16.8**	(7.7)
Other losses excluding catastrophes	**309**	339	371	**(8.9)**	(8.5)
Total losses incurred excluding catastrophe losses	**393**	405	452	**(3.0)**	(10.2)
Catastrophe losses	**86**	51	77	**69.8**	(34.2)
Total losses incurred	$ **479**	$ 456	$ 529	**5.1**	(13.7)
Ratios as a percent of earned premiums:					
Losses $1 million or more	**3.0 %**	1.5 %	2.2 %		
Losses $250 thousand to $1 million	**5.2**	4.3	5.4		
Development and case reserve increases of $250 thousand or more	**2.9**	2.4	2.6		
Other losses excluding catastrophes	**40.5**	42.2	46.8		
Loss ratio excluding catastrophe losses	**51.6**	50.4	57.0		
Catastrophe losses	**11.3**	6.3	9.7		
Total loss ratio	**62.9 %**	56.7 %	66.7 %		

Catastrophe Loss and Loss Expenses

Personal lines catastrophe losses, net of reinsurance and before taxes, contributed 5 percentage points more to the combined ratio in 2006 because of an increase of $35 million in incurred catastrophe losses and lower earned premium. The majority of these losses related to wind and hail from storms in Indiana and Ohio.

Commission Expenses

Personal lines commission expense as a percent of earned premium rose by 0.7 percentage points in 2006 after declining by 0.9 percentage points in 2005. The 2006 change was primarily due to higher profit-sharing commissions resulting from accrual and allocation adjustments. Profit-sharing, or contingent, commissions are calculated on the profitability of an agency's aggregate book of business, taking into account longer-term profit, with a percentage for prompt payment of premiums and other criteria, and reward the agencies' efforts. These profit-based commissions generally fluctuate with our loss and loss expenses.

A refinement and subsequent release of a contingent commission over accrual from 2004 in the first three months of 2005 was responsible for 0.2 percentage points of the decline in 2005. The refinement reflected the use of final 2004 financial data to calculate the contingent commissions paid in 2005.
Our 2006 contingent commission accrual reflected our estimate of the profit-sharing commissions that will be paid to our agencies in early 2007.

Underwriting Expenses

Non-commission underwriting expenses increased 1.2 percentage points in 2006 and 2.0 percentage points in 2005. We continue to invest in our associates and technology, which is contributing to an increase in non-commission underwriting expenses. Higher technology expense contributed 0.8 and 0.5 percentage points to the increase in 2006 and 2005. Higher staffing expense contributed 0.8 to the increase in 2006, with stock option expense accounting for 0.5 percentage points of that amount. Increases in those amounts in 2006 were offset partially by savings in taxes, licenses and fees. The increase in 2005 reflected an unfavorable deferred acquisition cost comparison of 1.0 percentage points due to premium declines.

Line of Business Analysis

We prefer to write personal lines coverage on an account basis that includes both auto and homeowner coverages as well as coverages from the other personal business line. As a result, we believe that personal lines is best measured and evaluated on a segment basis. However, we provide the line of business data to summarize growth and profitability trends separately for the three business lines.

(Dollars in millions)	Years ended December 31,			2006-2005	2005-2004
	2006	2005	2004	**Change %**	Change %
Personal auto:					
Written premiums	**$ 359**	$ 409	$ 453	**(12.4)**	(9.6)
Earned premiums	**385**	433	451	**(11.2)**	(4.0)
Loss and loss expenses incurred	**250**	259	298	**(3.5)**	(13.0)
Loss and loss expense ratio	**65.0 %**	59.9 %	66.1 %		
Loss and loss expense ratio excluding catastrophes	**62.2**	59.3	65.1		
Homeowner:					
Written premiums	**$ 290**	$ 288	$ 270	**0.7**	6.7
Earned premiums	**289**	282	256	**2.3**	10.4
Loss and loss expenses incurred	**240**	213	247	**12.4**	(13.4)
Loss and loss expense ratio	**83.0 %**	75.5 %	96.3 %		
Loss and loss expense ratio excluding catastrophes	**59.3**	58.6	69.0		
Other personal:					
Written premiums	**$ 87**	$ 89	$ 88	**(2.0)**	1.3
Earned premiums	**88**	89	86	**(1.1)**	3.4
Loss and loss expenses incurred	**52**	40	55	**31.6**	(27.6)
Loss and loss expense ratio	**59.4 %**	44.6 %	63.7 %		
Loss and loss expense ratio excluding catastrophes	**52.0**	41.6	60.0		

The accident year loss data provides current estimates of incurred loss and loss expenses for the past three accident years. Accident year data classifies losses according to the year in which the corresponding loss event occurred, regardless of when the losses are actually reported, booked or paid.

(Dollars in millions)	Accident year		
	2006	2005	2004
Loss and loss expenses incurred:			
Personal Auto	$ 248	$ 272	$ 303
Homeowner	235	219	255
Other Personal	77	58	64
Loss and loss expenses ratio:			
Personal Auto	64.5 %	62.8 %	67.3 %
Homeowner	81.5	77.6	99.6
Other Personal	88.0	65.4	74.4

Personal Auto

Written and earned premiums for the personal auto line declined in 2006 and 2005. As noted above, the decline primarily was due to price competition in some states and territories, which resulted in lower policy renewal retention and significantly lower new business levels through mid-2006. We continue to monitor and modify selected rates and credits to address our competitive position.

The loss and loss expense ratio for personal auto has remained satisfactory. For selected agencies, we use re-underwriting programs to review and to strengthen underwriting standards, such as requiring motor vehicle reports for insured drivers. We work with agencies to develop strategies to increase the company's penetration of the agency's personal lines business. The rise in the ratio in 2006 was due to price reductions.

In each of the last three calendar years, activity in the reserves for prior period losses contributed to the changes in the loss and loss expense ratio.

- 2006 – Reserve strengthening raised the loss and loss expense ratio by 0.6 percentage points.
- 2005 – Favorable development lowered the loss and loss expense ratio by 1.9 percentage points.
- 2004 – Reserve strengthening raised the loss and loss expense ratio by 0.2 percentage points.

Homeowner

The growth rate of written and earned premiums for the homeowner line slowed over the three-year period. As discussed above, until mid-2006, the benefit of rate increases in 2004 and 2005 was being increasingly offset by lower policy renewal retention rates and significantly lower new business levels. Earned premiums rose more rapidly because of the benefit of higher written premium growth in earlier periods.

We began a strategic shift in 2004 to a more conventional one-year homeowner policy term from our traditional three-year policy term. We are transitioning to one-year policies in conjunction with the state-by-state deployment of Diamond, our personal lines policy processing system. One-year policies allow us to modify rates, terms and conditions more promptly in response to market changes. At year-end 2006, approximately 85 percent of all homeowner policies had been converted to a one-year term, up from approximately 56 percent at year-end 2005. We are continuing to renew homeowner policies for three-year terms in five states that currently account for less than 1 percent of total personal lines premiums.

The loss and loss expense ratio for the homeowner line excluding catastrophe losses rose in 2006 after improving in 2005. The increase in 2006 reflected a higher contribution from large losses. In each of the last three calendar years, activity in the reserves for prior period losses also contributed to the changes in the loss and loss expense ratio.

- 2006 – Reserve strengthening raised the loss and loss expense ratio by 1.5 percentage points.
- 2005 – Favorable development lowered the loss and loss expense ratio by 0.4 percentage points.
- 2004 – Favorable development lowered the loss and loss expense ratio by 2.7 percentage points.

We continue to seek to improve homeowner results so that this line achieves profitability. Since we generally do not allocate non-commission expenses to individual business lines, to measure homeowner profitability, we now assume total commission and underwriting expenses would contribute approximately 33 percentage points to our homeowner combined ratio, up from a 32 percent assumption in prior years. Lower levels of premium growth affected our ability to attain our expense ratio target in 2006 and may continue to do so in the future.

We also assume catastrophe losses as a percent of homeowner earned premium would be in the range of 17 percent. Over the past three years, catastrophe losses have averaged 22.2 percent of homeowner earned premiums. We did not change our catastrophe loss assumption because the geographic concentration of these losses has been unusual in the past three years.

We had hoped that by 2007 the full benefit of our pricing and underwriting actions would be reflected in homeowner results and this line would be approaching breakeven. Pricing changes enacted in mid-2006, however, have slowed our progress toward overall homeowner profitability.

Other Personal

Other personal written premiums were down slightly in 2006 after rising slightly in 2005. Lower retention and new business for homeowner and personal auto during 2005 and the first half of 2006 contributed to the decline, since most of our other personal coverages are endorsed to homeowner or auto policies.

The loss and loss expense ratio for other personal rose in 2006 due to higher personal umbrella and dwelling fire losses in the second quarter. Personal umbrella losses can fluctuate significantly, and we do not believe that the increase indicated any new trend or risk. In each of the last three calendar years, activity in the reserves for prior period losses also contributed to the changes in the loss and loss expense ratio.

- 2006 – Favorable development lowered the loss and loss expense ratio by 28.6 percentage points.
- 2005 – Favorable development lowered the loss and loss expense ratio by 28.7 percentage points.

- 2004 – Favorable development lowered the loss and loss expense ratio by 18.9 percentage points.

Personal Lines Insurance Outlook

Industry experts currently anticipate industrywide personal lines written premiums will rise approximately 1.2 percent in 2007. While the rise in new business levels and policy retention rates in the second half of 2006 are positive indications for our personal lines business, we believe our growth rate will be below that of the industry in 2007.

We are pursuing a number of strategies in our personal lines business to achieve our long-term objectives for this segment:

- Competitive rates –In mid-2006, we introduced insurance scores into our program of policy credits for homeowner and personal auto pricing. That action led to the increased new business for both personal auto and homeowners in the second half of 2006. It also led to improved retention of current business. While these pricing refinements have reduced premiums per policy, we believe they present an opportunity to attract our agents' more quality conscious clientele.
- Policy characteristics – In keeping with industry practices, most of our homeowner products no longer automatically provide guaranteed full replacement cost coverage in our basic policies. We add specific charges for some optional coverages previously included at no charge, such as limited replacement cost and water damage coverages. Policyholders who need the water damage protection now can select the amount of coverage that meets their needs. However, these changes and our transition to one-year homeowner policies have diminished some of the factors that distinguished our products.
- Diamond introduction –The Diamond system is in use by agencies writing approximately 90 percent of personal lines premium volume. We believe the system ultimately will make it easier for agents to place personal auto, homeowner and other personal lines business with us, while greatly increasing policy-issuance and policy-renewal efficiencies and providing direct-bill capabilities. Agents using Diamond chose direct bill for 47 percent and headquarters printing for 81 percent of policy transactions in 2006.
- New agencies – The availability of Diamond should help us increase the number of agencies that offer our personal lines products, which also should contribute to personal lines growth and geographic diversity. We currently market both homeowner and personal auto insurance products through 772 of our 1,289 reporting agency locations in 22 of the 32 states where we market commercial lines insurance. We market homeowner products through 22 locations in three additional states (Maryland, North Carolina and West Virginia).

  During 2007, we hope to add personal lines for 30 to 35 agency locations in the 13 states in which Diamond is in use that currently market only our commercial lines products. During 2007, our field teams and personal lines associates are contacting these agencies to re-introduce them to our personal lines product line and technology. Expanding into these agencies would provide additional sources of premiums and help geographically diversify our personal lines portfolio.

We identify several other factors that may affect the personal lines combined ratio in 2007 and beyond. Personal lines underwriters continue to focus on insurance-to-value initiatives to verify that policyholders are buying the correct level of coverage for the value of the insured risk, and we are carefully maintaining underwriting standards. However, if premiums decline more than we expect, the personal lines expense ratio may be higher than the 2006 level, because some of our costs are relatively fixed, such as our planned investments in technology. We discuss our overall outlook for the property casualty insurance operations in Measuring Our Success in 2007 and Beyond, Page 34.

LIFE INSURANCE RESULTS OF OPERATIONS

Overview – Three-year Highlights

Performance highlights for the life insurance segment include:

- Revenues – Revenue growth has accelerated over the past three years as gross in-force policy face amounts increased to $56.971 billion at year-end 2006 from $51.493 billion at year-end 2005 and $44.921 billion at year-end 2004.
- Profitability – The life insurance segment reports a small GAAP loss because its investment income is included in investment segment results, except investment income credited to contract holders (interest assumed in life insurance policy reserve calculations). The segment operating profit declined in 2006 after improving in 2005 due to:
  - Higher mortality expenses compared with the year-earlier periods principally due to growth in life insurance in force. Mortality experience remained within pricing guidelines.
  - Adoption of stock option expensing, which added approximately $1 million to 2006 other operating expenses.

At the same time, we recognize that assets under management, capital appreciation and investment income are integral to evaluation of the success of the life insurance segment because of the long duration of life products. For that reason, we also evaluate GAAP data, including all investment activities on life insurance-related assets, which grew 32.6 percent in 2006 to $63 million and 23.8 percent in 2005 to $47 million. The life insurance company portfolio had pretax realized investment gains of $45 million in 2006 compared with $17 million in 2005 and $9 million in 2004.

Life Insurance Results

(In millions)	Years ended December 31,			**2006-2005**	2005-2004
	2006	2005	2004	**Change %**	Change %
Written premiums	**$ 161**	$ 205	$ 193	**(21.3)**	6.5
Earned premiums	**$ 115**	$ 106	$ 101	**7.9**	5.7
Separate account investment management fees	**3**	4	3	**(0.3)**	18.5
Total revenues	**118**	110	104	**7.6**	6.0
Contract holders benefits incurred	**122**	102	95	**20.1**	7.2
Investment interest credited to contract holders	**(54)**	(51)	(46)	**5.7**	12.9
Operating expenses incurred	**51**	52	53	**(1.8)**	(0.3)
Total benefits and expenses	**119**	103	102	**16.1**	0.8
Life insurance segment profit (loss)	**$ (1)**	$ 7	$ 2	**(115.4)**	334.2

Growth

We offer term, whole life and universal life products, fixed annuities and disability income products.

Total statutory life insurance net written premiums were $161 million in 2006 compared with $205 million in 2005 and $193 million in 2004. Total statutory written premiums for life insurance operations for all periods include life insurance, annuity and accident and health premiums. The change primarily was due to:

- Statutory written premiums for term and other life insurance products rose 12.7 percent to $127 million for 2006 and declined 4.2 percent to $113 million for 2005.
- Statutory written annuity premiums declined $58 million in 2006 and increased $18 million in 2005. Since late 2005, we have de-emphasized annuities because of an unfavorable interest rate environment.

Fee income from universal life products declined 14.9 percent to $23 million in 2006 and rose 2.7 percent in 2005 to $27 million. Separate account investment management fee income contributed $3 million, $4 million and $3 million to total revenues in 2006, 2005 and 2004.

In 2006, our life insurance segment experienced a 0.3 percent rise in life applications submitted and a 10.6 percent increase in gross face amounts issued, primarily due to continued strong sales of term insurance marketed through the company's property casualty agency force.

Over the past several years, we have worked to maintain a portfolio of straightforward and up-to-date products, primarily under the LifeHorizons banner. Our product development efforts emphasize death benefit protection and guarantees.

Distribution expansion within our property casualty insurance agencies remains a high priority. In the past several years, we have added life field marketing representatives for the western and northeastern states.

Profitability

Life segment expenses consist principally of:

- Contract holders benefits incurred related to traditional life and interest-sensitive products accounted for 70.3 percent of 2006 total benefits and expenses, 66.0 percent of 2005 total benefits and expenses and 64.3 percent of 2004 total benefits and expenses.
- Operating expenses incurred, net of deferred acquisition costs, accounted for 29.7 percent of 2006 total benefits and expenses, 34.0 percent of 2005 total benefits and expenses and 35.7 percent of 2004 total benefits and expenses. Stock option expense added $1 million, or 0.7 percentage points, to expenses in 2006.

Life segment profitability depends largely on premium levels, the adequacy of product pricing, underwriting skill and operating efficiencies. Life segment results include only investment interest credited to contract holders (interest assumed in life insurance policy reserve calculations). The remaining investment income is reported in the investment segment results. The life investment portfolio is managed to earn target spreads between earned investment rates on general account assets and rates credited to policyholders. We consider the value of assets under management and investment income for the life investment portfolio as key performance indicators for the life insurance segment.

We seek to maintain a competitive advantage with respect to benefits paid and reserve increases by consistently achieving better than average claims experience due to skilled underwriting. Commissions paid by the life insurance operation are on par with industry averages. During the past several years, we have invested in imaging and workflow technology and have significantly improved application processing. We have achieved efficiencies while maintaining our service standards.

Life Insurance Outlook

As the life insurance company seeks to improve penetration of our property casualty agencies, our objective is to increase premiums and contain expenses. Term insurance is our largest life insurance product line.
We continue to introduce new term products with features our agents indicate are important. In addition, we introduced new universal life products including cash value accumulation products for adults and children.

Marketplace and regulatory changes continued to affect the availability of cost-effective reinsurance for term life insurance. We are addressing this situation by retaining no more than a $500,000 exposure, ceding the balance using excess over retention mortality coverage and retaining the policy reserve.

Because of the conservative nature of statutory reserving principles, retaining the policy reserve requires a large commitment of capital and reduces statutory earnings. However, we believe the long-term profitability of term life insurance serves to enhance GAAP results. Although the exact timing and details are uncertain, the NAIC continues to make progress toward comprehensive reforms of statutory reserving principles, as we discuss in 2007 Reinsurance Programs, Page 69.

In the future, we expect that assets under management, capital appreciation and investment income, which are reported in investment segment results, will continue to be integral to our evaluation of the success of the life insurance operations. While life insurance segment profit may continue to fluctuate near break-even, when we also consider life insurance investment activities, we continue to believe the life insurance operations will continue to provide a steady income stream to help offset the fluctuations of the property casualty insurance business.

INVESTMENTS RESULTS OF OPERATIONS

Overview – Three-year Highlights

The investment segment contributes investment income and realized gains and losses to results of operations. Investments provide our primary source of pretax and after-tax profits.

- Investment income – Pretax investment income reached a new record in 2006, rising 8.4 percent from the prior record in 2005. Growth in investment income over the past two years has been driven by strong cash flow for new investments, higher interest income from the growing fixed-maturity portfolio and increased dividend income from the common stock portfolio.
- Realized investment gains and losses – We reported realized investment gains in 2006 and 2005 largely due to investment sales. The sale of our Alltel common stock holding contributed $647 million (pretax) of the 2006 gain.

Investment Results

(In millions)	Years ended December 31,			**2006-2005**	2005-2004
	2006	2005	2004	**Change %**	Change %
Investment income:					
Interest	**$ 300**	$ 280	$ 252	**7.1**	11.2
Dividends	**262**	244	239	**7.5**	2.1
Other	**15**	8	6	**90.0**	29.4
Investment expenses	**(7)**	(6)	(5)	**(19.3)**	(22.3)
Total net investment income	**570**	526	492	**8.4**	6.9
Investment interest credited to contract holders	**(54)**	(51)	(46)	**5.7**	12.9
Net realized investment gains and losses:					
Realized investment gains and losses	**678**	69	87	**883.0**	(20.7)
Change in valuation of embedded derivatives	**7**	(7)	10	**200.7**	(167.2)
Other-than-temporary impairment charges	**(1)**	(1)	(6)	**41.7**	78.5
Net realized investment gains	**684**	61	91	**1,026.0**	(33.1)
Investment operations income	**$ 1,200**	$ 536	$ 537	**124.0**	(0.4)

Investment Income

Growth in investment income reflected new investments, higher interest income from the growing fixed-maturity portfolio and increased dividend income from the common stock portfolio. The advantages of strong cash flow in the past three years for new investments have been somewhat offset by the challenge of investing in a low interest rate environment. In 2006, proceeds from the sale of the Alltel holding that were later used to make the applicable tax payments during the year were invested in short-term instruments that generated approximately $5 million in interest income.

Overall, common stock dividends contributed 42.4 percent of pretax investment income in 2006 compared with 43.7 percent in 2005 and 43.9 percent in 2004. Fifth Third, our largest equity holding, contributed

43.8 percent of total dividend income in 2006. We discuss our Fifth Third investment in Item 7A, Quantitative and Qualitative Disclosures About Market Risk, Page 75. In 2006, 38 of the 50 common stock holdings in the portfolio raised their indicated annual dividend payout, as did 36 of 49 in 2005 and 33 of 51 in 2004.

Net Realized Investment Gains and Losses

Net realized investment gains and losses are made up of realized investment gains and losses on the sale of securities, changes in the valuation of embedded derivatives within certain convertible securities and other-than-temporary impairment charges. These three areas are discussed below.

Realized Investment Gains and Losses

Realized investment gains in the past three years largely were due to the sale of equity holdings. We buy and sell both fixed-maturity and equity securities on an ongoing basis to help achieve our portfolio objectives.

- 2006 – We sold the remainder of our Alltel common stock holdings. We discuss this sale in Item 1, Investments Segment, Page 14, and Item 8, Note 2 to the Consolidated Financial Statements, Page 90.
- 2005 – We had gains from the sale of equity holdings that no longer met our investment parameters or were obtained from convertible securities whose underlying common stock was never intended to be a long-term holding. Included in 2005 were gains from the initial sales of a portion of our Alltel holding.
- 2004 – We sold $356 million in equity holdings as part of a program to support the financial strength ratings of our property casualty insurance operations. We selected holdings to sell primarily based on the belief of the investment committee and management that these securities would have a lower dividend growth rate over the next several years when compared with other holdings in the portfolio. We also considered the potential tax effect of any unrealized gains. Partial sales of holdings in which we held over $100 million in fair value at year-end 2003 contributed $311 million.

We sold fixed-maturity investments during the past three years as part of our portfolio management strategies. The majority of these were bonds disposed of due to rating or credit concerns, including several in the airline and auto-related industries. Although we prefer to hold fixed-maturity investments until they mature, a decision to sell reflects our perception of a change in the underlying fundamentals of the security and preference to allocate those funds to investments that more closely meet the established parameters for long-term stability and growth. Our opinion that a security fundamentally no longer meets our investment parameters may reflect a loss of confidence in the issuer's management, a change in underlying risk factors (such as political risk, regulatory risk, sector risk or credit risk), or a strategic shift in business strategy that is not consistent with our long-term outlook.

Realized gains in the past three years also have included gains from the sale of previously impaired securities.

Change in the Valuation of Embedded Derivatives

In 2006, we recorded $7 million in fair value increases compared with $7 million in fair value declines in 2005 and $10 million in fair value increases in 2004. These changes in fair value are due to the application of SFAS No. 133, which requires measurement of the fluctuations in the value of the embedded derivative features in selected convertible securities. The changes in fair values are recognized in net income in the period they occur. See the discussion of Derivative Financial Instruments and Hedging Activities in Item 8, Note 1 to the Consolidated Financial Statements, Page 85, for details on the accounting for convertible security embedded options.

Other-than-temporary Impairment Charges

In 2006 and 2005, we recorded $1 million in write-downs of investments that we deemed had experienced an other-than-temporary decline in market value versus $6 million in 2004. The factors we consider when evaluating impairments are discussed in Critical Accounting Estimates, Asset Impairment, Page 37.
The other-than-temporary impairment charges represented less than 0.1 percent of our total invested assets at year-end 2006, 2005 and 2004. Other-than-temporary impairment charges also include unrealized losses of holdings that we have identified for sale but not yet completed a transaction.

The significant decline in other-than-temporary impairment in the past three years was due to prior impairments in the portfolio, disposition of certain securities in prior years and an improvement in the general financial climate.

Other-than-temporary impairment charges from the investment portfolio by industry are summarized as follows:

(In millions)	Years ended December 31,		
	2006	2005	2004
Automotive	**$ (1)**	$ (1)	$ 0
Airline	**0**	0	(5)
Other	**0**	0	(1)
Total	**$ (1)**	$ (1)	$ (6)

Other-than-temporary impairment charges from the investment portfolio by the asset class we described in Item 1, Investments Segment, Page 14, are summarized below:

(Dollars in millions)	Years ended December 31,		
	2006	2005	2004
Taxable fixed maturities:			
Impairment amount	**$ (1)**	$ (1)	$ 0
New book value	**$ 0**	$ 0	$ 2
Percent to total owned	**0 %**	0 %	1 %
Number of securities impaired	**1**	2	1
Percent to total owned	**0 %**	0 %	1 %
Tax-exempt fixed maturities:			
Impairment amount	**$ 0**	$ 0	$ (5)
New book value	**$ 0**	$ 0	$ 9
Percent to total owned	**0 %**	0 %	1 %
Number of securities impaired	**0**	0	2
Percent to total owned	**0 %**	0 %	0 %
Common equities:			
Impairment amount	**$ 0**	$ 0	$ (1)
New book value	**$ 0**	$ 0	$ 0
Percent to total owned	**0 %**	0 %	0 %
Number of securities impaired	**0**	0	1
Percent to total owned	**0 %**	0 %	2 %
Total:			
Impairment amount	**$ (1)**	$ (1)	$ (6)
New book value	**$ 0**	$ 0	$ 11
Percent to total owned	**0 %**	0 %	0 %
Number of securities impaired	**1**	2	4
Percent to total owned	**0 %**	0 %	0 %

Investments Outlook

We believe investment income growth for 2007 could be in the range of 6.5 percent to 7.0 percent. This outlook is based on the higher anticipated level of dividend income from equity holdings, the investment of insurance operations cash flow and the current portfolio attributes. In 2007, we expect to allocate a higher proportion of cash available for investment to equity securities, taking into consideration insurance department regulations and ratings agency comments. We continue to identify companies with the potential for revenue, earnings and dividend growth, a strong management team and favorable outlook. These equities offer the potential for steadily increasing dividend income along with capital appreciation. Dividend increases within the last 12 months by Fifth Third and another 37 of the 50 common stock holdings in the equity portfolio should add $16 million to annualized investment income.

We believe impairments in 2007 should be limited to securities that have been identified for sale or that have experienced a sharp decline in fair value with little or no warning because of issuer-specific events.
All securities in the portfolio were trading at or above 70 percent of book value at December 31, 2006.
Our asset impairment committee continues to monitor the investment portfolio. The current asset impairment policy is in Critical Accounting Estimates, Asset Impairment, Page 37.

OTHER

In 2006, other income of the insurance subsidiaries, parent company operations and non-investment operations of CFC Investment Company and CinFin Capital Management Company resulted in $14 million in revenues compared with $12 million in 2005 and $8 million in 2004. Losses before income taxes of $51 million in 2006 were primarily due to $51 million in interest expense from debt of the parent company. Losses before income taxes were $50 million and $37 million in 2005 and 2004, when interest expense was $52 million and $36 million, respectively.

TAXES

Income tax expense was $399 million in 2006 compared with $221 million in 2005 and $216 million in 2004. The effective tax rate for 2006 was 30.0 percent compared with 26.8 percent in 2005 and 27.0 percent in 2004. The sale of our Alltel common stock holdings in the first three months of 2006, which generated a $647 million pretax gain, was the primary reason for the change in effective tax rate for the year. Growth in the tax-exempt municipal bond portfolio, higher investment income from dividends and lower operating earnings also contributed to the change in the effective tax rate for 2006.

We pursue a strategy of investing some portion of cash flow in tax-advantaged fixed-maturity and equity securities to minimize our overall tax liability and maximize after-tax earnings. For our insurance subsidiaries, approximately 85 percent of income from tax-advantaged fixed-maturity investments is exempt from federal tax calculations. Our non-insurance subsidiaries own no tax-advantaged fixed-maturity investments. For our insurance subsidiaries, the dividend received deduction exempts approximately 60 percent of dividends from qualified equities from federal tax calculations. The dividend received deduction exempts 70 percent of dividends from qualified equities for our non-insurance subsidiaries. Details regarding our effective tax rate are found in Item 8, Note 10 to the Consolidated Financial Statements, Page 95.

LIQUIDITY AND CAPITAL RESOURCES

Liquidity and capital resources represent the overall financial strength of our company and our ability to generate cash flows to meet the short- and long-term cash requirements of business obligations and growth needs. We seek to maintain prudent levels of liquidity and financial strength for the protection of our policyholders, creditors and shareholders.

The parent company's primary means of meeting liquidity requirements are dividends from our insurance subsidiary and income from investments held at the parent-company level supported by our capital resources. At year-end 2006, we had shareholders' equity of $6.808 billion and total debt of $840 million. Our ability to access the capital markets and short-term bank borrowing provide other potential sources of liquidity. One way we seek to maintain financial strength is by keeping our ratio of debt to capital below 15 percent. Our parent company's cash requirements include dividends to shareholders, interest payments on our long-term debt, common stock repurchases and general operating expenses.

Our insurance subsidiary's primary sources of liquidity are collection of premiums and investment income. Its cash needs primarily consist of paying property casualty and life insurance loss and loss expenses as well as ongoing operating expenses and payments of dividends to the parent company. Although we have never sold investments to pay claims, the sale of investments would provide an additional source of liquidity, if required. After satisfying operating cash requirements, cash flows are invested in fixed-maturity and equity securities, leading to the potential for increases in future investment income and unrealized appreciation.

SOURCES OF LIQUIDITY

Subsidiary Dividends

Our insurance subsidiary declared dividends to the parent company of $275 million in both 2006 and 2005 and $175 million in 2004. State of Ohio regulatory requirements restrict the dividends insurance subsidiaries can pay. During 2007, total dividends that our lead insurance subsidiary can pay to our parent company without regulatory approval are approximately $572 million.

Insurance Underwriting

Our property casualty and life insurance operations provide liquidity because premiums generally are received before losses are paid under the policies purchased with those premiums. After satisfying our cash requirements, excess cash flows are used for investment, increasing future investment income.

This table shows a summary of cash flow of the insurance subsidiary (direct method):

(In millions)	Years ended December 31,		
	2006	2005	2004
Premiums collected	**$ 3,285**	$ 3,187	$ 3,055
Loss and loss expenses paid	**(1,859)**	(1,752)	(1,694)
Commissions and other underwriting expenses paid	**(1,036)**	(995)	(894)
Insurance subsidiary cash flow from underwriting	**390**	440	467
Investment income received	**471**	427	362
Insurance subsidiary operating cash flow	**$ 861**	$ 867	$ 829

Historically, cash receipts from property casualty and life insurance premiums, along with investment income, have been more than sufficient to pay claims, operating expenses and dividends to the parent company. While first-year life insurance expenses normally exceed the premiums, subsequent premiums are used to generate investment income until the time the policy benefits are paid.

After paying claims and operating expenses, cash flows from underwriting declined in 2006 from the level of 2005 and 2004. We discuss our future obligations for claims payments in Contractual Obligations, Page 61, and our future obligations for underwriting expenses in Commissions and Other Underwriting Expenses, Page 62. Insurance subsidiary operating cash flow remained stable over the three years, however, due to rising investment income.

Based on our outlook for commercial lines, personal lines and life insurance, we believe that cash flows from underwriting could decline again in 2007. A lower level of cash flow available for investment could lead to lower investment income and reduced potential for capital gains.

Investing Activities

Investment income is a primary source of liquidity for both the parent company and insurance subsidiary. The transfer of equity holdings to our insurance subsidiary from the parent company in 2004 increased the amount of investment income generated at the subsidiary level but had no effect on consolidated investment income. As we discuss under Investments Results of Operations, Page 56, investment income rose in each of the past three years, and we expect investment income could grow 6.5 percent to 7.0 percent in 2007.

Realized gains also can provide liquidity, although we follow a buy-and-hold investment philosophy seeking to compound cash flows over the long-term. When we dispose of investments, we generally reinvest the gains in new investment securities. Disposition of investments occurs for a number of reasons:

- Sales of fixed-maturity investments – We prefer to hold fixed-maturity securities until maturity. Any decision to sell or to reduce a holding reflects our perception of a change in the underlying fundamentals of the security and our preference to allocate those funds to investments that more closely meet our established parameters for long-term stability and growth.
- Call or maturity of fixed-maturity investments – Calls and maturities of fixed-maturity investments are a function of the yield curve. The pace of calls of fixed maturities continued to decline in 2006 as interest rates generally shifted upward.
- Sales of equity securities investments – The decision to divest an equity position is generally reached after careful analysis regarding the direction the company is headed and how well it meets our investment parameters. In 2006, we completed the sale of our Alltel common stock holdings and made other sales of all or part of smaller holdings.

We generally have substantial discretion in the timing of investment sales and, therefore, the resulting gains or losses that are recognized in any period. That discretion generally is independent of the insurance underwriting process. In 2007, we expect to continue to limit the disposition of investments to those that no longer meet our investment parameters or those that reach maturity or are called by the issuer. The sale of equity investments that no longer meet our investment criteria can provide cash for investment in common stocks that we perceive to have greater potential for dividend growth and capital appreciation.

Capital Resources

As a long-term investor, we historically have followed a buy-and-hold investing strategy. This policy has generated a significant amount of unrealized appreciation on equity investments. Unrealized appreciation, before deferred income taxes, was $5.244 billion and $5.067 billion at year-end 2006 and 2005, respectively. On an after-tax basis, it constituted 49.6 percent of total shareholders' equity at year-end 2006.

At year-end 2006, our debt-to-capital ratio was 11.0 percent. Based on our present capital requirements, we do not anticipate a material increase in debt levels during 2007. As a result, we believe our debt-to-capital ratio will remain approximately 11 percent.

We had $791 million of long-term debt and $49 million in borrowings on our short-term lines of credit. We generally have minimized our reliance on debt financing although we may utilize lines of credit to fund short-term cash needs.

We provide details of our three long-term notes in Item 8, Note 7 of the Consolidated Financial Statements, Page 93. None of the notes are encumbered by rating triggers.

On April 28, 2006, A.M. Best affirmed its senior debt ratings and issuer credit rating (ICR) of aa- of Cincinnati Financial Corporation. On September 15, 2006, Fitch Ratings affirmed its AA- issuer default rating and A+ senior debt ratings of Cincinnati Financial Corporation. Moody's maintains our senior debt ratings at A2-. On July 25, 2006, Standard & Poor's Ratings Services affirmed its A (Strong) counterparty credit rating on Cincinnati Financial Corporation.

At December 31, 2006, we had two lines of credit totaling $125 million with $49 million outstanding. One line of credit for $75 million was established more than five years ago and has no financial covenants. The second line of credit is an unsecured $50 million line of credit from Fifth Third Bank established in 2005 and renewed annually. It is available for general corporate purposes and contains customary financial covenants. During 2006, CFC Investment Company, our commercial leasing and financing subsidiary, replaced $49 million of intercompany debt with $49 million in borrowings against our $75 million line of credit to improve cash flow for the parent company. This line of credit matures on February 28, 2007, and we expect to renew it under terms and conditions that are essentially unchanged.

During 2006, we entered into an interest-rate swap as an economic cash flow hedge of variable interest payments for certain variable-rate debt obligations ($49 million notional amount). Under this interest-rate swap contract, we have agreed to pay a fixed rate of interest for a three-year period. The contract is intended to be a hedge against changes in the amount of future cash flows associated with the related interest payments. The interest-rate swap contract is reflected at fair value in our balance sheet. SFAS No. 133 "Accounting for Derivative Financial Instruments and Hedging Activities," as amended, requires changes in the fair value of the company's derivative financial instruments to be recognized periodically as realized gains or losses on the consolidated statement of income or as a component of accumulated other comprehensive income in shareholders' equity, respectively. We recorded a $324,000 investment loss in 2006 due to the decline in the fair value of the interest-rate swap.

In October 2006, we completed the necessary requirements for the interest-rate swap to qualify for hedge accounting treatment under SFAS No. 133. We expect that the interest-rate swap will be a highly effective hedge and that future changes in the fair value of the interest-rate swap will be recorded as a component of accumulated other comprehensive income. As a result, we do not expect any significant amounts to be reclassified into earnings in the next 12 months.

Off-balance Sheet Arrangements

We do not utilize any special-purpose financing vehicles or have any undisclosed off-balance sheet arrangements (as that term is defined in applicable SEC rules) that are reasonably likely to have a current or future material effect on the company's financial condition, results of operation, liquidity, capital expenditures or capital resources. Similarly, the company holds no fair-value contracts for which a lack of marketplace quotations would necessitate the use of fair-value techniques.

Uses of Liquidity

Our parent company and insurance subsidiary have contractual obligations and other commitments.
In addition, one of our primary uses of cash is to enhance shareholder return.

Contractual Obligations

At December 31, 2006, we estimated our future contractual obligations as follows:

(In millions)	Payment due by period				
	Within 1 year	Years 2-3	Years 4-5	More than 5 years	Total
Interest on long-term debt	$ 52	$ 104	$ 104	$ 996	$ 1,256
Long-term debt	0	0	0	795	795
Short-term debt	49	0	0	0	49
Annuitization obligations	17	47	30	104	198
Headquarters building expansion	45	17	0	0	62
Computer hardware and software	9	11	2	0	22
Other invested assets	10	12	3	1	26
Net life claims payments	9	0	0	0	9
Subtotal	191	191	139	1,896	2,417
Net property casualty claims payments	1,074	1,150	493	639	3,356
Total	$ 1,265	$ 1,341	$ 632	$ 2,535	$ 5,773

Long-term Debt and Interest on Long-Term Debt

Our estimate of material commitments for interest on long-term debt was approximately 21.8 percent and our estimate of material commitments for long-term debt was 13.8 percent of the estimated contractual obligations at year-end 2006.

Our interest expense remained unchanged in 2006 at an annual rate of approximately $52 million.
We generally have tried to minimize our reliance on debt financing and do not expect a material increase in interest expense from long-term debt in the near future.

Short-term Debt

Our estimate of material commitments for short-term debt was 1.0 percent of material commitments at year-end 2006. On February 28, 2007, we plan to renew our $49 million outstanding note payable drawn on our $75 million in line of credit.

Annuitization Obligations

Our estimate of material commitments for obligations due under annuities written by our life insurance subsidiary was approximately 3.4 percent of the estimated contractual obligations at year-end 2006.

Headquarters Building Expansion

The completion of our new office building and parking garage to be situated at our headquarters located in Fairfield is expected to require approximately $62 million over the next two years. The construction project is on schedule and on budget. As of December 31, 2006, construction costs totaled $41 million. We expect construction to be completed by September 2008.

We invested $100 million of the proceeds from our 2004 issuance of $375 million aggregate principal amount of 6.125% senior notes due 2034 in short-term investments to fund this obligation.

Computer Hardware and Software

We expect to need approximately $22 million over the next five years for current material commitments for computer hardware and software, including maintenance contracts on hardware and other known obligations. We discuss below the non-contractual expenses we anticipate for computer hardware and software in 2007.

Property Casualty Claims Payments

Our estimate of material commitments for net property casualty claims payments was approximately 58.1 percent of the estimated contractual obligations at year-end 2006.

We direct our associates to settle claims and pay losses as quickly as practical and made $1.763 billion in net claim payments during 2006. At year-end 2006, we had net property casualty reserves of $3.356 billion, reflecting $1.843 billion in unpaid amounts on reported claims (case reserves), $771 million in loss expense reserves and $742 million in estimates of IBNR claims. The specific amounts and timing of obligations related to case reserves and associated loss expenses are not set contractually. The amounts and timing of obligations for IBNR claims and related loss expenses are unknown. We discuss the adequacy of our property casualty and life insurance loss and loss expense reserves in Property Casualty Insurance Reserves, Page 63.

The historic pattern of using premium receipts for the payment of loss and loss expenses has enabled us to extend slightly the maturities of our investment portfolio beyond the estimated settlement date of the loss reserves. The effective duration of our fixed-maturity portfolio was 5.1 years at year-end 2006. By contrast, the duration of our loss and loss expense reserves was 2.9 years and the duration of all liabilities was 2.6 years. We believe this difference in duration does not affect our ability to meet current obligations because cash flow from operations is sufficient to meet these obligations. In addition, our investment strategy has led to substantial unrealized gains from holdings in equity securities. These equity holdings could be liquidated to meet higher than anticipated loss and loss expenses.

We believe that our insurance subsidiaries maintain sufficient liquidity to pay claims and operating expenses, as well as meet commitments in the event of unforeseen circumstances such as catastrophe losses, reinsurer insolvencies, changes in the timing of claims payments, increases in claims severity, reserve deficiencies or inadequate premium rates. We believe catastrophic events are the most likely cause of an unexpected rise in claims severity or frequency.

Our reinsurance program mitigates the liquidity risk of a single large loss or an unexpected rise in claims severity or frequency due to a catastrophic event. Reinsurance does not relieve us of our obligation to pay covered claims. The financial strength of our reinsurers is important because our ability to recover for losses under one of our reinsurance agreements depends on the financial viability of the reinsurer.

While we believe that historical performance of property casualty and life loss payment patterns is a reasonable source for projecting future claims payments, there is inherent uncertainty in this estimate of contractual obligations. We believe that we could meet our obligations under a significant and unexpected change in the timing of these payments because of the liquidity of our invested assets, strong financial position and access to lines of credit.

Other Commitments

In addition to our contractual obligations, we have other operational commitments.

Commissions and Other Underwriting Expenses

As discussed above, commissions and non-commission underwriting expenses paid rose in each the past two years, reflecting the operating expense trends we discuss in the Commercial Lines and Personal Lines Insurance Results of Operations, Page 42 and Page 49. Commission payments also include contingent, or profit-sharing, commissions, which are paid to agencies using a formula that takes into account agency profitability and other factors. Commission payments generally track with written premiums. Contingent commission payments in 2007 will be influenced by the decline in profitability we experienced in 2006.

Many of our operating expenses are not contractual obligations, but reflect the ongoing expenses of our business. Staffing is the largest component of our operating expenses and is expected to rise again in 2007, reflecting the 2.9 percent average annual growth in our associate base over the past three years. Our associate base has grown as we focus on enhancing service to our agencies and staffing additional field territories. Other expenses should rise in line with our growth.

In addition to contractual obligations for hardware and software, we anticipate investing approximately $35 million in key technology initiatives in 2007, of which approximately $14 million will be capitalized. Technology projects for 2007 include continued spending on our personal lines policy processing system and investment in the development and rollout of our commercial lines policy processing system that we discuss in Item 1, Technology Solutions, Page 4. Capitalized development costs related to key technology initiatives totaled $15 million in 2006. These activities are conducted at our discretion and we have no material contractual obligations for activities planned as part of these projects.

Data Processing and Disaster Recovery Center

We expect to spend approximately $5 million in 2007 to begin renovation of a newly purchased building that will serve as our data processing and disaster recovery center.

Qualified Pension Plan

Effective in 2008, the Pension Protection Act of 2006 changes the manner in which pension funding is determined. We currently are assessing the impact of this Act but do not except it to have a material effect on our results of operations or financial position. We anticipate contributing $10 million to the plan in 2007.

Investing Activities

After fulfilling operating requirements, cash flows from underwriting, investment and other corporate activities are invested in fixed maturity and equity securities on an ongoing basis to help achieve our portfolio objectives. See Item 1, Investments Segment, Page 14, for a discussion of our investment strategy, portfolio allocation and quality. From the second quarter of 2004 until year-end 2005, virtually all of our available cash flow was used to purchase fixed-maturity investments to reduce our property casualty subsidiary's ratio of common stock to statutory surplus. In 2006, equity purchases returned to a more significant level.

In 2007 we anticipate a resumption of active equity investing while also continuing to be cognizant of rating agency and regulatory guidelines. See Item 1, Investments Segment, Page 14, for a discussion of our investment strategy, portfolio allocation and quality.

Uses of Capital

Uses of cash to enhance shareholder return include:

- Dividends to shareholders – Over the past 10 years, the company has paid an average of 38 percent of net income as dividends, with the remaining 62 percent available to reinvest for future growth and for share repurchases. The ability of the company to continue paying cash dividends is subject to factors the board of directors may deem relevant.

  In February 2007, the board of directors authorized a 6.0 percent increase in the regular quarterly cash dividend to an indicated annual rate of $1.42 per share. In 2006, 2005 and 2004, we paid cash dividends of $228 million and $204 million and $177 million.

- Common stock repurchase – Our board believes that stock repurchases can help fulfill our commitment to enhancing shareholder value. Consequently, the board has authorized the repurchase of outstanding shares. Common stock repurchases for treasury have continued at a steady pace over the last several years and occur when we believe that stock prices on the open market are favorable for such repurchases. At a minimum, we would expect the repurchase to offset dilution from share-based compensation. In 2006, 2005 and 2004, we used $120 million, $63 million and $66 million for share repurchase.

  In 2005, the board authorized a 10 million share repurchase program to replace a program authorized in 1999. At year-end 2006, 6.8 million shares remained authorized for repurchase under the 2005 program.

  The details of the repurchase activity are described in Item 5, Market for the Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities, Page 26. Between February 1999 and year-end 2006, we have repurchased 17.4 million shares at a total cost to the company of $661 million. We do not adjust the number of shares repurchased and average price per repurchased share for stock dividends.

Property Casualty Insurance Reserves

At year-end 2006, the total reserve balance, net of reinsurance, was $3.356 billion, compared with $3.111 billion at year-end 2005 and $2.977 billion at year-end 2004. We provide a reconciliation of the property casualty reserve balances with the loss and loss expense liability on the balance sheet in Item 8, Note 4 to the Consolidated Financial Statements, Page 92. The reserves reflected in the consolidated financial statements are management's best estimate.

The appointed actuary's range for adequate statutory reserves, net of reinsurance, was $3.194 billion to $3.440 billion for 2006; $2.921 billion to $3.153 billion for 2005; and $2.794 billion to $3.032 billion for 2004. The assumptions used to establish the recommended ranges were consistent with the actuary's practices. Historically, we have established reserves in the upper half of the actuary's range, as discussed in Critical Accounting Estimates, Property Casualty Loss and Loss Expense Reserves, Page 35.

In addition to our conclusions regarding adequate reserve levels, other factors that have affected reserve levels over the past three years included:

- Increases in coverage in force in selected business lines
- New business activity
- Higher initial case reserves on liability claims

- Workers' compensation case reserving practices
- Increased loss expenses due to higher legal fees
- Judicial decisions and mass tort claims
- Changes in reinsurance treaty retentions
- Loss cost inflation in selected lines
- Higher loss adjustment expense due to a claims mediation process that promotes earlier liability settlement resolution

The types of coverages we offer and the risk levels retained have a direct influence on the development of claims. Specifically, claims that develop quickly and have lower risk retention levels generally are more predictable.

As we discuss in Commercial Lines Insurance Segment Reserves, Page 66, re-underwriting the commercial lines book of business beginning in 2000, including decisions to non-renew certain policyholders due to risk levels and to increase rates to better reflect exposure levels, has resulted in improved profitability. We believe the program has led to a lower risk profile for the overall commercial lines segment, contributing to favorable loss reserve trends.

As we discuss in Personal Lines Insurance Segment Reserves, Page 68, we are seeking to improve our personal lines segment performance, in particular the homeowner business line, partially by reducing risk exposure through changes in policy terms and conditions. We do not expect our actions in personal lines to have a material impact on loss reserve trends, largely due to the relatively short-tail nature of homeowner claims.

In 2006, we reviewed each of our established workers' compensation case reserves above $100,000 in light of current trends in medical cost inflation and estimated payout periods. The review led to the allocation of additional amounts to case reserves held for specific claims from accident years going back as many as 20 years. Our intent is to bring workers' compensation case reserve adequacy more in line with our other business lines although our success may be affected by additional medical cost inflation and longer life spans.

In 2003 and 2004, $70 million in reserves were released following the November 2003 Ohio Supreme Court's decision limiting its 1999 Scott-Pontzer v. Liberty Mutual decision. The reserve releases were primarily made in the commercial auto and commercial casualty business lines. Following the fourth-quarter 2003 reserve review, reserve levels were modified to reflect management's assessment that mold claims behaved similar to asbestos and environmental claims, and reserves for these claims should be estimated using similar methods. These changes have been seen predominately in the commercial casualty business line. We expect that mold exclusions added to our commercial policies beginning in 2003 will mitigate this issue after 2006.

Further, beginning in 2003, reserve levels reflected the need to establish higher expense reserves because of the rise in litigation costs due to larger and more complex claims. These changes have been seen predominately in the commercial casualty business line. Beginning in 2002, our conclusions regarding reserve levels for all business lines reflected refinement of the manner in which the value of future salvage and subrogation for claims already incurred were estimated.

Development of Loss and Loss Expenses

We reconcile the beginning and ending balances of our reserve for loss and loss expenses at December 31, 2006, 2005 and 2004, in Item 8, Note 4 to the Consolidated Financial Statements, Page 92. The reconciliation of our year-end 2005 reserve balance to net incurred losses one year later recognizes approximately $116 million in redundant reserves.

The table on Page 65 shows the development of the estimated reserves for loss and loss expenses the past 10 years.

- Section A shows our total property casualty loss and loss expense reserves recorded at the balance sheet date for each of the indicated calendar years on a gross and net basis. Those reserves represent the estimated amount of unpaid loss and loss expenses for claims arising in the indicated calendar year and all prior accident years at the balance sheet date, including losses that have been incurred but not yet reported to the company.
- Section B shows the cumulative net amount paid with respect to the previously recorded reserve as of the end of each succeeding year. For example, as of December 31, 2006, we had paid $1.175 billion of loss and loss expenses in calendar years 1997 through 2006, for losses that occurred in accident years 1996 and prior. An estimated $148 million of losses remained unpaid as of year-end 2006 (net re-estimated reserves of $1.323 billion from Section C less cumulative paid loss and loss expenses of $1.175 billion).

- Section C shows the re-estimated amount of the previously reported reserves based on experience as of the end of each succeeding year. The estimate is increased or decreased as we learn more about the frequency and severity of claims.
- Section D, cumulative net redundancy, represents the aggregate change in the estimates for all years subsequent to the year the reserves were initially established. For example, reserves established at December 31, 1996, had developed a $379 million redundancy over 10 years, net of reinsurance, which was reflected in income over the 10 years. The table shows redundant reserves as a negative number. The effects on income in 2006, 2005 and 2004 of changes in estimates of the reserves for loss and loss expenses for all accident years are shown in the reconciliation below.

In evaluating the development of our estimated reserves for loss and loss expenses for the past 10 years, note that each amount includes the effects of all changes in amounts for prior periods. For example, payments or reserve adjustments related to losses settled in 2006 but incurred in 2000 are included in the cumulative deficiency or redundancy amount for 2000 and each subsequent year. In addition, this table presents calendar year data, not accident or policy year development data, which readers may be more accustomed to analyzing. Conditions and trends that have affected development of the reserves in the past may not necessarily occur in the future. Accordingly, it may not be appropriate to extrapolate future redundancies or deficiencies based on this data.

Differences between the property casualty reserves reported in the accompanying consolidated balance sheets (prepared in accordance with GAAP) and those same reserves reported in the annual statements (filed with state insurance departments in accordance with statutory accounting practices – SAP), relate principally to the reporting of reinsurance recoverables, which are recognized as receivables for GAAP and as an offset to reserves for SAP.

(In millions)	Calendar year ended December 31,										
	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	**2006**
A. Originally reported reserves for unpaid loss and loss expenses:											
Gross of reinsurance	$ 1,824	$ 1,889	$ 1,978	$ 2,093	$ 2,401	$ 2,865	$ 3,150	$ 3,386	$ 3,514	$ 3,629	$ **3,860**
Reinsurance recoverable	122	112	138	161	219	513	542	541	537	518	**504**
Net of reinsurance	$ 1,702	$ 1,777	$ 1,840	$ 1,932	$ 2,182	$ 2,352	$ 2,608	$ 2,845	$ 2,977	$ 3,111	$ **3,356**
B. Cumulative net paid as of:											
One year later	$ 453	$ 499	$ 522	$ 591	$ 697	$ 758	$ 799	$ 817	$ 907	$ **944**	
Two years later	732	761	833	943	1,116	1,194	1,235	1,293	**1,426**		
Three years later	884	965	1,067	1,195	1,378	1,455	1,519	**1,626**			
Four years later	992	1,075	1,207	1,327	1,526	1,614	**1,716**				
Five years later	1,049	1,152	1,283	1,412	1,623	**1,717**					
Six years later	1,093	1,205	1,333	1,464	**1,680**						
Seven years later	1,123	1,239	1,366	**1,496**							
Eight years later	1,146	1,260	**1,390**								
Nine years later	1,159	**1,279**									
Ten years later	**1,175**										
C. Net reserves re-estimated as of:											
One year later	$ 1,582	$ 1,623	$ 1,724	$ 1,912	$ 2,120	$ 2,307	$ 2,528	$ 2,649	$ 2,817	$ **2,995**	
Two years later	1,470	1,551	1,728	1,833	2,083	2,263	2,377	2,546	**2,743**		
Three years later	1,405	1,520	1,636	1,802	2,052	2,178	2,336	**2,489**			
Four years later	1,380	1,465	1,615	1,771	2,010	2,153	**2,299**				
Five years later	1,326	1,466	1,608	1,757	1,999	**2,127**					
Six years later	1,333	1,463	1,602	1,733	**1,992**						
Seven years later	1,333	1,460	1,577	**1,739**							
Eight years later	1,332	1,435	**1,593**								
Nine years later	1,305	**1,456**									
Ten years later	**1,323**										
D. Cumulative net redundancy as of:											
One year later	$ (120)	$ (154)	$ (116)	$ (20)	$ (62)	$ (45)	$ (80)	$ (196)	$ (160)	$ **(116)**	
Two years later	(232)	(226)	(112)	(99)	(99)	(89)	(231)	(299)	**(234)**		
Three years later	(297)	(257)	(204)	(130)	(130)	(174)	(272)	**(356)**			
Four years later	(322)	(312)	(225)	(161)	(172)	(199)	**(309)**				
Five years later	(376)	(311)	(232)	(175)	(183)	**(225)**					
Six years later	(369)	(314)	(238)	(199)	**(190)**						
Seven years later	(369)	(317)	(263)	**(193)**							
Eight years later	(370)	(342)	**(247)**								
Nine years later	(397)	**(321)**									
Ten years later	**(379)**										
Net liability re-estimated—latest	$ 1,323	$ 1,456	$ 1,593	$ 1,739	$ 1,992	$ 2,127	$ 2,299	$ 2,489	**$** 2,743	**$ 2,995**	
Re-estimated recoverable—latest	183	198	224	230	259	532	568	547	551	**517**	
Gross liability re-estimated—latest	$ 1,506	$ 1,654	$ 1,817	$ 1,969	$ 2,251	$ 2,659	$ 2,867	$ 3,036	**$** 3,294	**$ 3,512**	
Cumulative gross redundancy	$ (318)	$ (235)	$ (161)	$ (124)	$ (150)	$ (206)	$ (283)	$ (350)	**$** (220)	**$ (117)**	

Asbestos and Environmental Reserves

We believe that our asbestos and environmental reserves, including mold reserves, are adequate at this time and that these coverage areas are immaterial to our financial position due to the types of accounts we have insured in the past.

Loss and loss expenses incurred for all asbestos and environmental claims were $12 million, or 0.6 percent of total loss and loss expenses in 2006, compared with $12 million, or 0.7 percent in 2005 and $42 million, or 2.4 percent, in 2004.

Net reserves for all asbestos and environmental claims were $131 million in 2006 compared with $130 million in 2005 and $128 million in 2004. Net reserves for all asbestos and environmental claims were 3.9 percent, 4.2 percent and 4.3 percent of total reserves in 2006, 2005 and 2004, respectively.

We generally wrote commercial accounts after the development of coverage forms that exclude asbestos cleanup costs. We believe our exposure to risks associated with past production and/or installation of asbestos materials is minimal because we primarily were a personal lines company when most of the asbestos exposure occurred. The commercial coverage we did offer was predominantly related to local market construction activity rather than asbestos manufacturing. Further, over the past four years we have revised policy terms where permitted by state regulation to limit our exposure to mold and other environmental risks going forward.
We continue to evaluate our exposure to silicosis and welding claims, but believe our exposure is minimal.

Commercial Lines Insurance Segment Reserves

For the business lines in the commercial lines insurance segment, the following table shows the breakout of gross reserves among case, IBNR and loss expense reserves. The rise in total gross reserves for our commercial business lines is partially due to our growth. The increase also reflected higher loss expense reserves due to a claims mediation process that promoted earlier liability settlement resolution and increased loss expenses due to higher legal fees. In addition, commercial casualty, workers' compensation and surety and executive risk gross reserves rose because of the increase in large losses as we discussed in Commercial Lines Insurance Results of Operations, Page 42. Reserve practices discussed above also contributed.

(In millions)	Loss reserves		Loss	Total	
	Case reserves	IBNR reserves	expense reserves	gross reserves	Percent of total
At December 31, 2006					
Commercial casualty	**$ 923**	**$ 437**	**$ 483**	**1,843**	**54.0 %**
Commercial property	**132**	**31**	**36**	**199**	**5.8**
Commercial auto	**274**	**52**	**64**	**390**	**11.4**
Workers' compensation	**411**	**277**	**99**	**787**	**23.1**
Specialty packages	**80**	**1**	**5**	**86**	**2.5**
Surety and executive risk	**67**	**1**	**32**	**100**	**2.9**
Machinery and equipment	**5**	**3**	**1**	**9**	**0.3**
Total	**$ 1,892**	**$ 802**	**$ 720**	**$ 3,414**	**100.0 %**
At December 31, 2005					
Commercial casualty	$ 859	$ 451	$ 423	$ 1,733	54.6 %
Commercial property	135	40	36	211	6.6
Commercial auto	268	55	65	388	12.2
Workers' compensation	283	333	79	695	21.9
Specialty packages	63	0	12	75	2.4
Surety and executive risk	36	0	32	68	2.1
Machinery and equipment	3	3	0	6	0.2
Total	$ 1,647	$ 882	$ 647	$ 3,176	100.0 %

The following table provides the amounts of net reserve changes made over the past three years by commercial line of business and accident year:

(Dollars in millions)	Commercial casualty	Commercial property	Commercial auto	Workers' compensation	Specialty packages	Surety & executive risk	Machinery & equipment	Totals
As of December 31, 2006								
2005 accident year	**$ (52)**	**$ 17**	**$ (17)**	**$ (2)**	**$ 3**	**$ 7**	**$ 1**	**$ (43)**
2004 accident year	**(21)**	**(3)**	**1**	**5**	**(1)**	**(3)**	**0**	**(22)**
2003 accident year	**(12)**	**(3)**	**1**	**0**	**1**	**(1)**	**0**	**(14)**
2002 accident year	**2**	**(1)**	**(2)**	**(3)**	**0**	**1**	**0**	**(3)**
2001 accident year	**(9)**	**(4)**	**(2)**	**(1)**	**0**	**1**	**0**	**(15)**
2000 accident year	**(9)**	**(1)**	**(1)**	**1**	**(1)**	**0**	**0**	**(11)**
1999 and prior accident years	**2**	**0**	**(1)**	**9**	**0**	**0**	**0**	**10**
Deficiency/(redundancy)	**$ (99)**	**$ 5**	**$ (21)**	**$ 9**	**$ 2**	**$ 5**	**$ 1**	**$ (98)**
Reserves as originally estimated	**$ 1,359**	**$ 160**	**$ 386**	**$ 634**	**$ 73**	**$ 63**	**$ 6**	**$ 2,681**
Reserves re-estimated as of December 31, 2006	**1,260**	**165**	**365**	**643**	**75**	**68**	**7**	**2,583**
Deficiency/(redundancy)	**$ (99)**	**$ 5**	**$ (21)**	**$ 9**	**$ 2**	**$ 5**	**$ 1**	**$ (98)**
Impact on loss and loss expense ratio	**(12.0) %**	**0.9 %**	**(4.6) %**	**2.6 %**	**1.6 %**	**6.3 %**	**2.8 %**	**(4.1) %**
As of December 31, 2005								
2004 accident year	$ (78)	$ 23	$ (15)	$ 9	$ 7	$ 2	$ (1)	$ (53)
2003 accident year	(51)	(3)	(5)	13	3	(4)	0	(47)
2002 accident year	(17)	(3)	(1)	8	2	0	0	(11)
2001 accident year	(7)	(1)	(1)	3	0	(1)	0	(7)
2000 accident year	8	0	0	3	2	0	0	13
1999 accident year	(1)	0	0	3	0	0	0	2
1998 and prior accident years	(25)	1	(1)	2	1	(1)	0	(23)
Deficiency/(redundancy)	$ (171)	$ 17	$ (23)	$ 41	$ 15	$ (4)	$ (1)	$ (126)
Reserves as originally estimated	$ 1,332	$ 104	$ 372	$ 558	$ 72	$ 64	$ 5	$ 2,507
Reserves re-estimated as of December 31, 2005	1,161	121	349	599	87	60	4	2,381
Deficiency/(redundancy)	$ (171)	$ 17	$ (23)	$ 41	$ 15	$ (4)	$ (1)	$ (126)
Impact on loss and loss expense ratio	(22.5) %	3.5 %	(5.0) %	12.9 %	10.9 %	(5.4) %	(3.7) %	(5.6) %
As of December 31, 2004								
2001 accident year	$ (46)	$ 7	$ (11)	$ (5)	$ 3	$ (1)	$ 0	$ (53)
2000 accident year	(44)	(2)	(10)	1	1	(3)	0	(57)
1999 accident year	(27)	(7)	(4)	6	1	(1)	0	(32)
1998 accident year	(19)	0	(5)	3	0	(1)	0	(22)
1997 accident year	(1)	0	(7)	2	0	0	0	(6)
1996 accident year	(1)	0	(3)	1	0	0	0	(3)
1995 and prior accident years	2	0	(8)	6	0	(1)	0	(1)
Deficiency/(redundancy)	$ (136)	$ (2)	$ (48)	$ 14	$ 5	$ (7)	$ 0	$ (174)
Reserves as originally estimated	$ 1,280	$ 101	$ 382	$ 515	$ 75	$ 57	$ 5	$ 2,415
Reserves re-estimated as of December 31, 2004	1,144	99	334	529	80	50	5	2,241
Deficiency/(redundancy)	$ (136)	$ (2)	$ (48)	$ 14	$ 5	$ (7)	$ 0	$ (174)
Impact on loss and loss expense ratio	(20.0) %	(0.3) %	(10.5) %	4.9 %	3.7 %	(9.3) %	(1.3) %	(8.2) %

The overall favorable development recorded in the commercial lines reserves illustrates the potential for revisions inherent in estimating reserves, especially in long-tail lines such as commercial casualty. With the exception of the UM/UIM reserve releases and other significant changes in assumptions discussed above, commercial lines reserve development over the past three years was consistent with:

- The initiative, begun in 2001, to establish higher initial case reserves on liability claims in the period in which the claim is reported
- The initiative, begun in 2000 and expanded to other states in 2004, to use a claims mediation process that promotes earlier liability settlement resolution
- Increased loss expenses due to higher legal fees
- Workers' compensation claim reserve practices
- Higher than expected medical inflation affecting the workers' compensation line
- Changes in reinsurance treaty retentions
- Settlements that differed from the established case reserves
- Changes in case reserves based on new information for specific claims or classes of claims
- Differences in the timing of actual settlements compared with the payout patterns assumed in the accident year IBNR reductions
- Lower risk profile after 2001 due to commercial lines underwriting initiatives

Personal Lines Insurance Segment Reserves

For the business lines in the personal lines insurance segment, the following table shows the breakout of gross reserves among case, IBNR and loss expense reserves. Total gross reserves were down slightly from year-end 2005 due to the decline in premiums in this business line. Homeowner gross reserves reflected the increase in large losses as we discussed in Personal Lines Insurance Results of Operations, Page 49.

(In millions)	Loss reserves		Loss	Total	
	Case reserves	IBNR reserves	expense reserves	gross reserves	Percent of total
At December 31, 2006					
Personal auto	**$ 169**	**$ 5**	**$ 32**	**$ 206**	**46.2 %**
Homeowners	**69**	**24**	**17**	**110**	**24.7**
Other personal	**55**	**61**	**14**	**130**	**29.1**
Total	**$ 293**	**$ 90**	**$ 63**	**$ 446**	**100.0 %**
At December 31, 2005					
Personal auto	$ 175	$ 4	$ 34	$ 213	47.1 %
Homeowners	70	21	18	109	24.0
Other personal	52	67	12	131	28.9
Total	$ 297	$ 92	$ 64	$ 453	100.0 %

The following table provides the amounts of net reserve changes made over the past three years by personal line of business and accident year:

(Dollars in millions)	Personal auto	Homeowner	Other personal	Totals
As of December 31, 2006				
2005 accident year	**$ 4**	**$ 5**	**$ (7)**	**$ 2**
2004 accident year	**6**	**1**	**(2)**	**5**
2003 accident year	**(3)**	**0**	**(4)**	**(7)**
2002 accident year	**(2)**	**(1)**	**(4)**	**(7)**
2001 accident year	**(2)**	**0**	**(2)**	**(4)**
2000 accident year	**(1)**	**0**	**(3)**	**(4)**
1999 and prior accident years	**0**	**0**	**(3)**	**(3)**
Deficiency/(redundancy)	**$ 2**	**$ 5**	**$ (25)**	**$ (18)**
Reserves as originally estimated	**$ 213**	**$ 99**	**$ 118**	**$ 430**
Reserves re-estimated as of December 31, 2006	**215**	**104**	**93**	**412**
Deficiency/(redundancy)	**$ 2**	**$ 5**	**$ (25)**	**$ (18)**
Impact on loss and loss expense ratio	**0.6 %**	**1.5 %**	**(28.6) %**	**(2.4) %**
As of December 31, 2005				
2002 accident year	$ 0	$ 0	$ (5)	$ (5)
2001 accident year	0	(2)	(11)	(13)
2000 accident year	(3)	0	(3)	(6)
1999 accident year	(4)	0	(3)	(7)
1998 accident year	(1)	0	0	(1)
1997 accident year	0	1	0	1
1996 and prior accident years	0	0	(3)	(3)
Deficiency/(redundancy)	$ (8)	$ (1)	$ (25)	$ (34)
Reserves as originally estimated	$ 231	$ 114	$ 125	$ 470
Reserves re-estimated as of December 31, 2005	223	113	100	436
Deficiency/(redundancy)	$ (8)	$ (1)	$ (25)	$ (34)
Impact on loss and loss expense ratio	(1.9) %	(0.4) %	(28.7) %	(4.3) %
As of December 31, 2004				
2001 accident year	$ 9	$ (1)	$ (3)	$ 5
2000 accident year	1	(1)	(4)	(4)
1999 accident year	(3)	(4)	(5)	(12)
1998 accident year	(3)	(1)	(3)	(7)
1997 accident year	(1)	0	0	(1)
1996 accident year	(1)	0	0	(1)
1995 and prior accident years	(1)	0	(1)	(2)
Deficiency/(redundancy)	$ 1	$ (7)	$ (16)	$ (22)
Reserves as originally estimated	$ 224	$ 90	$ 116	$ 430
Reserves re-estimated as of December 31, 2004	225	83	100	408
Deficiency/(redundancy)	$ 1	$ (7)	$ (16)	$ (22)
Impact on loss and loss expense ratio	0.2 %	(2.7) %	(18.9) %	(2.8) %

The overall favorable development recorded in the personal lines segment reserves illustrates the potential for revisions inherent in estimating reserves. Personal lines reserve development over the past three years was consistent with:

- The initiative, begun in 2001, to establish higher initial case reserves on liability claims in the period in which the claim is reported
- Settlements that differed from the established case reserves
- Changes in reinsurance treaty retentions
- Changes in case reserves based on new information for specific claims or classes of claims
- Differences in the timing of actual settlements compared with the payout patterns assumed in the accident year IBNR reductions
- Recognition of favorable case reserve development

LIFE INSURANCE RESERVES

Gross life policy reserves were $1.409 billion at year-end 2006, compared with $1.343 billion at year-end 2005. We establish reserves for traditional life insurance policies based on expected expenses, mortality, morbidity, withdrawal rates and investment yields, including a provision for uncertainty. Once these assumptions are established, they generally are maintained throughout the lives of the contracts. We use both our own experience and industry experience adjusted for historical trends in arriving at our assumptions for expected mortality, morbidity and withdrawal rates. We use our own experience and historical trends for setting our assumptions for expected expenses. We base our assumptions for expected investment income on our own experience adjusted for current economic conditions.

We establish reserves for our universal life, deferred annuity and investment contracts equal to the cumulative account balances, which include premium deposits plus credited interest less charges and withdrawals. Some of our universal life insurance policies contain no-lapse guarantee provisions. For these policies, we establish a reserve in addition to the account balance based on expected no-lapse guarantee benefits and expected policy assessments.

We regularly review our life insurance business to ensure that any deferred acquisition cost associated with the business is recoverable and that our actuarial liabilities (life insurance segment reserves) make sufficient provision for future benefits and related expenses.

2007 REINSURANCE PROGRAMS

A single large loss or an unexpected rise in claims severity or frequency due to a catastrophic event could present us with a liquidity and financial risk. In an effort to control such losses, we forego marketing property casualty insurance in specific geographic areas, monitor our exposure in certain coastal regions, review aggregate exposures to huge disasters and purchase reinsurance. We use the Risk Management Solutions (RMS) and Applied Insurance Research (AIR) models to evaluate exposures in determining appropriate reinsurance coverage programs. In conjunction with these activities, we also continue to evaluate information provided by our reinsurance broker. These various sources explore and analyze credible scientific evidence, including the impact of global climate change, which may affect our exposure under insurance policies.

Reinsurance mitigates the risk of highly uncertain exposures and limits the maximum net loss that can arise from large risks or risks concentrated in areas of exposure. Management's decisions regarding the appropriate level of property casualty risk retention are affected by various factors, including changes in our underwriting practices, capacity to retain risks and reinsurance market conditions. Reinsurance does not relieve us of our obligation to pay covered claims. The financial strength of our reinsurers is important because our ability to recover for losses covered under one of our reinsurance agreements depends on the financial viability of the reinsurer.

Currently participating on our property and casualty per-occurrence programs are Hannover Reinsurance Company, Munich Reinsurance America, Partner Reinsurance Company of the U.S. and Swiss Reinsurance America Corporation and its subsidiaries, all of which have A.M. Best insurer financial strength ratings of A (Excellent) or A+ (Superior). Our property catastrophe program is subscribed through a broker by reinsurers from the United States, Bermuda, London and European markets.

Primary components of the 2007 property and casualty reinsurance program include:

- Property per risk treaty – The primary purpose of the property treaty is to provide capacity up to $25 million, supplying adequate capacity for the majority of the risks we write and also includes protection for extra-contractual liability coverage losses. The ceded premium is estimated to be $35 million for 2007, compared with $30 million in 2006 and $29 million in 2005. We retain the first $4 million of each loss. Losses between $4 million and $25 million are reinsured at 100 percent.

- Casualty per occurrence treaty – The casualty treaty provides capacity up to $25 million. Similar to the property treaty, this provides sufficient capacity to cover the vast majority of casualty accounts we insure and also includes protection for extra-contractual liability coverage losses. The ceded premium is estimated to be $50 million in 2007, compared with $45 million in 2006 and $64 million in 2005. We retain the first $4 million of each loss. Losses between $4 million and $25 million are reinsured at 100 percent.

  We have modified our casualty per occurrence treaty for director and officer policies for four Fortune 1000 companies and one financial services company. For one of the five companies, our retention could be as high as $15 million rather than the $4 million for a typical policy; for one of the companies, our retention could be as high as $10 million; for the remaining three companies, our retention per policy could be as high as $5 million. We believe the additional risk undertaken with these selected policies remains at an acceptable level based on our financial strength. We arranged for this exception for this small group of companies to maintain business relationships with key agencies and insureds. We intend to review this element of our working treaties on an ongoing basis.
- Casualty excess treaties – We purchase a casualty reinsurance treaty that provides an additional $25 million in protection for certain casualty losses. This treaty, along with the casualty per occurrence treaty, provides a total of $50 million of protection for workers' compensation, extra-contractual liability coverage and clash coverage losses, which is used when there is a single occurrence involving multiple policyholders of The Cincinnati Insurance Companies or multiple coverages for one insured. The ceded premium is estimated to be $2 million in 2007 and is comparable with the premium paid in 2006.

  We purchase another casualty excess treaty, which provides an additional $20 million in casualty loss coverage. This treaty also provides catastrophic coverage for workers' compensation and extra-contractual liability coverage losses. The ceded premium is estimated to be $1 million for 2007, comparable with the premium paid in 2006.
- Property catastrophe treaty – To protect against catastrophic events such as wind and hail, hurricanes or earthquakes, we purchase property catastrophe reinsurance, with a limit up to $500 million. For the 2007 treaty, ceded premiums are estimated to be $49 million, up from $38 million in 2006, and $29 million, excluding the reinstatement premium, in 2005. The premium increase for 2007 primarily was due to the difficult market conditions brought on in part by the record catastrophe losses experienced by reinsurance companies in recent years. Our retention on this program remains at $45 million and we will retain:
  - 5 percent of losses between $45 million and $200 million
  - 14 percent of losses between $200 million and $300 million
  - 18 percent of losses between $300 million and $500 million

  Our maximum exposure to a 2007 catastrophic event that resulted in $500 million in losses would be $103 million compared with $68 million in 2006. The largest catastrophe loss in our history was $87 million before reinsurance.

Individual risks with insured values in excess of $25 million, as identified in the policy, are handled through a different reinsurance mechanism. We reinsure property coverage for individual risks with insured values between $25 million and $50 million under an automatic facultative treaty. For risks with property values exceeding $50 million, we negotiate the purchase of facultative coverage on an individual certificate basis. For casualty coverage on individual risks with limits exceeding $25 million, facultative reinsurance coverage is placed on an individual certificate basis.

Responding to the challenges presented by terrorism has become a very important issue for the insurance industry over the last five years. Terrorism coverage at various levels has been secured in all of our reinsurance agreements. The broadest coverage for this peril is found in the property and casualty working treaties, which provide coverage for commercial and personal risks. In addition, our property catastrophe treaty provides coverage for personal risks and the majority of our reinsurers provide limited coverage for commercial risks with total insured values of $10 million or less.

Reinsurance protection for the company's surety business is covered under separate treaties with many of the same reinsurers that write the property casualty working treaties.

Reinsurance protection for our life insurance business is covered under separate treaties with many of the same reinsurers that write the property casualty working treaties. In 2005, we modified our reinsurance protection for our term life insurance business due to changes in the marketplace that affected the cost and availability of reinsurance for term life insurance. We are retaining no more than a $500,000 exposure, ceding the balance using excess over retention mortality coverage, and retaining the policy reserve. Retaining the policy reserve has no direct impact on GAAP results. However, because of the conservative nature of statutory reserving principles, retaining the policy reserve unduly depresses our statutory earnings and requires a large commitment of our capital. We also have catastrophe reinsurance coverage on our life insurance operations that reimburses us up to $20 million for covered net losses in excess of $5 million. The treaty contains a reinstatement provision, provided the covered losses were not due to terrorism, and contains protection for extra-contractual liability coverage losses. For term life insurance business written prior to 2005, we retain 10 percent to 25 percent of each term policy, not to exceed $500,000, ceding the balance or mortality risk and policy reserve.

The NAIC has asked for comments on proposals to modify statutory accounting procedures to reduce the negative effect on statutory life insurance income. We expect the NAIC proposals will be adopted. If they are not, we believe we will be able to structure a reinsurance program to provide the life insurance company with the ability to continue to grow in the term life insurance marketplace while appropriately managing risk, at a cost that allows us to achieve our life insurance company profit targets.

SAFE HARBOR STATEMENT

This is our "Safe Harbor" statement under the Private Securities Litigation Reform Act of 1995. Our business is subject to certain risks and uncertainties that may cause actual results to differ materially from those suggested by the forward-looking statements in this report. Some of those risks and uncertainties are discussed in our Item 1A, Risk Factors, Page 20. Although we often review or update our forward-looking statements when events warrant, we caution our readers that we undertake no obligation to do so.

Factors that could cause or contribute to such differences include, but are not limited to:

- Unusually high levels of catastrophe losses due to risk concentrations, changes in weather patterns, environmental events, terrorism incidents or other causes
- Increased frequency and/or severity of claims
- Inaccurate estimates or assumptions used for critical accounting estimates
- Events or actions, including unauthorized intentional circumvention of controls, that reduce the company's future ability to maintain effective internal control over financial reporting under the Sarbanes-Oxley Act of 2002
- Events or conditions that could weaken or harm the company's relationships with its independent agencies and hamper opportunities to add new agencies, resulting in limitations on the company's opportunities for growth, such as:
    - Downgrade of the company's financial strength ratings
    - Concerns that doing business with the company is too difficult or
    - Perceptions that the company's level of service, particularly claims service, is no longer a distinguishing characteristic in the marketplace
- Delays or inadequacies in the development, implementation, performance and benefits of technology projects and enhancements
- Ability to obtain adequate reinsurance on acceptable terms, amount of reinsurance purchased, financial strength of reinsurers and the potential for non-payment or delay in payment by reinsurers
- Increased competition that could result in a significant reduction in the company's premium growth rate
- Underwriting and pricing methods adopted by competitors that could allow them to identify and flexibly price risks, which could decrease our competitive advantages
- Actions of insurance departments, state attorneys general or other regulatory agencies that:
    - Restrict our ability to exit or reduce writings of unprofitable coverages or lines of business
    - Place the insurance industry under greater regulatory scrutiny or result in new statutes, rules and regulations
    - Increase our expenses
    - Add assessments for guaranty funds, other insurance related assessments or mandatory reinsurance arrangements; or that impair our ability to recover such assessments through future surcharges or other rate changes
    - Limit our ability to set fair, adequate and reasonable rates
    - Place us at a disadvantage in the marketplace or
    - Restrict our ability to execute our business model, including the way we compensate agents
- Sustained decline in overall stock market values negatively affecting the company's equity portfolio and book value; in particular a sustained decline in the market value of Fifth Third shares, a significant equity holding
- Recession or other economic conditions or regulatory, accounting or tax changes resulting in lower demand for insurance products

- Events that lead to a significant decline in the value of a particular security and impairment of the asset
- Prolonged low interest rate environment or other factors that limit the company's ability to generate growth in investment income or interest-rate fluctuations that result in declining values of fixed-maturity investments
- Adverse outcomes from litigation or administrative proceedings
- Investment activities or market value fluctuations that trigger restrictions applicable to the parent company under the Investment Company Act of 1940
- Events, such as an avian flu epidemic, natural catastrophe, terrorism or construction delays, that could hamper our ability to assemble our workforce at our headquarters location

Further, the company's insurance businesses are subject to the effects of changing social, economic and regulatory environments. Public and regulatory initiatives have included efforts to adversely influence and restrict premium rates, restrict the ability to cancel policies, impose underwriting standards and expand overall regulation. The company also is subject to public and regulatory initiatives that can affect the market value for its common stock, such as recent measures affecting corporate financial reporting and governance. The ultimate changes and eventual effects, if any, of these initiatives are uncertain.

Item 7A. Quantitative and Qualitative Disclosures About Market Risk

INTRODUCTION

Market risk is the potential for a decrease in securities value resulting from broad yet uncontrollable forces such as: inflation, economic growth, interest rates, world political conditions or other widespread unpredictable events. It is comprised of many individual risks that, when combined, create a macroeconomic impact. The company accepts and manages risks in the investment portfolio as part of the means of achieving portfolio objectives. Some of the risks are:

- Political – the potential for a decrease in market value due to the real or perceived impact of governmental policies or conditions
- Regulatory – the potential for a decrease in market value due to the impact of legislative proposals or changes in laws or regulations
- Economic – the potential for a decrease in value due to changes in general economic factors (recession, inflation, deflation, etc.)
- Revaluation – the potential for a decrease in market value due to a change in relative value (change in market multiple) of the market brought on by general economic factors
- Interest-rate – the potential for a decrease in market value of a security or portfolio due to its sensitivity to changes (increases or decreases) in the general level of interest rates

Company-specific risk is the potential for a particular issuer to experience a decline in valuation due to the impact of sector or market risk on the holding or because of issues specific to the firm:

- Fraud – the potential for a negative impact on an issuer's performance due to actual or alleged illegal or improper activity of individuals it employs
- Credit – the potential for deterioration in an issuer's financial profile due to specific company issues, problems it faces in the course of its operations or industry-related issues
- Default – the possibility that an issuer will not make a required payment (interest payment or return of principal) on its debt. Generally this occurs after its financial profile has deteriorated (credit risk) and it no longer has the means to make its payments

The investment committee of the board of directors monitors the investment risk management process primarily through its executive oversight of our investment activities. We take an active approach to managing market and other investment risks, including the accountabilities and controls over these activities. Actively managing these market risks is integral to our operations and could require us to change the character of future investments purchased or sold or require us to shift the existing asset portfolios to manage exposure to market risk within acceptable ranges.

Sector risk is the potential for a negative impact on a particular industry due to its sensitivity to factors that make up market risk. Market risk affects general supply/demand factors for an industry and will affect companies within that industry to varying degrees.

Risks associated with the five asset classes described in Item 1, Investments Segment, Page 14, can be summarized as follows (H – high, A – average, L – low):

	Taxable fixed maturities	Tax-exempt fixed maturities	Common equities	Preferred equities	Short-term investments
Political	A	H	A	A	L
Regulatory	A	A	A	A	L
Economic	A	A	H	A	L
Revaluation	A	A	H	A	L
Interest rate	H	H	A	H	L
Fraud	A	L	A	A	L
Credit	A	L	A	A	L
Default	A	L	A	A	L

FIXED-MATURITY INVESTMENTS

For investment-grade corporate bonds, the inverse relationship between interest rates and bond prices leads to falling bond values during periods of increasing interest rates. Although the potential for a worsening financial condition, and ultimately default, does exist with investment-grade corporate bonds, their higher-quality financial profiles make credit risk less of a concern than for lower-quality investments. We address this risk by consistently investing within a particular maturity range, which has, over the years, provided the portfolio with a laddered maturity schedule, which we believe is less subject to large swings in value due to interest rate changes. While a single maturity range may see values drop due to general interest rate levels, other maturity ranges will be less affected by those changes. Additionally, purchases are spread across a wide spectrum of industries and companies, diversifying our holdings and minimizing the impact of specific industries or companies with greater sensitivities to interest rate fluctuations.

The primary risk related to high-yield corporate bonds is credit risk or the potential for a deteriorating financial structure. A weak financial profile can lead to rating downgrades from the credit rating agencies, which can put further downward pressure on bond prices. Interest rate risk is less of a factor with high-yield corporate bonds, as valuation is related more directly to underlying operating performance than to general interest rates. This puts more emphasis on the financial results achieved by the issuer rather than general economic trends or statistics within the marketplace. We address this concern by analyzing issuer- and industry-specific financial results and by closely monitoring holdings within this asset class.

The primary risks related to tax-exempt bonds are interest rate risk and political risk associated with the specific economic environment within the political boundaries of the issuing municipal entity. We address these concerns by focusing on municipalities' general-obligation debt and on essential-service bonds. Essential-service bonds derive a revenue stream from the services provided by the municipality, which are vital to the people living in the area (water service, sewer service, etc.). Another risk related to tax-exempt bonds is regulatory risk or the potential for legislative changes that would negate the benefit of owning tax-exempt bonds. We monitor regulatory activity for situations that may negatively affect current holdings and its ongoing strategy for investing in these securities.

The final, less significant risk is a small exposure to credit risk for a portion of the tax-exempt portfolio that has support from corporate entities. Examples are bonds insured by corporate bond insurers or bonds with interest payments made by a corporate entity through a municipal conduit/authority. While decisions regarding these investments primarily consider the underlying municipal situation, the existence of third-party insurance reduces risk in the event of default. In circumstances in which the municipality is unable to meet its obligations, risk would be increased if the insuring entity were experiencing financial duress. Because of our diverse exposure and selection of higher-rated entities with strong financial profiles, we do not believe this is a material concern.

Interest Rate Sensitivity Analysis

Because of our strong surplus, long-term investment horizon and ability to hold most fixed-maturity investments until maturity, we believe the company is well positioned if interest rates were to rise. A higher rate environment would provide the opportunity to invest cash flow in higher-yielding securities, while reducing the likelihood of untimely redemptions of currently callable securities. While higher interest rates would be expected to continue to increase the number of fixed-maturity holdings trading below 100 percent of book value, we believe lower fixed-maturity security values due solely to interest rate changes would not signal a decline in credit quality.

A dynamic financial planning model developed during 2002 uses analytical tools to assess market risks. As part of this model, the effective duration of the fixed-maturity portfolio is continually monitored by our investment department to evaluate the theoretical impact of interest rate movements.

The table below summarizes the effect of hypothetical changes in interest rates on the fixed-maturity portfolio:

(In millions)	Fair value of fixed maturity portfolio	Effective duration 100 basis point spread decrease	100 basis point spread increase
At December 31, 2006	**$ 5,805**	**$ 6,099**	**$ 5,511**
At December 31, 2005	5,476	5,759	5,194

The effective duration of the fixed maturity portfolio is currently 5.1 years. A 100 basis point movement in interest rates would result in an approximately 5.1 percent change in the market value of the fixed maturity portfolio. Generally speaking, the higher a bond is rated, the more directly correlated movements in its market value will be to changes in the general level of interest rates, exclusive of call features. The market values of average- to lower-rated corporate bonds are additionally influenced by the expansion or contraction of credit spreads. In prior reporting periods we have expressed our interest rate sensitivity using both modified duration and duration to worst measures. Going forward, we will use effective duration, a measure we believe more accurately depicts duration on an option-adjusted basis.

In the dynamic financial planning model, the selected interest rate change of 100 basis points represents our views of a shift in rates that is quite possible over a one-year period. The rates modeled should not be considered a prediction of future events as interest rates may be much more volatile in the future. The analysis is not intended to provide a precise forecast of the effect of changes in rates on our results or financial condition, nor does it take into account any actions that we might take to reduce exposure to such risks.

SHORT-TERM INVESTMENTS

Our short-term investments present minimal risk as we generally purchase the highest quality commercial paper.

EQUITY INVESTMENTS

Common stocks are subject to a variety of risk factors encompassed under the umbrella of market risk. General economic swings influence the performance of the underlying industries and companies within those industries. A downturn in the economy can have a negative impact on an equity portfolio. Industry- and company-specific risks have the potential to substantially affect the market value of the company's equity portfolio. We address these risks by maintaining investments in a small group of holdings that we can analyze closely, better understanding their business and the related risk factors.

At December 31, 2006, the company held 13 individual equity positions valued at approximately $100 million or above, see Item 1, Investments Segment, Page 14, for additional details on these holdings. These equity positions accounted for approximately 91.8 percent of the unrealized appreciation of the entire portfolio.

We believe our equity investment style – centered on companies that pay and increase dividends to shareholders – is an appropriate long-term strategy. While our long-term financial position would be affected by prolonged changes in the market valuation of our investments, we believe our strong surplus position and cash flow provide a cushion against short-term fluctuations in valuation. We believe that the continued payment of cash dividends by the issuers of the common equities we hold also should provide a floor to their valuation.

Our investments are heavily weighted toward the financials sector, which represented 66.6 percent of the total fair value of the common stock portfolio at December 31, 2006. Financials sector investments typically underperform the overall market during periods when interest rates are expected to rise. We historically have seen these types of short-term fluctuations in market value of our holdings as potential buying opportunities but are cognizant that a prolonged downturn in this sector could create a long-term negative effect on the portfolio.

Over the longer term, our objective is for the performance of our equity portfolio to exceed that of the broader market. Over the five years ended December 31, 2006, our compound annual equity portfolio return was 2.0 percent compared with a compound annual total return of 6.2 percent for the Standard & Poor's 500 Index, a common benchmark of market performance. In 2006, our annual equity portfolio return was 16.1 percent, compared with an annual total return of 15.8 percent for that Index. Our equity portfolio underperformed the market for the five-year period because of the decline in the market value of our holdings of Fifth Third common stock between 2002 and year-end 2005.

The primary risks related to preferred stocks are similar to those related to investment grade corporate bonds. Falling interest rates adversely affect market values due to the normal inverse relationship between rates and yields. Credit risk exists due to the subordinate position of preferred stocks in the capital structure. We minimize this risk by primarily purchasing investment grade preferred stocks of issuers with a strong history of paying a common stock dividend.

Fifth Third Bancorp Holding

One of our common stock holdings, Fifth Third, accounted for 25.7 percent of our shareholders' equity at year-end 2006 and dividends earned from our Fifth Third investment were 20.2 percent of our investment income in 2006.

(In millions except market price data)	Years ended December 31,	
	2006	2005
Fifth Third Bancorp common stock holding:		
Dividends earned	**$ 115**	$ 106
Percent of total net investment income	**20.2 %**	20.2 %
	At December 31, 2006	At December 31, 2005
Shares held	**73**	73
Closing market price of Fifth Third	**$ 40.93**	$ 37.72
Book value of holding	**283**	283
Fair value of holding	**2,979**	2,745
After-tax unrealized gain	**1,752**	1,600
Market value as a percent of total equity investments	**38.2 %**	38.6 %
Market value as a percent of invested assets	**21.7**	21.6
Market value as a percent of total shareholders' equity	**43.8**	45.1
After-tax unrealized gain as a percent of total shareholders' equity	**25.7**	26.3

Based on 2006 results, a 10 percent change in dividends earned from our Fifth Third holding would result in an $11 million change in pretax investment income and a $10 million change in after-tax earnings.

Every $1.00 change in the market price of Fifth Third's common stock has approximately a 27 cent impact on our book value per share. A 20 percent change in the market price of Fifth Third's common stock from its year-end 2006 closing price would result in a $596 million change in assets and a $387 million change in after-tax unrealized gains.

The market value of Fifth Third, our largest holding, has been affected by the residual effects of a regulatory review concluded in 2004 and, more recently, by a difficult interest rate environment. We believe that its management team can execute on the strategy for growth its management has defined. During this challenging period for the bank, we have continued to benefit from its superior dividend growth. In June 2006, Fifth Third increased its indicated annual dividend by 5.3 percent, which is expected to contribute an additional $6 million to investment income on an annualized basis.

UNREALIZED INVESTMENT GAINS AND LOSSES

At December 31, 2006, unrealized investment gains before taxes totaled $5.303 billion and unrealized investment losses in the investment portfolio amounted to $59 million.

Unrealized Investment Gains

The unrealized gains at December 31, 2006, were due to long-term gains from our holdings of Fifth Third common stock, which contributed 51.9 percent of the gain, and from our other common stock holdings, including ExxonMobil Corporation, The Procter & Gamble Company and PNC Financial Services Group, which each contributed at least 5 percent of the gain. Reflecting the company's long-term investment philosophy, of the 1,294 securities trading at or above book value, 633, or 48.9 percent, have shown unrealized gains for more than 24 months.

Unrealized Investment Losses – Potential Other-than-temporary Impairments

During 2006 and 2005, a total of three securities were written down as other-than-temporarily impaired.
We expect the number of securities trading below 100 percent of book value to fluctuate as interest rates rise or fall. Further, book values for some securities have been revised due to impairment charges recognized during 2003 and 2002. At December 31, 2006, 679 of the 1,973 securities we owned were trading below 100 percent of book value compared with 732 of the 1,814 securities we owned at December 31, 2005, and 208 of the 1,593 securities we owned at December 31, 2004.

The 679 holdings trading below book value at December 31, 2006, represented 19.8 percent of invested assets and $59 million in unrealized losses. We deem the risk related to securities trading between 70 percent and 100 percent of book value to be relatively minor and at least partially offset by the earned income potential of these investments.

- 671 of these holdings were trading between 90 percent and 100 percent of book value. The value of these securities fluctuates primarily because of changes in interest rates. The fair value of these 671 securities was $2.698 billion at December 31, 2006, and they accounted for $55 million in unrealized losses.

- Eight of these holdings were trading below 90 percent of book value at December 31, 2006. The fair value of these holdings was $30 million, and they accounted for the remaining $4 million in unrealized losses. These holdings are being monitored for credit- and industry-related risk factors, but we believe the changes in value primarily are due to normal fluctuations and economic factors.

  Of these securities, the largest is a media-related convertible debenture with a fair value of $9 million and an unrealized loss of $1.5 million. No other security had an unrealized loss in excess of $1 million.

- No holdings were trading below 70 percent of book value at December 31, 2006.

As discussed in Critical Accounting Estimates, Asset Impairment, Page 37, when evaluating other-than-temporary impairments, we consider our intent and ability to retain a security for a period adequate to recover a substantial portion of its cost. Because of our investment philosophy and strong capitalization, we can hold securities until their scheduled redemption that might otherwise be deemed impaired as we evaluate their potential for recovery based on economic, industry or company factors.

The following table summarizes the length of time securities in the investment portfolio have been in a continuous unrealized gain or loss position.

(Dollars in millions)	6 Months or less		> 6 - 12 Months		> 12 - 24 Months		> 24 - 36 Months	
	Number of issues	Gross unrealized gain/loss	Number of issues	Gross unrealized gain/loss	Number of issues	Gross unrealized gain/loss	Number of issues	Gross unrealized gain/loss
Taxable fixed maturities:								
Trading below 70% of book value	0	$ 0	0	$ 0	0	$ 0	0	$ 0
Trading at 70% to less than 100% of book value	28	(2)	55	(3)	195	(33)	40	(12)
Trading at 100% and above of book value	145	12	12	2	7	1	258	67
Total	173	10	67	(1)	202	(32)	298	55
Tax-exempt fixed maturities:								
Trading below 70% of book value	0	0	0	0	0	0	0	0
Trading at 70% to less than 100% of book value	95	(1)	12	0	213	(3)	34	(2)
Trading at 100% and above of book value	437	9	14	1	3	0	337	31
Total	532	8	26	1	216	(3)	371	29
Common equities:								
Trading below 70% of book value	0	0	0	0	0	0	0	0
Trading at 70% to less than 100% of book value	0	0	1	(2)	1	0	0	0
Trading at 100% and above of book value	7	10	6	267	2	14	33	4,875
Total	7	10	7	265	3	14	33	4,875
Preferred equities:								
Trading below 70% of book value	0	0	0	0	0	0	0	0
Trading at 70% to less than 100% of book value	0	0	2	0	1	0	1	(1)
Trading at 100% and above of book value	24	6	2	0	0	0	5	8
Total	24	6	4	0	1	0	6	7
Short-term investments:								
Trading below 70% of book value	0	0	0	0	0	0	0	0
Trading at 70% to less than 100% of book value	1	0	0	0	0	0	0	0
Trading at 100% and above of book value	2	0	0	0	0	0	0	0
Total	3	0	0	0	0	0	0	0
Summary:								
Trading below 70% of book value	0	0	0	0	0	0	0	0
Trading at 70% to less than 100% of book value	124	(3)	70	(5)	410	(36)	75	(15)
Trading at 100% and above of book value	615	37	34	270	12	15	633	4,981
Total	739	$ 34	104	$ 265	422	$ (21)	708	$ 4,966

The following table summarizes the investment portfolio:

(Dollars in millions)	Number of issues	Book value	Fair value	Gross unrealized gain/loss	Gross investment income
At December 31, 2006					
Taxable fixed maturities:					
Trading below 70% of book value	0	$ 0	$ 0	$ 0	$ 0
Trading at 70% to less than 100% of book value	318	1,943	1,893	(50)	100
Trading at 100% and above of book value	422	1,414	1,496	82	93
Securities sold in current year	0	0	0	0	10
Total	740	3,357	3,389	32	203
Tax-exempt fixed maturities:					
Trading below 70% of book value	0	0	0	0	0
Trading at 70% to less than 100% of book value	354	785	778	(7)	26
Trading at 100% and above of book value	791	1,597	1,638	41	72
Securities sold in current year	0	0	0	0	3
Total	1,145	2,382	2,416	34	101
Common equities:					
Trading below 70% of book value	0	0	0	0	0
Trading at 70% to less than 100% of book value	2	35	33	(2)	0
Trading at 100% and above of book value	48	2,365	7,531	5,166	240
Securities sold in current year	0	0	0	0	1
Total	50	2,400	7,564	5,164	241
Preferred equities:					
Trading below 70% of book value	0	0	0	0	0
Trading at 70% to less than 100% of book value	4	18	18	0	1
Trading at 100% and above of book value	31	203	217	14	11
Securities sold in current year	0	0	0	0	0
Total	35	221	235	14	12
Short-term investments:					
Trading below 70% of book value	0	0	0	0	0
Trading at 70% to less than 100% of book value	1	6	6	0	0
Trading at 100% and above of book value	2	89	89	0	0
Securities sold in current year	0	0	0	0	5
Total	3	95	95	0	5
Portfolio summary:					
Trading below 70% of book value	0	0	0	0	0
Trading at 70% to less than 100% of book value	679	2,787	2,728	(59)	127
Trading at 100% and above of book value	1,294	5,668	10,971	5,303	416
Securities sold in current year	0	0	0	0	19
Total	1,973	$ 8,455	$ 13,699	$ 5,244	$ 562
At December 31, 2005					
Portfolio summary:					
Trading below 70% of book value	2	$ 12	$ 8	$ (4)	$ 1
Trading at 70% to less than 100% of book value	730	2,894	2,820	(74)	118
Trading at 100% and above of book value	1,082	4,684	9,829	5,145	387
Securities sold in current year	0	0	0	0	18
Total	1,814	$ 7,590	$ 12,657	$ 5,067	$ 524