The Progressive Corporation and Subsidiaries

Consolidated Statements of Income

For the years ended December 31,

(millions — except per share amounts)	2009	2008	2007
Revenues			
Net premiums earned	$14,012.8	$13,631.4	$13,877.4
Investment income	507.0	637.7	680.8
Net realized gains (losses) on securities:			
Other-than-temporary impairment (OTTI) losses:			
Total OTTI losses	(80.9)	—	—
Less: portion of OTTI losses recognized in other comprehensive income	40.1	—	—
Net impairment losses recognized in earnings	(40.8)	—	—
Net realized gains (losses) on securities	67.9	(1,445.1)	106.3
Total net realized gains (losses) on securities	27.1	(1,445.1)	106.3
Service revenues	16.7	16.1	22.3
Total revenues	14,563.6	12,840.1	14,686.8
Expenses			
Losses and loss adjustment expenses	9,904.9	10,015.0	9,926.2
Policy acquisition costs	1,364.6	1,358.1	1,399.9
Other underwriting expenses	1,567.7	1,523.4	1,526.2
Investment expenses	11.1	8.8	12.4
Service expenses	19.4	20.4	20.5
Interest expense	139.0	136.7	108.6
Total expenses	13,006.7	13,062.4	12,993.8
Net Income (Loss)			
Income (loss) before income taxes	1,556.9	(222.3)	1,693.0
Provision (benefit) for income taxes	499.4	(152.3)	510.5
Net income (loss)	$ 1,057.5	$ (70.0)	$ 1,182.5
Computation of Earnings Per Share			
Basic:			
Average shares outstanding	666.8	668.0	710.4
Per share	$ 1.59	$ (.10)	$ 1.66
Diluted:			
Average shares outstanding	666.8	668.0	710.4
Net effect of dilutive stock-based compensation	5.4	5.9	8.1
Total equivalent shares	672.2	673.9	718.5
Per share[1]	$ 1.57	$ (.10)	$ 1.65

[1] For 2008, amount represents basic earnings per share since diluted earnings per share was antidilutive due to the net loss for the year.

See notes to consolidated financial statements.

The Progressive Corporation and Subsidiaries

Consolidated Balance Sheets

December 31,

(millions)	2009	2008
Assets		
Investments — Available-for-sale, at fair value:		
Fixed maturities (amortized cost: $11,717.0 and $10,295.3)	$11,563.4	$ 9,946.7
Equity securities:		
Nonredeemable preferred stocks (cost: $665.4 and $1,131.3)	1,255.8	1,150.0
Common equities (cost: $598.4 and $553.6)	816.2	727.8
Short-term investments (amortized cost: $1,078.0 and $1,153.6)	1,078.0	1,153.6
Total investments	14,713.4	12,978.1
Cash	160.7	2.9
Accrued investment income	110.4	125.7
Premiums receivable, net of allowance for doubtful accounts of $116.4 and $113.7	2,454.8	2,408.6
Reinsurance recoverables, including $35.4 and $44.0 on paid losses and loss adjustment expenses	564.8	288.5
Prepaid reinsurance premiums	69.3	62.4
Deferred acquisition costs	402.2	414.0
Income taxes	416.7	821.6
Property and equipment, net of accumulated depreciation of $595.8 and $653.6	961.3	997.1
Other assets	195.7	151.6
Total assets	$20,049.3	$18,250.5
Liabilities and Shareholders' Equity		
Unearned premiums	$ 4,172.9	$ 4,175.9
Loss and loss adjustment expense reserves	6,653.0	6,177.4
Accounts payable, accrued expenses, and other liabilities[1]	1,297.6	1,506.4
Debt	2,177.2	2,175.5
Total liabilities	14,300.7	14,035.2
Common Shares, $1.00 par value (authorized 900.0; issued 797.8 and 797.9, including treasury shares of 125.2 and 121.4)	672.6	676.5
Paid-in capital	939.7	892.9
Retained earnings	3,683.1	2,697.8
Accumulated other comprehensive income (loss):		
Net unrealized gains (losses) on securities	456.3	(76.8)
Portion of OTTI losses recognized in other comprehensive income	(26.1)	—
Total net unrealized gains (losses) on securities	430.2	(76.8)
Net unrealized gains on forecasted transactions	21.6	24.9
Foreign currency translation adjustment	1.4	—
Total accumulated other comprehensive income (loss)	453.2	(51.9)
Total shareholders' equity	5,748.6	4,215.3
Total liabilities and shareholders' equity	$20,049.3	$18,250.5

[1]See *Note 12 – Litigation* and *Note 13 – Commitments and Contingencies* for further discussion.

See notes to consolidated financial statements.

The Progressive Corporation and Subsidiaries

Consolidated Statements of Changes in Shareholders' Equity

For the years ended December 31,

(millions — except per share amounts)	2009		2008		2007	
Retained Earnings						
Balance, Beginning of year	$2,697.8		$ 2,927.7		$ 4,646.9	
Cumulative effect of change in accounting principle	189.6		—		—	
Net income (loss)	1,057.5	$1,057.5	(70.0)	$ (70.0)	1,182.5	$1,182.5
Cash dividends declared on common shares ($.1613, $0, and $2.1450 per share)	(108.5)		—		(1,507.6)	
Treasury shares purchased	(154.5)		(157.1)		(1,388.4)	
Other, net	1.2		(2.8)		(5.7)	
Balance, End of year	$3,683.1		$ 2,697.8		$ 2,927.7	
Accumulated Other Comprehensive Income (Loss), Net of Tax						
Balance, Beginning of year	$ (51.9)		$ 492.8		$ 604.3	
Cumulative effect of change in accounting principle	(189.6)		—		—	
Changes in:						
Net unrealized gains (losses) on securities		722.7		(541.8)		(131.8)
Portion of OTTI losses recognized in other comprehensive income (loss)		(26.1)		—		—
Total net unrealized gains (losses) on securities		696.6		(541.8)		(131.8)
Net unrealized gains on forecasted transactions		(3.3)		(2.9)		20.3
Foreign currency translation adjustment		1.4		—		—
Other comprehensive income (loss)	694.7	694.7	(544.7)	(544.7)	(111.5)	(111.5)
Balance, End of year	$ 453.2		$ (51.9)		$ 492.8	
Comprehensive Income (Loss)		$1,752.2		$(614.7)		$1,071.0
Common Shares, $1.00 Par Value						
Balance, Beginning of year	$ 676.5		$ 680.2		$ 748.0	
Stock options exercised	3.5		3.5		3.4	
Treasury shares purchased	(11.1)		(9.9)		(72.9)	
Restricted stock issued, net of forfeitures	3.7		2.7		1.7	
Balance, End of year	$ 672.6		$ 676.5		$ 680.2	
Paid-In Capital						
Balance, Beginning of year	$ 892.9		$ 834.8		$ 847.4	
Stock options exercised	15.3		23.5		27.4	
Tax benefits from exercise/vesting of stock-based compensation	9.7		11.1		15.5	
Treasury shares purchased	(15.0)		(12.4)		(87.1)	
Restricted stock issued, net of forfeitures	(3.7)		(2.7)		(1.7)	
Amortization of stock-based compensation	39.2		35.1		28.0	
Other	1.3		3.5		5.3	
Balance, End of year	$ 939.7		$ 892.9		$ 834.8	
Total Shareholders' Equity	$5,748.6		$ 4,215.3		$ 4,935.5	

There are 20.0 million Serial Preferred Shares authorized; no such shares are issued or outstanding.
There are 5.0 million Voting Preference Shares authorized; no such shares have been issued.

See notes to consolidated financial statements.

The Progressive Corporation and Subsidiaries

Consolidated Statements of Cash Flows

For the years ended December 31,

(millions)	2009	2008	2007
Cash Flows From Operating Activities			
Net income (loss)	$ 1,057.5	$ (70.0)	$ 1,182.5
Adjustments to reconcile net income (loss) to net cash provided by operating activities:			
Depreciation	87.3	99.1	106.9
Amortization of fixed-income securities	230.8	249.6	284.1
Amortization of stock-based compensation	40.3	34.5	26.5
Net realized (gains) losses on securities	(27.1)	1,445.1	(106.3)
Net loss on disposition of property and equipment	13.3	1.6	.4
Changes in:			
Premiums receivable	(46.2)	(13.5)	103.1
Reinsurance recoverables	(276.3)	46.6	98.7
Prepaid reinsurance premiums	(6.9)	7.4	19.7
Deferred acquisition costs	11.8	12.3	14.7
Income taxes	29.7	(423.8)	(30.3)
Unearned premiums	(3.0)	(34.5)	(124.6)
Loss and loss adjustment expense reserves	475.6	234.7	217.7
Accounts payable, accrued expenses, and other liabilities	(71.8)	(101.2)	2.4
Other, net	(28.2)	61.3	(4.5)
Net cash provided by operating activities	1,486.8	1,549.2	1,791.0
Cash Flows From Investing Activities			
Purchases:			
Fixed maturities	(10,046.3)	(7,593.9)	(8,184.6)
Equity securities	(624.2)	(598.3)	(1,490.3)
Short-term investments – auction rate securities	—	(631.5)	(7,156.6)
Sales:			
Fixed maturities	7,950.0	5,629.5	8,327.6
Equity securities	919.4	1,401.0	775.2
Short-term investments – auction rate securities	—	631.5	7,325.4
Maturities, paydowns, calls, and other:			
Fixed maturities	842.5	505.5	557.9
Equity securities	15.7	34.9	10.7
Net sales (purchases) of short-term investments – other	75.6	(771.0)	30.0
Net unsettled security transactions	(246.5)	177.2	35.1
Purchases of property and equipment	(66.6)	(98.5)	(136.3)
Sales of property and equipment	1.8	1.1	2.0
Net cash provided by (used in) investing activities	(1,178.6)	(1,312.5)	96.1
Cash Flows From Financing Activities			
Proceeds from exercise of stock options	18.8	27.0	30.8
Tax benefits from exercise/vesting of stock-based compensation	9.7	11.1	15.5
Proceeds from debt[1]	—	—	1,021.7
Dividends paid to shareholders	—	(98.3)	(1,406.5)
Acquisition of treasury shares	(180.6)	(179.4)	(1,548.4)
Net cash used in financing activities	(152.1)	(239.6)	(1,886.9)
Effect of exchange rate changes on cash	1.7	—	—
Increase (decrease) in cash	157.8	(2.9)	.2
Cash, Beginning of year	2.9	5.8	5.6
Cash, End of year	$ 160.7	$ 2.9	$ 5.8

[1]2007 includes a pretax gain received upon closing a forecasted debt issuance hedge. See *Note 4 – Debt* for further discussion.

See notes to consolidated financial statements.

1. REPORTING AND ACCOUNTING POLICIES

Nature of Operations The Progressive Corporation, an insurance holding company formed in 1965, owned 53 subsidiaries and had 1 mutual insurance company affiliate as of December 31, 2009. Our insurance subsidiaries provide personal and commercial automobile insurance and other specialty property-casualty insurance and related services. Our Personal Lines segment writes insurance for personal autos and recreational vehicles through both an independent insurance agency channel and a direct channel. Our Commercial Auto segment writes primary liability and physical damage insurance for automobiles and trucks owned by small businesses through both the independent agency and direct channels. We operate our businesses throughout the United States; in December 2009, we began selling personal auto physical damage insurance via the Internet in Australia.

Basis of Consolidation and Reporting The accompanying consolidated financial statements include the accounts of The Progressive Corporation, its subsidiaries, and affiliate. All of the subsidiaries and the mutual company affiliate are wholly owned or controlled. We achieve control of our mutual company affiliate through a 100% reinsurance contract and a management service contract between a wholly-owned insurance subsidiary and such affiliate. All intercompany accounts and transactions are eliminated in consolidation.

Subsequent events have been evaluated through March 1, 2010, the date the financial statements were issued via filing our Annual Report on Form 10-K with the Securities and Exchange Commission.

Estimates We are required to make estimates and assumptions when preparing our financial statements and accompanying notes in conformity with accounting principles generally accepted in the United States of America (GAAP). As estimates develop into fact (e.g., losses are paid), results may, and will likely, differ from those estimates.

Investments Progressive's fixed-maturity securities, equity securities, and short-term investments are accounted for on an available-for-sale basis. See *Note 2 – Investments* for the detailed composition of our investment portfolio.

Fixed-maturity securities include debt securities and redeemable preferred stocks, which may have fixed or variable principal payment schedules, may be held for indefinite periods of time, and may be used as a part of our asset/liability strategy or sold in response to changes in interest rates, anticipated prepayments, risk/reward characteristics, liquidity needs, or other economic factors. These securities are carried at fair value with the corresponding unrealized gains (losses), net of deferred income taxes, reported in accumulated other comprehensive income. Fair values are obtained from recognized pricing services or are quoted by market makers and dealers, with limited exceptions discussed in *Note 3 – Fair Value*.

Included in the fixed-maturity portfolio are asset-backed securities. The asset-backed securities are generally accounted for under the retrospective method. Under the current accounting guidance, the prospective method is used primarily for interest-only securities, non-investment-grade asset-backed securities, and certain asset-backed securities with sub-prime loan exposure or where there is a greater risk of non-performance, and where it is possible the initial investment may not be substantially recovered. The retrospective method recalculates yield assumptions (based on changes in interest rates or cash flow expectations) historically to the inception of the investment holding period, and applies the required adjustment, if any, to the cost basis, with the offset recorded to investment income. The prospective method requires a calculation of future expected repayments and resets the yield to allow for future period adjustments; no current period impact to investment income or the securities cost is made based on the cash flow update. Prepayment assumptions are based on market expectations and are updated quarterly.

Equity securities include common stocks, nonredeemable preferred stocks, and other risk investments and are reported at quoted fair values. Changes in fair value of these securities, net of deferred income taxes, are reflected as unrealized gains (losses) in accumulated other comprehensive income. To the extent we hold any foreign equities or foreign currency hedges, any change in value due to exchange rate fluctuations would be limited by foreign currency hedges, if any, and would be recognized in income in the current period.

Short-term investments can include auction rate securities (i.e., certain municipal bonds and preferred stocks). Due to the nature of auction rate securities, these securities are classified as short-term based upon their expected auction date (generally 7-49 days) rather than on their contractual obligation (which is greater than one year at original issuance). In the event that an auction fails, the security may need to be reclassified from short term. In addition to auction rate securities, short-term investments may include Eurodollar deposits, commercial paper, reverse repurchase transactions, and other securities expected to mature within one year. Changes in fair value of these securities, net of deferred income taxes, are reflected as unrealized gains (losses) in accumulated other comprehensive income.

Trading securities are securities bought principally for the purpose of sale in the near term. To the extent we have trading securities, changes in fair value would be recognized in income in the current period. Derivative instruments, which may be used for trading purposes or classified as trading derivatives due to the characteristics of the transaction, are discussed below.

Derivative instruments may include futures, options, forward positions, foreign currency forwards, interest rate swap agreements, and credit default swaps and may be used in the portfolio for general investment purposes or to hedge the exposure to:

- Changes in fair value of an asset or liability (fair value hedge);
- Foreign currency of an investment in a foreign operation (foreign currency hedge); or
- Variable cash flows of a forecasted transaction (cash flow hedge).

To the extent we have derivatives held or issued for general investment purposes, these derivative instruments are recognized as either assets or liabilities and measured at fair value with changes in fair value recognized in income as a component of net realized gains (losses) on securities during the period of change.

Derivatives designated as hedges are required to be evaluated on established criteria to determine the effectiveness of their correlation to, and ability to reduce the designated risk of, specific securities or transactions. Effectiveness is required to be reassessed regularly. Hedges that are deemed to be effective would be accounted for as follows:

- *Fair value hedge:* changes in fair value of the hedge, as well as the hedged item, would be recognized in income in the period of change while the hedge was in effect.
- *Foreign currency hedge:* changes in fair value of the hedge, as well as the hedged item, would be reflected as a change in translation adjustment as part of accumulated other comprehensive income. Gains and losses on the foreign currency hedge would offset the foreign exchange gains and losses on the foreign investment as they are recognized into income.
- *Cash flow hedge:* changes in fair value of the hedge would be reported as a component of accumulated other comprehensive income and subsequently amortized into earnings over the life of the hedged transaction (see *Note 4 – Debt* for discussion regarding a forecasted debt issuance hedge we held in 2007).

If a hedge is deemed to become ineffective and discontinued, the following accounting treatment would be applied:

- *Fair value hedge:* the derivative instrument would continue to be adjusted through income, while the adjustment in the change in value of the hedged item would be reflected as a change in unrealized gains (losses) as part of accumulated other comprehensive income.
- *Foreign currency hedge:* changes in the value of the hedged item would continue to be reflected as a change in translation adjustment as part of accumulated other comprehensive income, but the derivative instrument would be adjusted through income for the current period.
- *Cash flow hedge:* changes in fair value of the derivative instrument would be reported in income for the current period.

For all derivative positions, net cash requirements are limited to changes in fair values, which may vary based upon changes in interest rates, currency exchange rates, and other factors. Exposure to credit risk is limited to the carrying value;

collateral may be required to limit credit risk. We have elected not to offset fair value amounts that arise from derivative positions with the same counterparty under a master netting arrangement.

Investment securities are exposed to various risks such as interest rate, market, credit, and liquidity risk. Fair values of securities fluctuate based on the nature and magnitude of changing market conditions; significant changes in market conditions could materially affect the portfolio's value in the near term. We regularly monitor our portfolio for price changes, which might indicate potential impairments, and perform detailed reviews of securities with unrealized losses based on predetermined guidelines. In such cases, changes in fair value are evaluated to determine the extent to which such changes are attributable to (i) fundamental factors specific to the issuer, such as financial condition, business prospects, or other factors, (ii) market-related factors, such as interest rates or equity market declines, or (iii) credit-related losses, where the present value of cash flows expected to be collected are lower than the amortized cost basis of the security.

We analyze our debt securities to determine if we intend to sell, or if it is more likely than not that we will be required to sell, the security prior to recovery and, if so, we write down the security to its current fair value with the entire amount of the write-down recorded to earnings. To the extent that it is more likely than not that we will hold the debt security until recovery (which could be maturity), we determine if any of the decline in value is due to a credit loss (i.e., where the present value of cash flows expected to be collected is lower than the amortized cost basis of the security) and, if so, we recognize that portion of the impairment in earnings, with the balance (i.e., non-credit related impairment in 2009) recognized as part of our net unrealized gains (losses) in accumulated other comprehensive income. When an equity security (common equity and nonredeemable preferred stock) in our investment portfolio has an unrealized loss in fair value that is deemed to be other-than-temporary, we reduce the book value of such security to its current fair value, recognizing the decline as a realized loss in the income statement. Any future changes in fair value, either increases or decreases, are reflected as changes in unrealized gains (losses) as part of accumulated other comprehensive income.

Realized gains (losses) on securities are computed based on the first-in first-out method and include write-downs on available-for-sale securities considered to have other-than-temporary declines in fair value (excluding non-credit related impairments), as well as holding period valuation changes on derivatives, trading securities, and hybrid instruments (securities with embedded call options, where the call option is a feature of the overall change in the value of the instrument).

Insurance Premiums and Receivables Insurance premiums written are earned into income on a pro rata basis over the period of risk, based on a daily earnings convention. Accordingly, unearned premiums represent the portion of premiums written that is applicable to the unexpired risk. We provide insurance and related services to individuals and small commercial accounts and offer a variety of payment plans. Generally, premiums are collected prior to providing risk coverage, minimizing our exposure to credit risk. We perform a policy level evaluation to determine the extent to which the premiums receivable balance exceeds the unearned premiums balance. We then age this exposure to establish an allowance for doubtful accounts based on prior experience.

Deferred Acquisition Costs Deferred acquisition costs include commissions, premium taxes, and other variable underwriting and direct sales costs incurred in connection with writing business. These costs are deferred and amortized over the policy period in which the related premiums are earned. We consider anticipated investment income in determining the recoverability of these costs. Management believes that these costs will be fully recoverable in the near term. We do not defer any direct-response advertising costs.

Loss and Loss Adjustment Expense Reserves Loss reserves represent the estimated liability on claims reported to us, plus reserves for losses incurred but not recorded (IBNR). These estimates are reported net of amounts estimated to be recoverable from salvage and subrogation. Loss adjustment expense reserves represent the estimated expenses required to settle these claims and losses. The methods of making estimates and establishing these reserves are reviewed regularly, and resulting adjustments are reflected in income currently. Such loss and loss adjustment expense reserves are susceptible to change in the near term.

Reinsurance Our reinsurance transactions primarily include premiums written under state-mandated involuntary plans for commercial vehicles (Commercial Auto Insurance Procedures/Plans – "CAIP") and premiums ceded to state-provided reinsurance facilities (e.g., Michigan Catastrophic Claims Association, North Carolina Reinsurance Facility) (collectively, "State Plans"), for which we retain no loss indemnity risk (see *Note 7 – Reinsurance* for further discussion). We also cede a portion of the premiums in our non-auto programs to limit our exposure in those particular markets. Prepaid reinsurance premiums are earned on a pro rata basis over the period of risk, based on a daily earnings convention, which is consistent with premiums written.

Income Taxes The income tax provision is calculated under the balance sheet approach. Deferred tax assets and liabilities are recorded based on the difference between the financial statement and tax bases of assets and liabilities at the enacted tax rates. The principal assets and liabilities giving rise to such differences are write-downs of investment securities determined to be other-than-temporarily impaired, net unrealized gains (losses) on securities, loss reserves, unearned premiums reserves, deferred acquisition costs, and non-deductible accruals. We review our deferred tax assets regularly for recoverability. See *Note 5 – Income Taxes* for further discussion.

Property and Equipment Property and equipment are recorded at cost, less accumulated depreciation. Depreciation is recognized over the estimated useful lives of the assets using accelerated methods for computer equipment and the straight-line method for all other fixed assets. The useful lives range from 3 to 4 years for computer equipment, 10 to 40 years for buildings and improvements, and 3 to 10 years for all other property and equipment. Land and buildings comprised 77% and 78% of total property and equipment at December 31, 2009 and 2008, respectively. Property and equipment include capitalized software developed or acquired for internal use. Total interest capitalized was $2.6 million in 2009, $5.0 million in 2008, and $2.4 million in 2007, relating to capitalized computer software costs and construction projects.

Guaranty Fund Assessments We are subject to state guaranty fund assessments, which provide for the payment of covered claims or other insurance obligations of insurance companies deemed insolvent. These assessments are accrued after a formal determination of insolvency has occurred, and we have written the premiums on which the assessments will be based.

Service Revenues and Expenses Our service businesses provide insurance-related services. Service revenues generated from processing business for involuntary CAIP plans are earned on a pro rata basis over the term of the related policies. Service expenses related to these CAIP plans include acquisition expenses, which are deferred and amortized over the period in which the related revenues are earned. Other service business revenues and expenses are recorded in the period in which they are earned or incurred.

Stock-Based Compensation We issue restricted stock awards, both time-based and performance-based, as our form of equity compensation to key members of management and non-employee directors. We currently do not issue stock options as a form of equity compensation, although there are vested options still outstanding as of December 31, 2009. Compensation expense for restricted stock awards is recognized over the respective vesting periods. For the years ended December 31, 2009, 2008, and 2007, the pretax expense of our stock-based compensation was $40.3 million, $34.5 million, and $26.5 million, respectively (tax benefit of $14.1 million, $12.1 million, and $9.3 million).

We record an estimate for expected forfeitures of restricted stock based on our historical forfeiture rates. In addition, we shorten the vesting periods of certain stock-based awards based on the “qualified retirement” provisions in our incentive compensation plans, under which (among other provisions) the vesting of 50% of outstanding time-based restricted stock awards will accelerate upon retirement if the participant is 55 years of age or older and satisfies certain years-of-service requirements.

Earnings Per Share Basic earnings per share are computed using the weighted average number of common shares outstanding, excluding both the time-based and performance-based unvested restricted stock awards that are subject to forfeiture. Diluted earnings per share include common stock equivalents assumed outstanding during the period. Our common stock equivalents include stock options and time-based restricted stock awards accounted for as equity awards. In periods where we report a net loss, the calculated diluted earnings per share is antidilutive, therefore, basic earnings per share is reported.

Supplemental Cash Flow Information Cash includes only bank demand deposits. We paid income taxes, net of recoverables received, if any, of $461.7 million, $258.0 million, and $526.0 million in 2009, 2008, and 2007, respectively. Total interest paid was $144.7 million during both 2009 and 2008 and $110.1 million during 2007. Non-cash activity includes declared but unpaid dividends.

New Accounting Standards During 2009, the Financial Accounting Standards Board (FASB) issued updated guidance on accounting for transfers of financial assets. This guidance eliminates the concept of a qualifying special-purpose entity and its exemption from consolidation in the transferor’s financial statements. It also establishes conditions for reporting a transfer of financial assets as sales and requires additional disclosure. This guidance is effective for fiscal years beginning after November 15, 2009 (January 2010 for calendar-year companies). Based on our current investment portfolio, we do not expect the guidance to have any impact on our financial condition, cash flows, or results of operations.

During 2009, the FASB issued guidance which: (i) replaces the quantitative-based risks and rewards calculation for determining whether an enterprise is the primary beneficiary in a variable interest entity with an approach that is primarily qualitative; (ii) requires ongoing assessments of whether an enterprise is the primary beneficiary of a variable interest entity; and (iii) requires additional disclosures about an enterprise's involvement in variable interest entities. This guidance is effective for fiscal years beginning after November 15, 2009 (January 2010 for calendar-year companies). Based on our current investment portfolio, we do not expect the guidance to have any impact on our financial condition, cash flows, or results of operations.

2. INVESTMENTS

The following table presents the composition of our investment portfolio by major security type, consistent with our internal classification of how we manage, monitor, and measure the portfolio:

($ in millions)	Cost	Gross Unrealized Gains	Gross Unrealized Losses	Net Realized Gains (Losses)[1]	Fair Value	% of Total Fair Value
December 31, 2009						
Fixed maturities:						
U.S. government obligations	$ 4,939.6	$ 6.4	$(128.5)	$ —	$ 4,817.5	32.8%
State and local government obligations	1,974.2	55.1	(5.3)	—	2,024.0	13.8
Corporate debt securities	1,244.9	43.4	(6.9)	—	1,281.4	8.7
Residential mortgage-backed securities	592.0	4.3	(79.9)	—	516.4	3.5
Commercial mortgage-backed securities	1,572.0	37.0	(18.9)	—	1,590.1	10.8
Other asset-backed securities	721.9	6.1	(1.8)	—	726.2	4.9
Redeemable preferred stocks	671.3	20.7	(85.3)	—	606.7	4.1
Other debt obligations	1.1	—	—	—	1.1	—
Total fixed maturities	11,717.0	173.0	(326.6)	—	11,563.4	78.6
Equity securities:						
Nonredeemable preferred stocks	665.4	597.6	—	(7.2)	1,255.8	8.5
Common equities	598.4	220.1	(2.3)	—	816.2	5.6
Short-term investments - other	1,078.0	—	—	—	1,078.0	7.3
Total portfolio[2,3]	$14,058.8	$990.7	$(328.9)	$ (7.2)	$14,713.4	100.0%

($ in millions)	Cost	Gross Unrealized Gains	Gross Unrealized Losses	Net Realized Gains (Losses)[1]	Fair Value	% of Total Fair Value
December 31, 2008						
Fixed maturities:						
U.S. government obligations	$ 3,565.7	$129.0	$ (1.1)	$ —	$ 3,693.6	28.5%
State and local government obligations	3,041.4	53.1	(90.1)	—	3,004.4	23.1
Foreign government obligations	16.2	.2	—	—	16.4	.1
Corporate debt securities	692.1	1.6	(54.4)	—	639.3	4.9
Residential mortgage-backed securities	758.7	1.4	(137.1)	—	623.0	4.8
Commercial mortgage-backed securities	1,692.7	1.0	(243.7)	—	1,450.0	11.2
Other asset-backed securities	139.2	—	(10.1)	—	129.1	1.0
Redeemable preferred stocks	387.2	8.7	(8.0)	—	387.9	3.0
Other debt obligations	2.1	.9	—	—	3.0	—
Total fixed maturities	10,295.3	195.9	(544.5)	—	9,946.7	76.6
Equity securities:						
Nonredeemable preferred stocks	1,131.3	73.5	(17.3)	(37.5)	1,150.0	8.9
Common equities	553.6	203.5	(29.3)	—	727.8	5.6
Short-term investments - other	1,153.6	—	—	—	1,153.6	8.9
Total portfolio[2,3]	$13,133.8	$472.9	$(591.1)	$(37.5)	$12,978.1	100.0%

[1] Represents net holding period gains (losses) on certain hybrid securities (discussed below).

[2] At December 31, 2009 and 2008, we had $7.7 million and $254.2 million, respectively, of net unsettled security transactions offset in other liabilities.

[3] Includes $2.2 billion and $1.0 billion at December 31, 2009 and 2008, respectively, of securities in the portfolio of a consolidated, non-insurance subsidiary of the holding company, net of any unsettled security transactions.

Our fixed-maturity securities include debt securities and redeemable preferred stocks. At December 31, 2009 and 2008, the nonredeemable preferred stock portfolio included $66.3 million and $53.0 million, respectively, of hybrid securities (i.e., perpetual preferred stocks that have call features with fixed-rate coupons, whereby the change in value of the call feature is a component of the overall change in value of the preferred stock). Common equities include common stocks and other risk investments (e.g., private equity investments). Our other short-term investments include Eurodollar deposits, commercial paper, and other investments which are expected to mature within one year. At December 31, 2009, our other short-term investments also included $0.9 million in treasury bills issued by the Australian government.

At December 31, 2009, bonds and certificates of deposit in the principal amount of $131.9 million were on deposit to meet state insurance regulatory and/or rating agency requirements. We did not have any securities of any one issuer, excluding U.S. government obligations with an aggregate cost or fair value exceeding 10% of total shareholders' equity at December 31, 2009 or 2008. At December 31, 2009, we had fixed-maturity securities with a fair value of $1.1 million that were non-income producing during the preceding 12 months.

Fixed Maturities The composition of fixed maturities by maturity at December 31, 2009 was:

(millions)	Cost	Fair Value
Less than one year	$ 1,231.1	$ 1,220.9
One to five years	7,419.7	7,443.0
Five to ten years	3,013.1	2,857.2
Ten years or greater	53.0	42.2
Total[1]	$11,716.9	$11,563.3

[1]Excludes $0.1 million of gains on the open interest rate swap position.

Asset-backed securities are classified in the maturity distribution table based upon their projected cash flows. All other securities which do not have a single maturity date are reported at expected average maturity. Contractual maturities may differ from expected maturities because the issuers of the securities may have the right to call or prepay obligations.

Net Investment Income The components of net investment income for the years ended December 31, were:

(millions)	2009	2008	2007
Fixed maturities:			
U.S. government obligations	$ 79.6	$ 54.1	$115.0
State and local government obligations	91.9	126.5	135.9
Corporate debt securities	48.2	53.4	52.7
Residential mortgage-backed securities	33.4	47.1	40.3
Commercial mortgage-backed securities	90.7	102.1	94.8
Other asset-backed securities	9.7	6.9	6.7
Redeemable preferred stocks	47.5	47.0	32.0
Other debt obligations	.3	1.3	1.2
Total fixed maturities	401.3	438.4	478.6
Equity securities:			
Nonredeemable preferred stocks	89.7	144.5	126.9
Common equities	13.3	38.9	46.2
Short-term investments:			
Auction-rate municipal obligations	—	1.4	2.6
Auction-rate preferred stocks	—	—	.8
Other short-term investments	2.7	14.5	25.7
Investment income	507.0	637.7	680.8
Investment expenses	(11.1)	(8.8)	(12.4)
Net investment income	$495.9	$628.9	$668.4

Net Realized Gains (Losses) The components of net realized gains (losses) for the years ended December 31, were:

(millions)	**2009**	**2008**	**2007**
Gross realized gains on security sales			
Fixed maturities:			
U.S. government obligations	$ 103.1	$ 243.2	$100.2
State and local government obligations	35.2	17.3	3.1
Corporate and other debt securities	20.5	5.5	7.1
Commercial mortgage-backed securities	.8	—	—
Redeemable preferred stocks	—	—	2.9
Total fixed maturities	159.6	266.0	113.3
Equity securities:			
Nonredeemable preferred stocks	32.6	11.6	2.1
Common equities	148.5	320.7	55.4
Short-term investments - other	—	—	.1
Subtotal gross realized gains on security sales	340.7	598.3	170.9
Gross realized losses on security sales			
Fixed maturities:			
U.S. government obligations	(2.1)	(.7)	(14.2)
State and local government obligations	(7.6)	—	(.8)
Corporate and other debt securities	(.5)	(13.1)	(4.0)
Residential mortgage-backed securities	(3.2)	—	(1.0)
Commercial mortgage-backed securities	(9.9)	(1.4)	(.3)
Other asset-backed securities	(.7)	(.4)	—
Redeemable preferred stocks	—	(1.8)	(1.4)
Total fixed maturities	(24.0)	(17.4)	(21.7)
Equity securities:			
Nonredeemable preferred stocks	(57.3)	(541.8)	(2.2)
Common equities	(40.0)	(179.3)	(33.4)
Subtotal gross realized losses on security sales	(121.3)	(738.5)	(57.3)
Net realized gains (losses) on security sales			
Fixed maturities:			
U.S. government obligations	101.0	242.5	86.0
State and local government obligations	27.6	17.3	2.3
Corporate and other debt securities	20.0	(7.6)	3.1
Residential mortgage-backed securities	(3.2)	—	(1.0)
Commercial mortgage-backed securities	(9.1)	(1.4)	(.3)
Other asset-backed securities	(.7)	(.4)	—
Redeemable preferred stocks	—	(1.8)	1.5
Total fixed maturities	135.6	248.6	91.6
Equity securities:			
Nonredeemable preferred stocks	(24.7)	(530.2)	(.1)
Common equities	108.5	141.4	22.0
Short-term investments - other	—	—	.1
Subtotal net realized gains (losses) on security sales	219.4	(140.2)	113.6
Other-than-temporary impairment losses			
Fixed maturities:			
Corporate and other debt securities	—	(69.0)	—
Residential mortgage-backed securities	(32.0)	(38.2)	(1.7)
Commercial mortgage-backed securities	(.9)	(.6)	(.2)
Redeemable preferred stocks	(6.1)	(301.0)	—
Total fixed maturities	(39.0)	(408.8)	(1.9)
Equity securities:			
Nonredeemable preferred stocks	(158.8)	(941.3)	(17.4)
Common equities	(10.3)	(43.0)	(.3)
Subtotal other-than-temporary impairment losses	(208.1)	(1,393.1)	(19.6)
Net holding period gains (losses)			
Hybrid preferred stocks	14.5	(73.6)	(7.4)
Derivative instruments	1.3	161.8	19.7
Subtotal net holding period gains (losses)	15.8	88.2	12.3
Total net realized gains (losses) on securities	$ 27.1	$(1,445.1)	$106.3

Gross realized gains and losses were the result of traditional investment sales transactions in our fixed-income portfolio, affected by movements in credit spreads and interest rates, sales of our common stocks to reduce our risk exposure, rebalancing of our equity-indexed portfolio, tax management, and holding period valuation changes on hybrids and derivatives. In addition, in 2007, gains and losses also reflected the sale of securities to fund our $1.4 billion extraordinary dividend payment in September 2007. Also included are write-downs for securities determined to be other-than-temporarily impaired in our fixed-maturity and/or equity portfolios. These write-downs were the result of fundamental matters related to either specific issues or issuers and/or the significant decline in the credit and mortgage-related markets.

Other-than-Temporary Impairment (OTTI) During 2009, we adopted the new accounting standards related to OTTI that provide guidance in determining whether impairments in debt securities are other-than-temporary and require additional disclosures relating to OTTI and unrealized losses on investments; the new standards did not change the impairment model for equity securities.

The new guidance required that, during the initial period of adoption, we record a cumulative effect of change in accounting principle to reclassify the non-credit component of a previously recognized OTTI from retained earnings to other comprehensive income. Based on our review of OTTI losses on securities held at March 31, 2009, we reclassified $189.6 million (or $291.8 million on a pretax basis) from retained earnings to accumulated other comprehensive income (loss) during the second quarter 2009.

The following table shows our OTTI losses separated between those related to a credit loss and the portion that was a non-credit related impairment for the period since the adoption of the new guidance (second quarter 2009):

(millions)	**Total OTTI**	**Credit Related and Other OTTI (Income Statement)**	**Non-Credit Related OTTI (Balance Sheet)[1]**
Fixed maturities:			
Residential mortgage-backed:			
Bifurcated	$56.6	$16.9	$39.7
Non-bifurcated[2]	14.2	14.2	—
Total residential mortgage-backed	70.8	31.1	39.7
Commercial mortgage-backed - bifurcated	1.3	.9	.4
Other asset-backed - non-bifurcated[2]	.2	.2	—
Total fixed maturities	72.3	32.2	40.1
Nonredeemable preferred stocks	6.9	6.9	NA
Common equities	1.7	1.7	NA
Total	$80.9	$40.8	$40.1

NA = Not Applicable

[1]Reflects the non-credit related OTTI recorded as a component of accumulated other comprehensive income at the time the credit impairment was determined. The valuation on these positions improved by $16.0 million subsequent to the write-downs, resulting in a remaining balance of $24.1 million in accumulated other comprehensive income at December 31, 2009.

[2]Represents securities where our total OTTI losses were credit related; no unrealized losses are recorded as a component of accumulated other comprehensive income.

The following table provides a rollforward of the amounts related to credit losses recognized in earnings for which a portion of the OTTI loss was recognized in accumulated other comprehensive income at the time the credit impairment was determined and recognized:

(millions)	Commercial Mortgage-Backed	Corporate Debt	Residential Mortgage-Backed	Total
Beginning balance at April 1, 2009	$—	$6.5	$24.2	$30.7
Credit losses for which an OTTI was previously recognized	—	—	1.4	1.4
Credit losses for which an OTTI was not previously recognized	.9	—	15.5	16.4
Ending balance at December 31, 2009	$ .9	$6.5	$41.1	$48.5

Since it was determined that it is more likely than not that we will not be required to sell the securities prior to the recovery (which could be maturity) of their respective cost bases, in order to measure the amount of credit losses on the securities that were determined to be other-than-temporarily impaired during the year, we considered a number of factors and inputs related to the individual securities. The methodology and significant inputs used to measure the amount of credit losses in our asset-backed portfolio included: current performance indicators on the underlying assets (i.e., delinquency rates, foreclosure rates, and default rates), credit support (via current levels of subordination), and historical credit ratings. Updated cash flow expectations were also generated by our portfolio managers based upon these performance indicators. In order to determine the amount of credit loss, if any, the net present value of the cash flows expected (i.e., expected recovery value) was calculated using the current implied yield for each security, and was compared to its current amortized value. In the event that the net present value was below the amortized value, a credit loss was deemed to exist, and the security was written-down.

Gross Unrealized Losses As of December 31, 2009, we had $326.6 million of gross unrealized losses in our fixed-income portfolio (i.e., fixed-maturity securities, nonredeemable preferred stocks, and short-term investments) and $2.3 million in our common equities. We currently do not intend to sell the fixed-income securities and determined that it is more likely than not that we will not be required to sell these securities for the period of time necessary to recover their cost bases. In addition, we may retain the common stocks to maintain correlation to the Russell 1000 Index, as long as the portfolio and index correlation remain similar. If our strategy was to change and these securities were determined to be other-than-temporarily impaired, we would recognize a write-down in accordance with our stated policy.

The following tables show the composition of gross unrealized losses by major security type by the length of time that individual securities have been in a continuous unrealized loss position:

(millions)	Total Fair Value	Total Unrealized Losses	Less than 12 Months		12 Months or Greater	
			Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
December 31, 2009						
Fixed maturities:						
U.S. government obligations	$4,595.3	$(128.5)	$2,408.1	$ (6.4)	$2,187.2	$(122.1)
State and local government obligations	448.6	(5.3)	41.3	(.2)	407.3	(5.1)
Corporate debt securities	344.2	(6.9)	264.6	(1.8)	79.6	(5.1)
Residential mortgage-backed securities	367.4	(79.9)	27.9	(2.5)	339.5	(77.4)
Commercial mortgage-backed securities	386.1	(18.9)	32.6	(.9)	353.5	(18.0)
Other asset-backed securities	81.6	(1.8)	71.6	(.3)	10.0	(1.5)
Redeemable preferred stocks	507.5	(85.3)	—	—	507.5	(85.3)
Total fixed maturities	6,730.7	(326.6)	2,846.1	(12.1)	3,884.6	(314.5)
Equity securities - common equities	30.7	(2.3)	20.9	(1.7)	9.8	(.6)
Total portfolio	$6,761.4	$(328.9)	$2,867.0	$(13.8)	$3,894.4	$(315.1)

(millions)	Total Fair Value	Total Unrealized Losses	Less than 12 Months Fair Value	Less than 12 Months Unrealized Losses	12 Months or Greater Fair Value	12 Months or Greater Unrealized Losses
December 31, 2008						
Fixed maturities:						
U.S. government obligations	$ 232.5	$ (1.1)	$ 232.5	$ (1.1)	$ —	$ —
State and local government obligations	1,100.6	(90.1)	274.8	(17.9)	825.8	(72.2)
Corporate debt securities	493.1	(54.4)	278.3	(27.4)	214.8	(27.0)
Residential mortgage-backed securities	592.8	(137.1)	219.1	(41.4)	373.7	(95.7)
Commercial mortgage-backed securities	1,422.1	(243.7)	842.9	(116.7)	579.2	(127.0)
Other asset-backed securities	128.8	(10.1)	117.7	(7.4)	11.1	(2.7)
Redeemable preferred stocks	60.6	(8.0)	60.6	(8.0)	—	—
Total fixed maturities	4,030.5	(544.5)	2,025.9	(219.9)	2,004.6	(324.6)
Equity securities:						
Nonredeemable preferred stocks	437.6	(17.3)	305.4	(13.2)	132.2	(4.1)
Common equities	123.2	(29.3)	110.5	(26.5)	12.7	(2.8)
Total equity securities	560.8	(46.6)	415.9	(39.7)	144.9	(6.9)
Total portfolio	$4,591.3	$(591.1)	$2,441.8	$(259.6)	$2,149.5	$(331.5)

The $85.3 million gross unrealized losses in our redeemable preferred stock portfolio reflects the effect of our $266.7 million reclassification, on a pretax basis, of prior other-than-temporary impairment losses under the accounting guidance for impairments that was adopted during 2009, partially offset by the subsequent recovery in value recorded during the remainder of 2009.

Included in gross unrealized losses at December 31, 2009, was $24.1 million related to securities for which a portion of the OTTI loss was recorded in earnings as a credit loss. The fair value and gross unrealized losses for these securities were comprised of the following:

(millions)	Total Fair Value	Total Unrealized Losses	Less than 12 Months Fair Value	Less than 12 Months Unrealized Losses	12 Months or Greater Fair Value	12 Months or Greater Unrealized Losses
Fixed maturities:						
Residential mortgage-backed securities	$77.4	$(23.6)	$15.6	$(1.9)	$61.8	$(21.7)
Commercial mortgage-backed securities	1.8	(.5)	.5	(.2)	1.3	(.3)
Total fixed maturities	$79.2	$(24.1)	$16.1	$(2.1)	$63.1	$(22.0)

Trading Securities At December 31, 2009 and 2008, we did not hold any trading securities and we did not have any net realized gains (losses) on trading securities for the years ended December 31, 2009, 2008, and 2007.

Derivative Instruments We have invested in the following derivative exposures at various times: interest rate swaps, asset-backed credit default swaps, U.S. corporate debt credit default swaps, and cash flow hedges. In addition, during 2009, we invested in equity options as an economic, forecasted forward sale.

For all derivative positions discussed below, realized holding period gains and losses are netted with any upfront cash that may be exchanged under the contract to determine if the net position should be classified either as an asset or liability. To be reported as a component of the available-for-sale portfolio, the inception-to-date realized gain on the derivative position at period end would have to exceed any upfront cash received (net derivative asset). On the other hand, a net derivative liability would include any inception-to-date realized loss plus the amount of upfront cash received (or netted, if upfront cash was paid) and would be reported as a component of other liabilities. These net derivative assets/liabilities are not separately disclosed on the balance sheet due to their immaterial effect on our financial condition, cash flows, and results of operations.

The following table shows the status of our derivative instruments at December 31, 2009 and 2008, and for the years ended December 31, 2009, 2008, and 2007; amounts are on a pretax basis:

(millions)					Balance Sheet			Income Statement		
	Notional Value[1]					Fair Value		Net Realized Gains (Losses) on Securities		
	December 31,					December 31,		Years ended December 31,		
Derivatives designated as:	**2009**	**2008**	**2007**	**Purpose**	**Classification**	**2009**	**2008**	**2009**	**2008**	**2007**
Hedging instruments										
Foreign currency cash flow hedge[2]	$ —	$ 8	$ —	Forecasted transaction	Accumulated other comprehensive income	$—	$ .2	$ —	$ —	$ —
Non-hedging instruments										
Assets:										
Interest rate swaps[3]	713	1,800	1,325	Manage portfolio duration	Investments - fixed maturities	.1	96.3	.1	104.3	53.1
Liabilities:										
Corporate credit default swaps	25	25	—	Manage credit risk	Other liabilities	(.8)	(.5)	(.6)	(.7)	—
Asset-backed credit default swaps	—	—	140	General portfolio investing	NA	—	—	—	—	(45.9)
Closed:										
Interest rate swaps	4,186	1,550	—	Manage portfolio duration	—	—	—	10.4	57.1	—
Corporate credit default swaps	7	545	250	Manage credit risk	—	—	—	(.4)	20.8	10.0
Asset-backed credit default swaps	—	140	50	General portfolio investing	—	—	—	—	(19.7)	2.5
Equity options[4] (177,190 contracts)	NA	NA	NA	Manage price risk	—	—	—	(9.1)	—	—
Foreign currency trade[2]	8	—	—	Manage currency risk	—	—	—	.9	—	—
Total	NA	NA	NA			$(.7)	$96.0	$ 1.3	$161.8	$ 19.7

[1]The amounts represent the value held at year-end for open positions and the maximum amount held during the year for closed positions.

[2]During the fourth quarter 2009, we reclassified our cash flow hedge and closed the position; see *Cash Flow Hedges* below for further discussion.

[3]The $713 million notional value swap was entered into as a short position (i.e., receive variable and pay fixed coupon) while the swaps held at December 31, 2008 and 2007 were long positions (i.e., receive fixed and pay variable coupon).

[4]Each contract is equivalent to 100 shares of common stock of the issuer; we had no option activity in 2008 or 2007.

NA = Not Applicable

CASH FLOW HEDGES
In the fourth quarter 2009, we recognized a realized gain of $0.9 million reflecting the previously deferred gain on our foreign currency cash flow hedge.

During the second quarter 2007, we entered into a forecasted debt issuance hedge against a possible rise in interest rates in anticipation of issuing $1 billion of our 6.70% Fixed-to-Floating Rate Junior Subordinated Debentures due 2067 (the "Debentures"). The hedge was designated as, and qualified for, cash flow hedge accounting treatment. Upon issuance of the Debentures, the hedge was closed, and we recognized a pretax gain of $34.4 million, which is recorded as part of accumulated other comprehensive income. The $34.4 million gain is deferred and is being recognized as an adjustment to interest expense over the 10-year fixed interest rate term of the Debentures. During 2009, 2008, and 2007, we recognized $2.8 million, $2.6 million, and $1.3 million, respectively, as an adjustment to interest expense.

INTEREST RATE SWAPS
During the years ended December 31, 2009, 2008, and 2007, we invested in interest rate swap positions primarily to manage the fixed-income portfolio duration. As of December 31, 2009, no cash collateral was delivered or received on our open interest rate swap position. As of December 31, 2008 and 2007, we had received $79.6 million and $44.4 million, respectively, in cash collateral from the counterparties on our then open interest rate swap positions, which amounts were invested in short-term securities.

CORPORATE CREDIT DEFAULT SWAPS
During the years ended December 31, 2009 and 2008, we held a position, which was opened during the third quarter 2008, on one corporate issuer within the financial services sector where we bought credit default protection in the form of a credit default swap for a 5-year time horizon. We hold this protection to reduce our exposure to potential additional valuation declines on our preferred stock due to credit impairment of the issuer. As of December 31, 2009, we delivered $0.6 million in cash collateral to the counterparty on our open corporate credit default swap position. Additionally, during the third quarter 2009, we closed a position where we bought credit default protection in the form of credit default swaps for a 2-year time horizon on one corporate issuer within the industrial sector. We paid $0.6 million in upfront cash when we entered the 2-year exposure position, which was offset against our then open exposure. During the fourth quarter 2008, we closed positions where we bought credit default protection in the form of credit default swaps for 3-year and 5-year time horizons on debt issuances of nine different corporate issuers within the financial services sector that we opened during the third quarter 2008. We originally purchased the protection to reduce our overall financial sector exposure given the heightened risk in the financial markets at the time and our exposure to financial firms. No cash collateral was delivered or received on these positions during the year ended December 31, 2008.

During the year ended December 31, 2007, we opened and closed positions where we bought credit default protection in the form of credit default swaps on a corporate non-investment-grade index, and we closed positions where we bought credit default swaps on an investment-grade index. No cash collateral was delivered or received on these positions during the year ended December 31, 2007.

EQUITY OPTIONS
During the year ended December 31, 2009, we opened and closed positions where we simultaneously sold and purchased a substantially equivalent amount of call and put options, respectively, on Citigroup common stock, which related to our preferred stock holding. The purpose of this transaction was to effect a forward sale of a portion of the common stock we expected to receive from Citigroup resulting from the conversion of our preferred stock holding into common stock pursuant to Citigroup's exchange that occurred during the third quarter 2009. This was achieved through matching the strike price and term of the option contracts and was meant to offset the downside price risk of the common stock during the time period pending the exchange. All of the common stock we received from the preferred stock conversion was sold by the end of the third quarter. As of December 31, 2009, we did not have any unsettled collateral deliveries related to this position. We had no equity option positions during the years ended December 31, 2008 and 2007.

ASSET-BACKED CREDIT DEFAULT SWAPS
We held no asset-backed credit default swap positions during the year ended December 31, 2009. During the fourth quarter 2008, we closed a position for which we sold credit protection in the form of a credit default swap comprised of a basket of 20 asset-backed bonds supported by sub-prime mortgage loans. We covered the credit default swap's notional exposure by acquiring U.S. Treasury Notes of equal maturity and principal amount and reducing our overall exposure with any upfront cash received. As of December 31, 2009 and 2008, we did not have any collateral deliveries related to this position outstanding. As of December 31, 2007, we delivered $44.8 million ($34.1 million of U.S. Treasury Notes and $10.7 million of cash) in collateral to the counterparties on the asset-backed credit default swap position.

3. FAIR VALUE

We have categorized our financial instruments, based on the degree of subjectivity inherent in the method by which they are valued, into a fair value hierarchy of three levels, as follows:

- *Level 1*: Inputs are unadjusted, quoted prices in active markets for identical instruments at the measurement date (e.g., U.S. government obligations and active exchange-traded equity securities).
- *Level 2*: Inputs (other than quoted prices included within Level 1) that are observable for the instrument either directly or indirectly (e.g., certain corporate and municipal bonds and certain preferred stocks). This includes: (i) quoted prices for similar instruments in active markets, (ii) quoted prices for identical or similar instruments in markets that are not active, (iii) inputs other than quoted prices that are observable for the instruments, and (iv) inputs that are derived principally from or corroborated by observable market data by correlation or other means.
- *Level 3*: Inputs that are unobservable. Unobservable inputs reflect the reporting entity's subjective evaluation about the assumptions market participants would use in pricing the financial instrument (e.g., certain structured securities and privately held investments).

During 2009, we adopted the recently issued fair value guidance, pursuant to generally accepted accounting principles, that requires us to evaluate whether a market is distressed or inactive in determining the fair value for our portfolio. Based on this new guidance, we added to our review certain additional market level inputs to evaluate whether sufficient activity, volume, and new issuances existed to create an active market. Based on this evaluation, we concluded that there was sufficient activity related to the sectors and securities for which we obtained valuations.

The composition of the investment portfolio by major security type was:

	Fair Value				
(millions)	**Level 1**	**Level 2**	**Level 3**	**Total**	**Cost**
December 31, 2009					
Fixed maturities:					
U.S. government obligations	$4,817.5	$ —	$ —	$ 4,817.5	$ 4,939.6
State and local government obligations	—	2,024.0	—	2,024.0	1,974.2
Corporate and other debt securities	—	1,253.2	29.3	1,282.5	1,246.0
Subtotal	4,817.5	3,277.2	29.3	8,124.0	8,159.8
Asset-backed securities:					
Residential mortgage-backed	—	470.3	46.1	516.4	592.0
Commercial mortgage-backed	—	1,568.5	21.6	1,590.1	1,572.0
Other asset-backed	—	718.4	7.8	726.2	721.9
Subtotal asset-backed securities	—	2,757.2	75.5	2,832.7	2,885.9
Redeemable preferred stocks:					
Financials	17.8	231.9	—	249.7	277.2
Utilities	—	66.9	—	66.9	69.4
Industrials	—	237.0	53.1	290.1	324.7
Subtotal redeemable preferred stocks	17.8	535.8	53.1	606.7	671.3
Total fixed maturities	4,835.3	6,570.2	157.9	11,563.4	11,717.0
Equity securities:					
Nonredeemable preferred stocks:					
Financials	604.2	534.2	—	1,138.4	561.6
Utilities	—	65.8	—	65.8	50.8
Industrials	—	51.6	—	51.6	53.0
Subtotal nonredeemable preferred stocks	604.2	651.6	—	1,255.8	665.4
Common equities:					
Common stocks[1]	803.3	—	—	803.3	593.2
Other risk investments	—	—	12.9	12.9	5.2
Subtotal common equities	803.3	—	12.9	816.2	598.4
	$6,242.8	$7,221.8	$170.8	13,635.4	12,980.8
Other short-term investments[2]				1,078.0	1,078.0
Total portfolio				$14,713.4	$14,058.8
Debt[3]				$ 2,154.2	$ 2,177.2

(millions)	Fair Value Level 1	Level 2	Level 3	Total	Cost
December 31, 2008					
Fixed maturities:					
U.S. government obligations	$3,693.6	$ —	$ —	$ 3,693.6	$ 3,565.7
State and local government obligations	—	3,004.4	—	3,004.4	3,041.4
Foreign government obligations	—	16.4	—	16.4	16.2
Corporate and other debt securities	—	615.1	27.2	642.3	694.2
Subtotal	3,693.6	3,635.9	27.2	7,356.7	7,317.5
Asset-backed securities:					
Residential mortgage-backed	—	622.7	.3	623.0	758.7
Commercial mortgage-backed	—	1,423.6	26.4	1,450.0	1,692.7
Other asset-backed	—	118.1	11.0	129.1	139.2
Subtotal asset-backed securities	—	2,164.4	37.7	2,202.1	2,590.6
Redeemable preferred stocks:					
Financials	12.1	155.7	—	167.8	166.1
Utilities	—	37.0	—	37.0	37.0
Industrials	—	138.4	44.7	183.1	184.1
Subtotal redeemable preferred stocks	12.1	331.1	44.7	387.9	387.2
Total fixed maturities	3,705.7	6,131.4	109.6	9,946.7	10,295.3
Equity securities:					
Nonredeemable preferred stocks:					
Agencies	—	1.0	—	1.0	1.0
Financials	477.2	505.9	—	983.1	960.3
Utilities	—	53.6	—	53.6	54.5
Industrials	—	—	112.3	112.3	115.5
Subtotal nonredeemable preferred stocks	477.2	560.5	112.3	1,150.0	1,131.3
Common equities:					
Common stocks[1]	714.3	—	—	714.3	547.8
Other risk investments	—	—	13.5	13.5	5.8
Subtotal common equities	714.3	—	13.5	727.8	553.6
	$4,897.2	$6,691.9	$235.4	11,824.5	11,980.2
Other short-term investments[2]				1,153.6	1,153.6
Total portfolio				$12,978.1	$13,133.8
Debt[3]				$ 1,581.6	$ 2,175.5

[1] Common stocks are managed externally to track the Russell 1000 Index. Therefore, a break-out by major sector type is not provided.

[2] Due to the underlying nature of these securities, cost approximates fair value.

[3] Debt is not subject to measurement at fair value in the Consolidated Balance Sheets. Therefore, it is not broken out by hierarchy level; fair values are obtained from publicly quoted sources.

Our portfolio valuations classified as either Level 1 or Level 2 in the above table are priced exclusively by external sources, including: pricing vendors, dealers/market makers, and exchange-quoted prices. With limited exceptions, our Level 3 securities are also priced externally; however, due to several factors (e.g., nature of the securities, level of activity, lack of similar securities trading to obtain observable market level inputs), these valuations are more subjective in nature. Certain private equity investments and fixed-income investments included in the Level 3 category are valued using external pricing supplemented by internal review and analysis.

At December 31, 2009, vendor-quoted prices represented approximately 77% of our Level 1 classifications, compared to 74% at December 31, 2008. The securities quoted by vendors in Level 1 represent holdings in our U.S. Treasury Notes, which are frequently traded and the quotes are considered similar to exchange trade quotes. The balance of our Level 1 pricing comes from quotes obtained directly from trades made on an active exchange. At December 31, 2009, vendor-quoted prices comprised 92% of our Level 2 classifications, compared to 97% at December 31, 2008. We reviewed independent documentation detailing the pricing techniques, models, and methodologies used by these pricing vendors and believe that their policies adequately consider market activity, either based on specific transactions for the issue valued or based on modeling of securities with similar credit quality, duration, yield, and structure that were recently transacted. We continue to monitor any changes or modifications to their processes. During 2009 and 2008, we reviewed each sector for transaction volumes and determined that sufficient activity and liquidity existed to provide a credible source for market level valuations.

At December 31, 2009, broker-quoted prices represented the remaining 8% of our Level 2 classifications, compared to 3% at December 31, 2008. In these instances, we typically use broker/dealers because the security we hold is not widely held or frequently traded and thus is not serviced by the pricing vendors. We reviewed independent documentation detailing the pricing techniques, models, and methodologies used by broker/dealers and determined that they used the same pricing techniques as the external vendor pricing sources discussed above. The broker/dealers contain back office pricing desks, separate from the day-to-day traders that buy and sell the securities. This process creates uniformity in pricing when they quote externally to their various customers. The broker/dealer valuations are quoted in terms of spreads to various indices and the spreads are based off recent transactions adjusted for movements since the last trade or based off similar characteristic securities currently trading in the market. These quotes are not considered binding offers to transact. From time to time, we will obtain more than one broker quote for a security, when we feel it is necessary. In addition, from time to time, we will receive a broker/dealer quote for those securities priced by vendors as further evaluation of market price. We believe this additional step helps to ensure that we are reporting the most representative price and validates our pricing methodology.

To the extent the inputs used by external pricers are determined to not contain sufficient observable market information, we will reclassify the affected security valuations to Level 3. At December 31, 2009 and 2008, securities in our fixed-maturity portfolio listed as Level 3 were comprised substantially of securities that were either: (i) private placement deals, (ii) thinly held and/or traded securities, or (iii) lower rated non-investment-grade securities, where little liquidity exists. Based on these factors, it was difficult to independently verify observable market inputs that were used to generate the external valuations we received. At December 31, 2009 and 2008, one private common equity security with an aggregate value of $10.2 million was priced internally.

During each valuation period, we create internal estimations of portfolio valuation (performance returns), based on current market-related activity (i.e., interest rate and credit spread movements and other credit-related factors) within each major sector of our portfolio. We compare our internally-generated portfolio results with those generated based on quotes we received externally and research material valuation differences to identify the appropriate fair value to report for these securities.

Based on the criteria described above, we believe that the current level classifications are appropriate based on the valuation techniques used and that our fair values accurately reflect current market assumptions in the aggregate.

The following tables provide a summary of changes in fair value associated with Level 3 assets for the years ended December 31, 2009 and 2008:

	Level 3 Fair Value							
(millions)	**Fair Value at Dec. 31, 2008**	**Calls/ Maturities/ Paydowns**	**Purchases**	**Sales**	**Realized (gain)/loss**	**Change in Valuation**	**Transfers in (out)[1]**	**Fair value at Dec. 31, 2009**
Fixed maturities:								
Asset-backed securities:								
Residential mortgage-backed	$ .3	$ (3.9)	$49.4	$ —	$ —	$ .3	$ —	$ 46.1
Commercial mortgage-backed	26.4	(.8)	—	(23.3)	6.3	20.2	(7.2)	21.6
Other asset-backed	11.0	(3.5)	11.0	—	—	.3	(11.0)	7.8
Total asset-backed securities	37.7	(8.2)	60.4	(23.3)	6.3	20.8	(18.2)	75.5
Corporate debt securities	27.2	—	—	(1.1)	(1.8)	5.0	—	29.3
Redeemable preferred stocks - industrials	44.7	—	—	—	—	8.4	—	53.1
Total fixed maturities	109.6	(8.2)	60.4	(24.4)	4.5	34.2	(18.2)	157.9
Nonredeemable preferred stocks - industrials	112.3	(15.2)	—	(99.8)	(.6)	3.3	—	—
Common equities - other risk investments	13.5	(.1)	—	—	—	(.5)	—	12.9
Total Level 3 securities	$235.4	$(23.5)	$60.4	$(124.2)	$ 3.9	$37.0	$(18.2)	$170.8

[1]Of the $18.2 million of transfers out of Level 3, $11.0 million was due to a privately placed other asset-backed security that was priced internally at acquisition. The security was transferred into the Level 2 category once pricing was provided by a vendor. The remaining $7.2 million transferred out of Level 3 and placed into the Level 2 category reflects changes in the inputs used to measure fair value during the period.

	Level 3 Fair Value							
(millions)	**Fair value at Dec. 31, 2007**	**Calls/ Maturities/ Paydowns**	**Purchases**	**Sales**	**Realized (gain)/loss**	**Change in Valuation**	**Transfers in (out)[1]**	**Fair value at Dec. 31, 2008**
Fixed maturities:								
Asset-backed securities:								
Residential mortgage-backed	$ .5	$ (.1)	$—	$ —	$—	$ (.1)	$ —	$ .3
Commercial mortgage-backed	58.4	(3.1)	—	—	—	(30.5)	1.6	26.4
Other asset-backed	30.6	(3.9)	—	(14.3)	.5	(1.9)	—	11.0
Total asset-backed securities	89.5	(7.1)	—	(14.3)	.5	(32.5)	1.6	37.7
Corporate debt securities	29.9	—	—	—	—	(2.7)	—	27.2
Redeemable preferred stocks - industrials	—	—	—	—	—	—	44.7	44.7
Total fixed maturities	119.4	(7.1)	—	(14.3)	.5	(35.2)	46.3	109.6
Nonredeemable preferred stocks - industrials	115.6	—	—	—	—	(3.3)	—	112.3
Common equities - other risk investments	13.7	(.9)	—	—	—	.7	—	13.5
Total Level 3 securities	$248.7	$(8.0)	$—	$(14.3)	$ .5	$(37.8)	$46.3	$235.4

[1]Represents securities transferred into Level 3 during 2008 due to infrequent trading and illiquidity.

4. DEBT

Debt at December 31 consisted of:

	2009		2008	
(millions)	Carrying Value	Fair Value	Carrying Value	Fair Value
6.375% Senior Notes due 2012 (issued: $350.0, December 2001)	$ 349.2	$ 375.1	$ 348.9	$ 355.3
7% Notes due 2013 (issued: $150.0, October 1993)	149.5	166.9	149.3	154.3
6 5/8% Senior Notes due 2029 (issued: $300.0, March 1999)	294.7	317.9	294.6	272.0
6.25% Senior Notes due 2032 (issued: $400.0, November 2002)	394.1	409.4	394.0	350.0
6.70% Fixed-to-Floating Rate Junior Subordinated Debentures due 2067 (issued: $1,000.0, June 2007)	989.7	884.9	988.7	450.0
Total	$2,177.2	$2,154.2	$2,175.5	$1,581.6

All of the outstanding debt was issued by The Progressive Corporation. Debt includes amounts we have borrowed and contributed to the capital of our insurance subsidiaries or used, or have available for use, for other business purposes. Fair values are obtained from publicly quoted sources. There are no restrictive financial covenants or credit rating triggers on our debt.

Interest on all debt is payable semiannually at the stated rates. However, the 6.70% Fixed-to-Floating Rate Junior Subordinated Debentures due 2067 (the “Debentures”) will only bear interest at this fixed annual rate through, but excluding, June 15, 2017. Thereafter, the Debentures will bear interest at an annual rate equal to the three-month LIBOR plus 2.0175%, and the interest will be payable quarterly. In addition, subject to certain conditions, we have the right to defer the payment of interest on the Debentures for one or more periods not exceeding ten consecutive years each. During any such deferral period, among other conditions, interest would continue to accrue, including interest on the deferred interest, and we generally would not be able to declare or pay any dividends on, or repurchase any of, our common shares.

Except for the Debentures, all principal is due at the maturity stated in the table above. The Debentures will become due on June 15, 2037, the scheduled maturity date, but only to the extent that we have received sufficient net proceeds from the sale of certain qualifying capital securities. We must use our commercially reasonable efforts, subject to certain market disruption events, to sell enough qualifying capital securities to permit repayment of the Debentures in full on the scheduled maturity date or, if sufficient proceeds are not realized from the sale of such qualifying capital securities by such date, on each interest payment date thereafter. Any remaining outstanding principal will be due on June 15, 2067, the final maturity date.

The 7% Notes are noncallable. The 6.375% Senior Notes, the 6 5/8% Senior Notes, and the 6.25% Senior Notes (collectively, “Senior Notes”) may be redeemed in whole or in part at any time, at our option, subject to a “make-whole” provision. Subject to the Replacement Capital Covenant discussed below, the Debentures may be redeemed, in whole or in part, at any time: (a) prior to June 15, 2017, at a redemption price equal to the greater of (i) 100% of the principal amount of the Debentures being redeemed, or (ii) a “make-whole” amount, in each case plus any accrued and unpaid interest; or (b) on or after June 15, 2017, at a redemption price equal to 100% of the principal amount of the Debentures being redeemed, plus any accrued and unpaid interest. In connection with the issuance of the Debentures, we entered into a Replacement Capital Covenant in which we agreed, for the benefit of the holders of one of our Senior Notes, that we will not repay, redeem, defease, or purchase all or part of the Debentures before June 15, 2047, unless, subject to certain limitations, we have received proceeds from the sale of certain replacement capital securities, as defined in the Replacement Capital Covenant.

Prior to issuance of the Senior Notes and Debentures, we entered into forecasted debt issuance hedges against possible rises in interest rates. Upon issuance of the applicable debt securities, the hedges were closed. At that time, we recognized, as part of accumulated other comprehensive income, unrealized gains (losses) of $18.4 million, $(4.2) million, $5.1 million, and $34.4 million associated with the 6.375% Senior Notes, the 6 5/8% Senior Notes, the 6.25% Senior Notes, and the Debentures, respectively. The gains (losses) on these hedges are deferred and are being recognized as adjustments to interest expense over the life of the related debt issuances for the Senior Notes, and over the 10-year fixed interest rate term for the Debentures.

On December 31, 2009, we entered into an amendment to the 364-Day Secured Liquidity Credit Facility Agreement ("Credit Facility Agreement") with PNC Bank, National Association (PNC), successor to National City Bank (NCB), which extended the expiration date of our outstanding credit facility agreement until December 31, 2010, unless earlier pursuant to the terms of the agreement. Under this agreement, we may borrow up to $125 million, which may be increased to $150 million at our request but subject to PNC's discretion. The purpose of the credit facility is to provide liquidity in the event of disruptions in our cash management operations, such as disruptions in the financial markets that affect our ability to transfer or receive funds. We may borrow funds, on a revolving basis, either in the form of Eurodollar Loans or Base Rate Loans. Eurodollar Loans will bear interest at one-, two-, three-, or six-month LIBOR (as selected by us) plus 50 basis points for the selected period. Base Rate Loans will bear daily interest at the greater of (a) PNC's prime rate for such day, (b) the federal funds effective rate for such day plus 1/2% per annum, or (c) one-month LIBOR plus 2% per annum. Any borrowings under this agreement will be secured by a lien on certain marketable securities held in our investment portfolio. A facility fee of $12,500 was paid as consideration for this revolving agreement in each of 2008 and 2009. In addition, in January 2009, we deposited $125 million into an FDIC-insured deposit account (as part of the FDIC Temporary Liquidity Guarantee program) at NCB to provide us with additional cash availability in the event of such a disruption to our cash management operations; as of January 1, 2010, this deposit is no longer covered by FDIC insurance. Our access to these funds is unrestricted. However, if we withdraw funds from this account for any reason other than in connection with a disruption in our cash management operations, the availability of borrowings under the PNC credit facility will be reduced on a dollar-for-dollar basis until such time as we replenish the funds to the deposit account. There are no rating triggers under the credit agreement. We had no borrowings under this arrangement in 2009 or 2008.

The Credit Facility Agreement entered into on December 31, 2008, replaced an uncommitted line of credit with NCB in the principal amount of $125 million. Under the uncommitted line of credit, no commitment fees were required to be paid and there were no rating triggers. Interest on amounts borrowed would have generally accrued at the one-month LIBOR plus 0.375%. We had no borrowings under this arrangement during 2008.

Aggregate principal payments on debt outstanding at December 31, 2009, are $0 for 2010 and 2011, $350.0 million for 2012, $150.0 million for 2013, $0 for 2014, and $1.7 billion thereafter.

5. INCOME TAXES

The components of our income tax provision (benefit) were as follows:

(millions)	2009	2008	2007
Current tax provision	$491.0	$ 255.4	$503.7
Deferred tax expense (benefit)	8.4	(407.7)	6.8
Total income tax provision (benefit)	$499.4	$(152.3)	$510.5

The provision (benefit) for income taxes in the accompanying consolidated statements of income differed from the statutory rate as follows:

($ in millions)	2009		2008		2007	
Income (loss) before income taxes	$1,556.9		$(222.3)		$1,693.0	
Tax at statutory rate	$ 544.9	35%	$ (77.8)	35%	$ 592.6	35%
Tax effect of:						
Exempt interest income	(26.7)	(2)	(38.7)	17	(40.3)	(3)
Dividends received deduction	(17.9)	(1)	(35.0)	16	(35.4)	(2)
Other items, net	(.9)	—	(.8)	—	(6.4)	—
Total income tax provision (benefit)	$ 499.4	32%	$(152.3)	68%	$ 510.5	30%

Deferred income taxes reflect the effect for financial statement reporting purposes of temporary differences between the financial statement carrying amounts and the tax bases of assets and liabilities. At December 31, 2009 and 2008, the components of the net deferred tax assets were as follows:

(millions)	2009	2008
Deferred tax assets:		
Write-downs on securities	$ 353.8	$ 478.4
Unearned premiums reserve	290.5	291.4
Non-deductible accruals	158.5	150.0
Loss reserves	118.9	117.9
Derivative instruments	2.8	—
Net unrealized losses on securities	—	41.4
Other	1.4	10.0
Deferred tax liabilities:		
Net unrealized gains on securities	(231.6)	—
Hedges on forecasted transactions	(11.6)	(13.4)
Deferred acquisition costs	(140.8)	(144.9)
Depreciable assets	(97.9)	(96.1)
Derivative instruments	—	(23.8)
Other	(24.0)	(17.6)
Net deferred tax assets	420.0	793.3
Net income taxes recoverable (payable)	(3.3)	28.3
Income taxes	$ 416.7	$ 821.6

The decrease in our net deferred tax asset during the year is primarily due to the net unrealized gains that occurred in the investment portfolio. Although realization of the deferred tax asset is not assured, management believes that it is more likely than not that the deferred tax asset will be realized based on our expectation that we will be able to fully utilize the deductions that are ultimately recognized for tax purposes.

Our IRS exams for 2004-2007 have been completed. Technically the statute of limitations for all of these years remains open (for 2004 and 2005 until June 30, 2010 due to a statute extension, and for 2006 and 2007 until three years from the date the returns were filed). However, since the audits of these years have been completed, we consider these years to be effectively settled.

We are currently under IRS examination for the 2008 and 2009 tax years under the Compliance Assurance Program (CAP). Under CAP, the IRS begins its examination process for the tax year before the tax return is filed, by examining significant transactions and events as they occur. The goal of the CAP program is to expedite the exam process and to reduce the level of uncertainty regarding a taxpayer's tax filing positions.

We recognize interest and penalties, if any, related to unrecognized tax benefits as a component of income tax expense. We have not recorded any unrecognized tax benefits, or any related interest and penalties, as of December 31, 2009 or December 31, 2008. The 2009 tax provision includes an interest benefit (net of tax) of $0.3 million related to the settlement of the 2004-2007 IRS exams.

6. LOSS AND LOSS ADJUSTMENT EXPENSE RESERVES

Activity in the loss and loss adjustment expense reserves is summarized as follows:

(millions)	2009	2008	2007
Balance at January 1	$ 6,177.4	$ 5,942.7	$5,725.0
Less reinsurance recoverables on unpaid losses	244.5	287.5	361.4
Net balance at January 1	5,932.9	5,655.2	5,363.6
Incurred related to:			
Current year	10,040.9	9,981.8	9,845.9
Prior years	(136.0)	33.2	80.3
Total incurred	9,904.9	10,015.0	9,926.2
Paid related to:			
Current year	6,542.2	6,700.4	6,737.2
Prior years	3,172.0	3,036.9	2,897.4
Total paid	9,714.2	9,737.3	9,634.6
Net balance at December 31	6,123.6	5,932.9	5,655.2
Plus reinsurance recoverables on unpaid losses	529.4	244.5	287.5
Balance at December 31	$ 6,653.0	$ 6,177.4	$5,942.7

Our objective is to establish case and IBNR reserves that are adequate to cover all loss costs, while sustaining minimal variation from the date that the reserves are initially established until losses are fully developed. Our reserves developed favorably in 2009, compared to unfavorable development in both 2008 and 2007. Total development consists of net changes made by our actuarial department on prior accident year reserves, based on regularly scheduled reviews, claims settling for more or less than reserved, emergence of unrecorded claims at rates different than reserved, and changes in reserve estimates by claim representatives. In 2009, the favorable development was primarily related to lower than expected defense and cost containment reserves and favorable settlements on larger losses in our Commercial Auto business. In 2008, an increase in the number of late reported Commercial Auto claims, and an increase in the estimated severity on these claims, was a primary contributor to the unfavorable development. The unfavorable development in 2007 was due to the settlement of some large outstanding litigation, the number of large losses emerging from prior accident years being more than anticipated, plus the result of reviews of large bodily injury and uninsured motorist claims.

Because we are primarily an insurer of motor vehicles, we have limited exposure to environmental, asbestos, and general liability claims. We have established reserves for such exposures, in amounts that we believe to be adequate based on information currently known. These claims are not expected to have a material effect on our liquidity, financial condition, cash flows, or results of operations.

We write personal and commercial auto insurance in the coastal states, which could be exposed to hurricanes or other natural catastrophes. Although the occurrence of a major catastrophe could have a significant effect on our monthly or quarterly results, we believe that, based on historical performance, such an event would not be so material as to disrupt the overall normal operations of Progressive. We are unable to predict the frequency or severity of any such events that may occur in the near term or thereafter.

7. REINSURANCE

The effect of reinsurance on premiums written and earned for the years ended December 31 was as follows:

	2009		2008		2007	
(millions)	Written	Earned	Written	Earned	Written	Earned
Direct premiums	$14,196.3	$14,199.4	$13,775.6	$13,810.1	$13,982.4	$14,107.0
Ceded	(193.4)	(186.6)	(171.3)	(178.7)	(209.9)	(229.6)
Net premiums	$14,002.9	$14,012.8	$13,604.3	$13,631.4	$13,772.5	$13,877.4

Our ceded premiums are attributable to premiums written under state-mandated involuntary Commercial Auto Insurance Procedures/Plans and premiums ceded to state-provided reinsurance facilities (together referred to as "State Plans"), for which we retain no loss indemnity risk, and premiums ceded related to our non-auto programs.

Reinsurance contracts do not relieve us from our obligations to policyholders. Failure of reinsurers to honor their obligations could result in losses to Progressive. Since the majority of our reinsurance is through State Plans, our exposure to losses from their failure is minimal, since the plans are funded by mechanisms supported by the insurance companies in the state. We evaluate the financial condition of our other reinsurers and monitor concentrations of credit risk to minimize our exposure to significant losses from reinsurer insolvencies. We also require unauthorized reinsurers to secure reinsurance through collateral, such as lines of credit or trust accounts.

At December 31, 2009, approximately 50% of the "prepaid reinsurance premiums" was comprised of State Plans, compared to about 55% at December 31, 2008. As of December 31, 2009 and 2008, approximately 90% and 80%, respectively, of the "reinsurance recoverables" were attributable to State Plans. The remainder of the "prepaid reinsurance premiums" and "reinsurance recoverables" was primarily related to non-auto programs.

Losses and loss adjustment expenses were net of reinsurance ceded of $417.6 million in 2009, $109.2 million in 2008, and $109.6 million in 2007. During 2009, we changed our loss reserving process regarding lifetime estimates for claims ceded to a state-provided reinsurance program, which increased both the amount of ceded loss reserves and the corresponding reinsurance recoverables on unpaid losses and, therefore, had no impact on our results of operations.

8. STATUTORY FINANCIAL INFORMATION

Consolidated statutory policyholders' surplus was $4,953.6 million and $4,470.6 million at December 31, 2009 and 2008, respectively. Statutory net income was $1,300.8 million, $368.4 million, and $1,105.2 million for the years ended December 31, 2009, 2008, and 2007, respectively.

At December 31, 2009, $477.7 million of consolidated statutory policyholders' surplus represented net admitted assets of our insurance subsidiaries and affiliate that are required to meet minimum statutory surplus requirements in such entities' states of domicile. The companies may be licensed in states other than their states of domicile, which may have higher minimum statutory surplus requirements. Generally, the net admitted assets of insurance companies that, subject to other applicable insurance laws and regulations, are available for transfer to the parent company cannot include the net admitted assets required to meet the minimum statutory surplus requirements of the states where the companies are licensed.

During 2009, the insurance subsidiaries paid aggregate cash dividends of $1,208.7 million to the parent company. Based on the dividend laws currently in effect, the insurance subsidiaries could pay aggregate dividends of $1,008.5 million in 2010 without prior approval from regulatory authorities, provided the dividend payments are not within 12 months of previous dividends paid by the applicable subsidiary.

9. EMPLOYEE BENEFIT PLANS

Retirement Plans Beginning January 1, 2009, Progressive has a defined contribution pension plan which covers all United States employees who are 18 years or older and have been employed with the company for at least 30 days. Progressive will match up to a maximum of 6% of the employee's eligible compensation contributed to the plan. Company matching contributions could be invested by a participant in any of the investments available under the plan. Company matching contributions were $60.7 million in 2009.

Prior to January 1, 2009, Progressive had a two-tiered Retirement Security Program. The first tier was a defined contribution pension plan covering all employees who met requirements as to age and length of service. Company contributions varied from 1% to 5% of annual eligible compensation up to the Social Security wage base, based on years of eligible service and could be invested by a participant in any of the investments available under the plan. Company contributions were $25.5 million in 2008 and $22.5 million in 2007.

The second tier was a long-term savings plan under which Progressive matched, up to a maximum of 3%, of the employee's eligible compensation, amounts contributed to the plan by an employee. Company matching contributions could be invested by a participant in any of the investments available under the plan. Company matching contributions were $30.9 million in 2008 and $29.3 million in 2007.

Postemployment Benefits Progressive provides various postemployment benefits to former or inactive employees who meet eligibility requirements, their beneficiaries, and covered dependents. Postemployment benefits include salary continuation and disability-related benefits, including workers' compensation, and, if elected, continuation of health-care benefits for specified limited periods. The liability for these benefits was $23.9 million at December 31, 2009, compared to $25.9 million in 2008.

Postretirement Benefits We provide postretirement health and life insurance benefits to all employees who met requirements as to age and length of service at December 31, 1988. There are approximately 100 people in this program. Our funding policy for the benefits is to fund these benefits by contributing annually to a 501(c)(4) trust the maximum amount that can be deducted for federal income tax purposes.

Incentive Compensation Plans – Employees Our incentive compensation includes both non-equity incentive plans (cash) and equity incentive plans (stock-based). The cash incentive compensation includes a cash bonus program for a limited number of senior executives and Gainsharing programs for other employees; the bases of these programs are similar in nature. The stock-based incentive compensation plans provide for the granting of restricted stock awards to key members of management. Prior to 2003, we granted non-qualified stock options as stock-based incentive compensation (see below). The amounts charged to income for the incentive compensation plans for the years ended December 31 were:

(millions)	2009	2008	2007
Cash	$120.4	$140.3	$126.2
Stock-based	40.3	34.5	26.5

Our 2003 Incentive Plan, which provides for the granting of stock-based awards, including restricted stock awards, to key employees of Progressive, has 18.7 million shares currently authorized, net of restricted stock awards cancelled; 4.8 million shares remain available for future awards. Our 1995 Incentive Plan has expired; however, awards made under that plan prior to its expiration are still in effect.

In 2003, we began issuing restricted stock awards in lieu of stock options. The restricted stock awards are issued as either time-based or performance-based awards. The vesting period (i.e., requisite service period) must be a minimum of six months and one day. The time-based awards vest in equal installments upon the lapse of specified periods of time, typically three, four, and five years. The performance-based awards vest upon the achievement of predetermined performance goals. The performance-based awards are granted to approximately 40 executives and senior managers, in addition to their time-based awards, to provide additional compensation for achieving pre-established profitability and growth targets. Generally, the restricted stock awards are expensed pro rata over their respective vesting periods based on the market value of the awards at the time of grant. However, restricted stock awards granted in 2003 and 2004, that were deferred pursuant to our deferred compensation plan, are accounted for as liability awards, since distributions from the deferred compensation plan for these awards will be made in cash; accordingly, we record expense on a pro rata basis based on the current market value of common shares at the end of the reporting period.

Prior to 2003, we granted nonqualified stock options. These options became exercisable at various dates not earlier than six months after the date of grant, and remain exercisable for up to ten years from the date of the award. All remaining options outstanding vested on or before January 1, 2007 and will expire on or before December 31, 2011, if not exercised prior to that date. All options granted had an exercise price equal to the market value of the common shares on the date of grant. All option exercises are settled in Progressive common shares from either existing treasury shares or newly issued shares.

A summary of all employee restricted stock activity during the years ended December 31 follows:

Restricted Shares	2009 Number of Shares	2009 Weighted Average Grant Date Fair Value	2008 Number of Shares	2008 Weighted Average Grant Date Fair Value	2007 Number of Shares	2007 Weighted Average Grant Date Fair Value
Beginning of year	8,260,696	$20.39	6,868,850	$22.33	6,232,522	$22.27
Add (deduct):						
Granted	4,072,152	12.08	3,038,793	15.98	2,318,637	21.01
Vested	(1,239,281)	23.14	(1,281,560)	19.98	(1,005,680)	18.80
Forfeited	(479,551)	16.98	(365,387)	21.61	(676,629)	22.44
End of year	10,614,016	$17.04	8,260,696	$20.39	6,868,850	$22.33
Available, end of year[1]	4,753,038		8,424,255		11,287,225	

[1] Represents shares available under the 2003 Incentive Plan. On January 1, 2010, 1,277,147 restricted stock awards vested with an aggregate fair value of $29.4 million.

Of the 1,239,281 restricted stock awards that vested during the year ended December 31, 2009, 1,001,051 shares were not deferred under our deferred compensation plan and 238,230 were deferred (see discussion of deferred compensation below). The aggregate fair value of the non-deferred awards, based on the respective grant date stock prices, was $23.2 million. Two types of deferred shares vested. First were 91,856 deferred liability awards. There was no intrinsic value attributed to these shares which were deferred, since, as previously discussed, these awards were granted in 2004 and, therefore, were expensed based on the current market value at the end of each reporting period. In addition, 146,374 deferred equity awards vested, which were granted after March 2005. The aggregate fair value of these deferred awards, based on the grant date stock price, was $3.5 million.

During the year ended December 31, 2009, we recognized $40.3 million, or $26.2 million after taxes, of compensation expense related to our outstanding unvested restricted stock. During the year ended December 31, 2008, we recognized $34.5 million, or $22.4 million after taxes, of compensation expense related to our outstanding unvested restricted stock. During the year ended December 31, 2007, we recognized $26.5 million, or $17.2 million after taxes, of compensation expense related to our outstanding unvested restricted stock and stock option awards. At December 31, 2009, the total unrecognized compensation cost related to unvested restricted stock awards was $79.6 million. This compensation expense will be recognized into the income statement over the weighted average vesting period of 2.25 years.

As discussed above, we stopped granting non-qualified stock options in 2002. All remaining stock option awards vested on January 1, 2007. Following is a summary of all employee stock option activity during the year ended December 31, 2007:

Nonvested stock options outstanding	Number of Shares	Weighted Average Grant Date Fair Value
Beginning of year	1,087,866	$5.82
Deduct:		
Vested	(1,087,866)	5.82
End of year	—	$ —

In September 2007, we paid a $2.00 per common share special dividend to shareholders of record at the close of business on August 31, 2007. Since the holders of the outstanding stock option awards were not entitled to receive the cash dividend, we were required to increase the number of shares and reduce the exercise price of any of our then outstanding stock option awards in accordance with the antidilution provisions of our incentive plans. This adjustment is reflected in the appropriate tables below.

	2009		2008		2007	
Options Outstanding	**Number of Shares**	**Weighted Average Exercise Price**	**Number of Shares**	**Weighted Average Exercise Price**	**Number of Shares**	**Weighted Average Exercise Price**
Beginning of year	8,503,273	$7.71	11,738,502	$7.75	13,747,221	$ 8.75
Add:						
Antidilution adjustment	—	—	—	—	1,201,984	NM
Deduct:						
Exercised	(3,394,633)	5.31	(3,235,229)	7.86	(3,208,873)	9.10
Forfeited	(5,752)	5.69	—	—	(1,830)	11.78
End of year	5,102,888	$9.31	8,503,273	$7.71	11,738,502	$ 7.75
Exercisable, end of year	5,102,888	$9.31	8,503,273	$7.71	11,738,502	$ 7.75

NM = not meaningful

The total pretax intrinsic value of options exercised during the year ended December 31, 2009, was $36.1 million, based on the actual stock price at time of exercise.

The following employee stock options were outstanding and exercisable as of December 31, 2009:

Number of Shares	Weighted Average Exercise Price	Aggregate Intrinsic Value	Weighted Average Remaining Contractual Life
5,102,888	$9.31	$44.3 million	1.47 years

The aggregate intrinsic value in the preceding table represents the total pretax intrinsic value, based on the difference between our closing stock price of $17.99 on December 31, 2009, and the exercise price of the options, which is the amount that would have been received by the option holders, before taxes, had all option holders exercised their options as of that date. All of the exercisable options at December 31, 2009, were “in-the-money.”

Incentive Compensation Plans – Directors Our 2003 Directors Equity Incentive Plan, which provides for the granting of stock-based awards, including restricted stock awards to non-employee directors of The Progressive Corporation, has 1.4 million shares currently authorized, net of restricted stock awards cancelled; 0.9 million shares remain available for future grants. Our 1998 Directors’ Stock Option Plan expired on April 24, 2008; however, stock option awards made under this plan prior to its expiration are still in effect.

In 2003, we began issuing restricted stock awards to non-employee directors as the equity component of their compensation. The restricted stock awards are issued as time-based awards. The vesting period (i.e., requisite service period) must be a minimum of six months and one day. The time-based awards granted to date have included vesting periods of 11 or 12 months from the date of each grant. The restricted stock awards are expensed pro rata over their respective vesting periods based on the market value of the awards at the time of grant.

Prior to 2003, we granted nonqualified stock options as the equity component of the directors compensation. These options were granted for periods up to ten years, became exercisable at various dates not earlier than six months after the date of grant, and remain exercisable for specified periods thereafter. All options granted had an exercise price equal to the market value of the common shares on the date of grant and, under the then applicable accounting guidance, no compensation expense was recorded. All option exercises are settled in Progressive common shares from either existing treasury shares or newly issued shares.

Restricted stock awards are granted to non-employee directors as their sole compensation for being a member of the Board of Directors.

A summary of all directors restricted stock activity during the years ended December 31 follows:

Restricted Shares	2009 Number of Shares	2009 Weighted Average Grant Date Fair Value	2008 Number of Shares	2008 Weighted Average Grant Date Fair Value	2007 Number of Shares	2007 Weighted Average Grant Date Fair Value
Beginning of year	105,420	$17.96	68,595	$23.52	66,031	$26.64
Add (deduct):						
Granted	129,467	15.78	105,420	17.96	76,074	23.52
Vested	(105,420)	17.96	(68,595)	23.52	(66,031)	26.64
Forfeited	(10,483)	15.74	—	—	(7,479)	23.52
End of year	118,984	$15.79	105,420	$17.96	68,595	$23.52
Available, end of year[1]	869,871		988,855		1,094,275	

[1]Represents shares available under the 2003 Directors Equity Incentive Plan.

A summary of all stock option activity for both current and former directors during the years ended December 31 follows:

Options Outstanding	2009 Number of Shares	2009 Weighted Average Exercise Price	2008 Number of Shares	2008 Weighted Average Exercise Price	2007 Number of Shares	2007 Weighted Average Exercise Price
Beginning of year	401,357	$8.60	628,813	$7.97	772,664	$8.59
Add:						
Antidilution adjustment[1]	—	—	—	—	55,851	NM
Deduct:						
Exercised	(88,812)	9.10	(227,456)	6.86	(199,702)	8.16
End of year	312,545	$8.46	401,357	$8.60	628,813	$7.97
Exercisable, end of year[2]	312,545	$8.46	401,357	$8.60	628,813	$7.97

NM = not meaningful

[1]See discussion above under *Incentive Compensation Plans — Employees.*

[2]The 1998 Directors' Stock Option Plan has expired.

The total pretax intrinsic value of options exercised during the year ended December 31, 2009, was $0.5 million, based on the actual stock price at time of exercise.

The following director stock options were outstanding and exercisable as of December 31, 2009:

Number of Shares	Weighted Average Exercise Price	Aggregate Intrinsic Value	Weighted Average Remaining Contractual Life
312,545	$8.46	$3.0 million	1.22 years

The aggregate intrinsic value in the preceding table represents the total pretax intrinsic value, based on the difference between our closing stock price of $17.99 on December 31, 2009, and the exercise price of the options, which is the amount that would have been received by the option holders, before taxes, had all option holders exercised their options as of that date. All of the exercisable options at December 31, 2009, were "in-the-money."

Deferred Compensation We maintain The Progressive Corporation Executive Deferred Compensation Plan ("Deferral Plan") that permits eligible executives to defer receipt of some or all of their annual bonuses or all of their annual restricted stock awards. Deferred cash compensation is deemed invested in one or more investment funds, including common shares of Progressive, offered under the Deferral Plan and elected by the participant. All distributions from the Deferral Plan pursuant to deferred cash compensation will be paid in cash.

For all restricted stock awards granted on or after March 17, 2005, and deferred pursuant to the Deferral Plan, the deferred amounts are deemed invested in our common shares and are ineligible for transfer to other investment funds in the Deferral Plan; all distributions will be made in common shares. For all awards granted prior to March 17, 2005, the deferred amounts are eligible to be transferred to any of the funds in the Deferral Plan; distributions of these deferred awards will be made in cash.

We reserved 3.6 million common shares for issuance under the Deferral Plan. An irrevocable grantor trust has been established to provide a source of funds to assist us in meeting our liabilities under the Deferral Plan. At December 31, 2009 and 2008, the trust held assets of $80.2 million and $66.7 million, respectively, of which $17.6 million and $13.5 million were held in Progressive's common shares; these shares will be distributed in cash. In addition, at December 31, 2009 and 2008, the trust held 0.2 million and 0.1 million common shares, respectively, to be distributed in-kind.

10. SEGMENT INFORMATION

We write personal auto and other specialty property-casualty insurance and provide related services throughout the United States. Our Personal Lines segment writes insurance for personal autos and recreational vehicles. The Personal Lines segment is comprised of both the Agency and Direct businesses. The Agency business includes business written by our network of more than 30,000 independent insurance agencies, including brokerages in New York and California, and strategic alliance business relationships (other insurance companies, financial institutions, and national agencies). The Direct business includes business written directly by us online and by phone.

Our Commercial Auto segment writes primary liability and physical damage insurance for automobiles and trucks owned by small businesses in the specialty truck and business auto markets. This segment is distributed through both the independent agency and direct channels.

Our other indemnity businesses primarily include writing professional liability insurance for community banks and managing a small amount of run-off businesses.

Our service businesses provide insurance-related services, including processing CAIP business and serving as an agent for homeowners insurance through our program with three unaffiliated homeowner insurance companies.

All segment revenues are generated from external customers and we do not have a reliance on any major customer.

We evaluate segment profitability based on pretax underwriting profit (loss) for the Personal Lines and Commercial Auto businesses. In addition, we use underwriting profit (loss) for the other indemnity businesses and pretax profit (loss) for the service businesses. Pretax underwriting profit (loss) is calculated as follows:

Net premiums earned
Less: Losses and loss adjustment expenses
Policy acquisition costs
Other underwriting expenses
Pretax underwriting profit (loss)

Service business profit (loss) is the difference between service business revenues and service business expenses.

Expense allocations are based on certain assumptions and estimates primarily related to revenue and volume; stated segment operating results would change if different methods were applied. We do not allocate assets or income taxes to operating segments. In addition, we do not separately identify depreciation and amortization expense by segment and such disclosure would be impractical. Companywide depreciation expense was $87.3 million in 2009, $99.1 million in 2008, and $106.9 million in 2007. The accounting policies of the operating segments are the same as those described in *Note 1 – Reporting and Accounting Policies*.

Following are the operating results for the years ended December 31:

(millions)	2009 Revenues	2009 Pretax Profit (Loss)	2008 Revenues	2008 Pretax Profit (Loss)	2007 Revenues	2007 Pretax Profit (Loss)
Personal Lines						
Agency	$ 7,414.8	$ 579.2	$ 7,362.0	$ 360.7	$ 7,636.4	$ 500.2
Direct	4,951.1	357.9	4,485.8	274.8	4,372.6	339.9
Total Personal Lines[1]	12,365.9	937.1	11,847.8	635.5	12,009.0	840.1
Commercial Auto	1,623.3	229.8	1,762.2	94.1	1,846.9	185.7
Other indemnity	23.6	8.7	21.4	5.3	21.5	(.7)
Total underwriting operations	14,012.8	1,175.6	13,631.4	734.9	13,877.4	1,025.1
Service businesses	16.7	(2.7)	16.1	(4.3)	22.3	1.8
Investments[2]	534.1	523.0	(807.4)	(816.2)	787.1	774.7
Interest expense	—	(139.0)	—	(136.7)	—	(108.6)
Consolidated total	$14,563.6	$1,556.9	$12,840.1	$(222.3)	$14,686.8	$1,693.0

[1]Personal auto insurance accounted for 90% of the total Personal Lines segment net premiums earned in 2009 and 2008, and 91% in 2007; insurance for our special lines products (e.g., motorcycles, ATVs, RVs, mobile homes, watercraft, and snowmobiles) accounted for the balance of the Personal Lines net premiums earned.

[2]Revenues represent recurring investment income and net realized gains (losses) on securities; pretax profit is net of investment expenses.

Progressive's management uses underwriting margin and combined ratio as primary measures of underwriting profitability. The underwriting margin is the pretax underwriting profit (loss) expressed as a percentage of net premiums earned (i.e., revenues from insurance operations). Combined ratio is the complement of the underwriting margin. Following are the underwriting margins/combined ratios for our underwriting operations for the years ended December 31:

	2009 Underwriting Margin	2009 Combined Ratio	2008 Underwriting Margin	2008 Combined Ratio	2007 Underwriting Margin	2007 Combined Ratio
Personal Lines						
Agency	7.8%	92.2	4.9%	95.1	6.5%	93.5
Direct	7.2	92.8	6.1	93.9	7.8	92.2
Total Personal Lines	7.6	92.4	5.4	94.6	7.0	93.0
Commercial Auto	14.2	85.8	5.3	94.7	10.1	89.9
Other indemnity[1]	NM	NM	NM	NM	NM	NM
Total underwriting operations	8.4	91.6	5.4	94.6	7.4	92.6

[1]Underwriting margins/combined ratios are not meaningful (NM) for our other indemnity businesses due to the low level of premiums earned by, and the variability of loss costs in, such businesses.

11. OTHER COMPREHENSIVE INCOME (LOSS)

The components of other comprehensive income (loss) for the years ended December 31 were as follows:

	2009			2008			2007		
(millions)	Pretax	Tax (Provision) Benefit	After Tax	Pretax	Tax (Provision) Benefit	After Tax	Pretax	Tax (Provision) Benefit	After Tax
Unrealized gains (losses) arising during period:									
Fixed maturities	$ 535.4	$(187.4)	$348.0	$(407.6)	$142.7	$(264.9)	$ 52.1	$(18.2)	$ 33.9
Non-credit related OTTI[1]	(40.1)	14.0	(26.1)	—	—	—	—	—	—
Equity securities	671.7	(235.1)	436.6	(238.6)	83.5	(155.1)	(189.2)	66.2	(123.0)
Reclassification adjustment for (gains) losses realized in net income:									
Fixed maturities	(8.5)	3.0	(5.5)	9.7	(3.4)	6.3	(2.3)	.8	(1.5)
Equity securities	(86.7)	30.3	(56.4)	(197.1)	69.0	(128.1)	(63.4)	22.2	(41.2)
Change in unrealized gains (losses)[2]	1,071.8	(375.2)	696.6	(833.6)	291.8	(541.8)	(202.8)	71.0	(131.8)
Net unrealized gains on forecasted transactions[3]	(5.1)	1.8	(3.3)	(4.4)	1.5	(2.9)	31.2	(10.9)	20.3
Foreign currency translation adjustment[4]	1.4	—	1.4	—	—	—	—	—	—
Other comprehensive income (loss)	$1,068.1	$(373.4)	$694.7	$(838.0)	$293.3	$(544.7)	$(171.6)	$ 60.1	$(111.5)

[1]Portion of other-than-temporary impairment losses that were non-credit related *(see Note 2 – Investments* for further discussion).

[2]Excludes the $189.6 million ($291.8 million pretax) cumulative effect of change in accounting principle we recorded in June 2009 in accordance with the new accounting guidance for other-than-temporary impairments we adopted during the second quarter 2009 (*see Note 2 – Investments* for further discussion).

[3]Entered into for the purpose of managing interest rate risk associated with our debt issuances (see *Note 4 – Debt* for further discussion), and managing foreign currency risk associated with our forecasted foreign currency transaction (*see Note 2 – Investments* for further discussion). We expect to reclassify $5.2 million into income within the next 12 months.

[4]Foreign currency translation adjustments have no tax effect.

12. LITIGATION

The Progressive Corporation and/or its insurance subsidiaries are named as defendants in various lawsuits arising out of claims made under insurance policies in the ordinary course of our business. All legal actions relating to such insurance claims are considered by us in establishing our loss and loss adjustment expense reserves.

In addition, The Progressive Corporation and/or its insurance subsidiaries are named as defendants in a number of class action or individual lawsuits arising out of the operation of the insurance subsidiaries. Other insurance companies face many of these same issues. The lawsuits discussed below are in various stages of development. We plan to contest these suits vigorously, but may pursue settlement negotiations in some cases, if appropriate. The outcomes of these cases are uncertain at this time.

Under current accounting guidance, we establish accruals for lawsuits when it is probable that a loss has been incurred and we can reasonably estimate its potential exposure (referred to as a loss that is both “probable and estimable” in the discussion below). Certain of the cases for which we have established accurals under this standard are mentioned in the discussion below. Based on currently available information, we believe that our accruals for these lawsuits are reasonable and that the amounts accrued did not have a material effect on our consolidated financial condition or results of operations. However, if any one or more of these cases results in a judgment against, or settlement by, our insurance subsidiaries for an amount that is significantly greater than the amount so accrued, the resulting liability could have a material effect on our consolidated financial condition, cash flows, and results of operations.

As to lawsuits that do not satisfy both parts of this GAAP standard (i.e., the loss is not both probable and estimable), we have not established a liability at this time. In the event that any one or more of these cases results in a substantial judgment against, or settlement by, Progressive, the resulting liability could also have a material effect on our consolidated financial condition, cash flows, and results of operations.

The following is a discussion of potentially significant pending cases at December 31, 2009, and certain cases resolved during 2009, 2008, and 2007. Unless specifically noted: 1) we do not consider the losses from these cases to be probable and estimable, and we are unable to estimate a range of loss, if any, at this time; and 2) settlements were not material to our consolidated financial condition, cash flows, or results of operations. The outcomes of the unsettled cases are uncertain, but in each case we do not believe that the outcome will have a material impact on our consolidated financial condition, cash flows, and results of operations.

There is one putative class action lawsuit, and one lawsuit that was certified as a class action during 2009 that challenges our insurance subsidiaries' use of certain automated database vendors or software to assist in the adjustment of bodily injury claims. The other lawsuits relating to this issue were either consolidated or dismissed. In each of these lawsuits, the plaintiffs allege that these databases or software systematically undervalue the claims. In 2007, we reached a settlement on a similar class action lawsuit and all payments for that settlement have been made and the file is closed.

There were eight class action lawsuits challenging certain aspects of our insurance subsidiaries use of credit information and compliance with notice requirements under the federal Fair Credit Reporting Act. The cases were consolidated and a tentative settlement agreement was negotiated in 2004. That settlement was amended in 2006, and all required payments were made by the end of 2009. We also had six similar individual cases that were resolved by a settlement in 2009. That resolution also included the claims of other class members who had opted out of the class action settlement. The administration of this settlement is expected to be completed in 2010.

During 2009, we settled one certified nationwide class action lawsuit challenging our insurance subsidiaries' practice of taking betterment on boat repairs, one putative class action lawsuit alleging that Progressive's insurance subsidiaries used non-conforming underinsured motorist rejection forms, one certified class action lawsuit alleging that Progressive's insurance subsidiaries failed to offer certain enhanced personal injury protection (PIP) benefits, and three state class action lawsuits related to over-charging municipal tax to shareholders.

We currently have one certified class action lawsuit seeking interest on PIP payments that allegedly were late. We understand that there are a number of similar class actions against others in the insurance industry.

Progressive's insurance subsidiaries are defending two putative class actions alleging that we violate the "make-whole" and "common-fund" doctrines. Specifically, it is alleged that we may obtain reimbursement of medical payments made on behalf of an insured only when the insured has been made whole by a third-party tortfeasor and that we further must deduct from the reimbursement amount a proportionate share of the insured's legal fees for pursuing the third-party tortfeasor.

There are currently four putative class action lawsuits challenging the labor rates our insurance subsidiaries pay to auto body repair shops. One action was brought on behalf of insureds, while the other two were brought on behalf of repair facilities.

There are three putative class action lawsuits challenging Progressive's insurance subsidiaries' practice in Florida of paying PIP and first-party medical payments at 200% of the amount allowed by Medicare. One additional case was dismissed during 2009.

In 2008, we settled a putative class action lawsuit challenging the installment fee program used by our insurance subsidiaries.

During 2007, we settled various class action lawsuits and all payments for those settlements have been made and the cases are now closed. There was one lawsuit alleging that the insurance subsidiaries' rating practices at renewal were improper, three lawsuits alleging that we failed to adjust MRI bills to a consumer price index in violation of a statute, and one lawsuit seeking refunds of all UIM premiums and certain UM premiums on grounds that the coverages were illusory. There were also three putative class action lawsuits related to the MRI billing issue that were either dismissed or settled for a nominal amount. There is one lawsuit pending relating to our rating practices at renewal, as to which class action status has been denied.

Progressive's subsidiaries are also named as a defendant in individual lawsuits related to employment issues. In 2009, we completed payments on the settlement reached in 2008 on one class action lawsuit challenging our classification of certain job titles under the Fair Labor Standards Act.

13. COMMITMENTS AND CONTINGENCIES

We have certain noncancelable operating lease commitments with lease terms greater than one year for property and computer equipment. The minimum commitments under these agreements at December 31, 2009, were as follows:

(millions) **Year**	**Commitment**
2010	$ 73.5
2011	58.5
2012	42.8
2013	25.3
2014	11.9
Thereafter	16.2
Total	$228.2

Some of the leases have options to renew at the end of the lease periods. The expense we incurred for the leases disclosed above, as well as other operating leases that may be cancelable or have terms less than one year, was:

(millions) **Year**	**Expense**
2009	$109.0
2008	124.8
2007	139.5

We also have certain noncancelable purchase obligations. The minimum commitment under these agreements at December 31, 2009 was $132.3 million.

As of December 31, 2009, we had open investment funding commitments of $0.2 million; we had no uncollateralized lines or letters of credit as of December 31, 2009 or 2008.