21ST CENTURY INSURANCE GROUP
Form 10-Q
July 23, 2004

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended June 30, 2004

o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from ______ to ______

Commission File Number 0-6964

21ST CENTURY INSURANCE GROUP

(Exact name of registrant as specified in its charter)

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

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

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes **x** No **o**

The number of shares outstanding of the registrant s common stock as of July 15, 2004 was 85,470,364.

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PART I - FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS

21ST CENTURY INSURANCE GROUP
CONDENSED CONSOLIDATED BALANCE SHEETS
Unaudited

AMOUNTS IN THOUSANDS, EXCEPT SHARE DATA		**June 30, 2004**		December 31, 2003
Assets				
Fixed maturity investments available-for-sale, at fair value (amortized cost: $1,243,240 and $1,183,526)	**$**	**1,229,413**	$	1,219,676
Cash and cash equivalents		**98,686**		65,010
Accrued investment income		**14,732**		14,746
Premiums receivable		**107,606**		104,638
Reinsurance receivables and recoverables		**7,350**		12,135
Prepaid reinsurance premiums		**1,705**		1,719
Deferred income taxes		**79,827**		76,611
Deferred policy acquisition costs		**56,122**		53,079
Leased property under capital lease, net of deferred gain of $3,907 and $4,698 and net of accumulated amortization of $18,596 and $12,397		**37,126**		42,534
Property and equipment, at cost less accumulated depreciation of $62,663 and $60,070		**114,248**		101,237
Other assets		**32,075**		46,747
Total assets	**$**	**1,778,890**	$	1,738,132
Liabilities and stockholders equity				
Unpaid losses and loss adjustment expenses	**$**	**461,949**	$	438,323
Unearned premiums		**330,127**		312,254
Debt		**144,069**		149,686
Claim checks payable		**42,124**		45,702
Reinsurance payable		**594**		1,761
Other liabilities		**93,435**		89,716
Total liabilities		**1,072,298**		1,037,442
Commitments and contingencies				
Stockholders equity:				
Common stock, par value $0.001 per share; 110,000,000 shares authorized 110,000,000 authorized; shares issued and outstanding 85,470,364 and 85,435,505		**85**		85
Additional paid-in capital		**419,850**		419,245
Retained earnings		**297,589**		259,808
Accumulated other comprehensive (loss) income:				
Unrealized (losses) gains on available-for-sale investments, net of deferred income taxes of ($4,839) and $12,653				

	(8,987)	23,497
Minimum pension liability in excess of unamortized prior service cost, net of deferred income taxes of $1,047 and $1,047	**(1,945)**	(1,945)
Total stockholders equity	**706,592**	700,690
Total liabilities and stockholders equity	**$ 1,778,890**	$ 1,738,132

See accompanying notes to condensed consolidated financial statements.

21ST CENTURY INSURANCE GROUP
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
Unaudited

AMOUNTS IN THOUSANDS, EXCEPT SHARE DATA	*Three Months Ended June 30,* **2004**	2003	*Six Months Ended June 30,* **2004**	2003
Revenues				
Net premiums earned	**$ 327,021**	$ 287,231	**$ 645,241**	$ 558,672
Net investment income	**14,315**	11,673	**27,461**	23,311
Other		14,065		14,065
Net realized investment gains	**1,337**	7,700	**8,983**	12,280
Total revenues	**342,673**	320,669	**681,685**	608,328
Losses and expenses				
Net losses and loss adjustment expenses	**244,556**	228,182	**492,070**	481,525
Policy acquisition costs	**54,782**	47,766	**108,472**	91,209
Other operating expenses	**9,844**	390	**16,244**	4,033
Interest and fees expense	**2,185**	833	**4,411**	1,540
Total losses and expenses	**311,367**	277,171	**621,197**	578,307
Income before provision for income taxes	**31,306**	43,498	**60,488**	30,021
Provision for income taxes	**9,932**	14,347	**19,289**	7,580
Net income	**$ 21,374**	$ 29,151	**$ 41,199**	$ 22,441
Earnings per common share				
Basic and diluted	**$ 0.25**	$ 0.34	**$ 0.48**	$ 0.26
Weighted average shares outstanding — basic	**85,462,774**	85,431,505	**85,452,194**	85,431,505
Weighted average shares outstanding — diluted	**85,611,192**	85,725,925	**85,614,711**	85,567,620

See accompanying notes to condensed consolidated financial statements.

21ST CENTURY INSURANCE GROUP
CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS EQUITY
Unaudited

	Common Stock					
		$ 0.001 par value				
AMOUNTS IN THOUSANDS, EXCEPT SHARE DATA	*Shares*	*Amount*	*Additional Paid-in Capital*	*Retained Earnings*	*Accumulated Other Comprehensive (Loss) Income*	*Total*
Balance January 1, 2004	85,435,505	$ 85	$ 419,245	$ 259,808	$ 21,552	$ 700,690
Comprehensive income				41,199[1]	(32,484)[2]	8,715
Cash dividends declared on common stock ($0.04 per share)				(3,418)		(3,418)
Other	34,859		605			605
Balance June 30, 2004	85,470,364	$ 85	$ 419,850	$ 297,589	$ (10,932)	$ 706,592

(1) Net income.

(2) Net change in accumulated other comprehensive (loss) income for the six months ended June 30, 2004, comprises unrealized losses on available-for-sale investments of $32,484 (net of income tax benefit of $17,492).

See accompanying notes to condensed consolidated financial statements.

21ST CENTURY INSURANCE GROUP
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

Unaudited

	Six Months Ended June 30,	
AMOUNTS IN THOUSANDS	**2004**	2003
Operating activities		
Net income	**$ 41,199**	$ 22,441
Adjustments to reconcile net income to net cash		
provided by operating activities:		
Depreciation and amortization	**13,603**	10,465
Amortization of restricted stock grants	**198**	155
Provision for deferred income taxes	**14,276**	14,810
Realized gains on sale of investments	**(8,983)**	(12,280)
Changes in assets and liabilities:		
Reinsurance balances	**3,633**	6,960
Federal income taxes	**5,851**	
Other assets	**(3,700)**	(29,269)
Unpaid losses and loss adjustment expenses	**23,626**	33,571
Unearned premiums	**17,873**	33,281)
Claims checks payable	**(3,578)**	3,239
Other liabilities	**12,035**	1,847
Net cash provided by operating activities	**116,033**	85,220
Investing activities		
Fixed maturities available-for-sale		
Purchases	**(693,343)**	(340,510)
Calls or maturities	**27,524**	19,498
Sales	**612,776**	274,424
Purchases of property and equipment	**(18,978)**	(7,848)
Net cash used in investing activities	**(72,021)**	(54,436)
Financing activities		
Repayment of debt	**(5,617)**	(4,721)
Dividends paid (per share: $0.06 and $0.04)	**(5,126)**	(3,417)
Proceeds from the exercise of stock options	**407**	
Net cash used in financing activities	**(10,336)**	(8,138)
Net increase in cash and cash equivalents	**33,676**	22,646
Cash and cash equivalents, beginning of period	**65,010**	105,897

Cash and cash equivalents, end of period	**$**	**98,686**	$	128,543
Supplemental information:				
Income taxes (refunded) paid	**$**	**(10,480)**	$	123
Interest paid		**4,439**		1,407

See accompanying notes to condensed consolidated financial statements.

21ST CENTURY INSURANCE GROUP
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
June 30, 2004
Unaudited

NOTE 1. BASIS OF PRESENTATION

21st Century Insurance Group and subsidiaries (the Company) prepared the accompanying unaudited condensed consolidated financial statements in accordance with the rules and regulations of the Securities and Exchange Commission for interim reporting. As permitted under those rules and regulations, certain notes or other information that are normally required by accounting principles generally accepted in the United States of America (GAAP) have been condensed or omitted if they substantially duplicate the disclosures contained in the annual audited consolidated financial statements. The unaudited condensed financial statements should be read in conjunction with the audited financial statements and notes thereto included in the Company s Annual Report on Form 10-K for the year ended December 31, 2003.

These condensed consolidated financial statements include all adjustments (consisting of normal, recurring accruals) that are considered necessary for the fair presentation of our financial position and results of operations in accordance with GAAP. Intercompany accounts and transactions have been eliminated in consolidation. Operating results for the six-month period ended June 30, 2004 are not necessarily indicative of results that may be expected for any other interim period or the year as a whole.

Certain amounts in the 2003 condensed consolidated financial statements have been reclassified to conform to the 2004 presentation.

Earnings Per Share (EPS)

For each of the quarters and six-month periods ended June 30, 2004 and 2003, the numerator for the calculation of both basic and diluted earnings per common share is equal to net income reported for that period. The difference between basic and diluted earnings per share denominators is due to dilutive stock options. Options to purchase an aggregate of 6,634,593 and 5,850,135 shares of common stock during the second quarter and six months ended June 30, 2004, respectively, and 5,043,374 and 5,088,168 shares of common stock during the second quarter and six months ended June 30, 2003, respectively, were not included in the computation of diluted earnings per share because the options exercise prices were greater than the average market price of the common stock for each respective period. These options expire at various points in time through May 2014.

Stock-Based Compensation

Statement of Financial Accounting Standards (SFAS) No. 148, *Accounting for Stock-Based Compensation-Transition and Disclosure*, amends the disclosure requirements of SFAS No. 123, *Accounting for Stock-Based Compensation*, to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. As permitted by SFAS No. 148, the Company accounts for its fixed stock options using the intrinsic-value method, prescribed in APB Opinion No. 25, *Accounting for Stock Issued to Employees*, which generally does not result in compensation expense recognition. Under the intrinsic-value method, compensation cost for stock options is measured at the date of grant as the excess, if any, of the quoted market price of the Company s stock over the exercise price of the options.

21ST CENTURY INSURANCE GROUP
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)
June 30, 2004
Unaudited

Had compensation cost for the Company s stock-based compensation plans been determined based on the estimated fair value at the grant dates of options, net income and earnings per share would have been reduced to the pro-forma amounts indicated below:

	Three Months Ended June 30,		*Six Months Ended June 30,*	
AMOUNTS IN THOUSANDS, EXCEPT SHARE DATA	**2004**	2003	**2004**	2003
Net income, as reported	**$ 21,374**	$ 29,151	**$ 41,199**	$ 22,441
Add: Stock-based employee compensation expense included in reported net income, net of related tax effects	**65**	60	**130**	120
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	**(1,301)**	(1,165)	**(3,280)**	(3,061)
Net income, pro-forma	**$ 20,138**	$ 28,046	**$ 38,049**	$ 19,500
Basic and diluted earnings per share:				
As reported	**$ 0.25**	$ 0.34	**$ 0.48**	$ 0.26
Pro-forma	**$ 0.24**	$ 0.33	**$ 0.44**	$ 0.23

For pro-forma disclosure purposes, the fair value of stock options was estimated for grants during the periods ended June 30 using the Black-Scholes valuation model with the following weighted-average assumptions:

	Six Months Ended June 30,	
	2004	2003
Risk-free interest rate:		
Minimum	**3.43%**	2.65%
Maximum	**4.24%**	3.75%
Dividend yield	**0.56%**	0.67%
Volatility factor of the expected market price of the Company s common stock:		
Minimum	**0.36**	0.38
Maximum	**0.41**	0.40
Weighted-average expected life of the options	**6 years**	6 years

21ST CENTURY INSURANCE GROUP
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)
June 30, 2004
Unaudited

NOTE 2. HOMEOWNER AND EARTHQUAKE LINES IN RUNOFF

California Senate Bill 1899 (SB 1899), effective from January 1, 2001, to December 31, 2001, allowed the re-opening of previously closed earthquake claims arising out of the 1994 Northridge earthquake. The discovery stay imposed in early 2002 was lifted in the first quarter of 2003 and the Company obtained more information with which to estimate the ultimate cost of resolving its SB 1899 claims. Based on events occurring during the first quarter of 2003, the Company increased its 1994 Northridge earthquake/SB 1899 reserves by $37.0 million, resulting in an after-tax charge of $24.1 million. The revised estimate was based on the pace and cost of settlements reached thus far, the actual costs incurred during that quarter, and the Company s assessment of the expected length and intensity of the litigation arising out of the remaining claims. The estimate was subsequently increased by $1.0 million during the first quarter of 2004 based on the Company s reassessment of its remaining estimated litigation costs.

A substantial majority of the claims submitted and litigation brought against the Company as a result of SB 1899 have been resolved. Substantially all of the Company s remaining 1994 Earthquake claims are in litigation, including two seeking class action status. While the reserves established are the Company s current best estimate of the cost of resolving its 1994 Earthquake claims, the reserves for this legislatively created event continue to be highly uncertain because of the difficulty in predicting how the remaining litigated cases will be resolved. The estimate currently recorded by the Company assumes that relatively few of the remaining cases will require a full trial to resolve, that any trial costs will approximate those encountered by the Company in the past, that most cases will be settled without need for extensive pre-trial preparation, and that no cases seeking class action status will be certified as a class action. Current reserves contain no provisions for extracontractual or punitive damages, bad faith judgments or similar unpredictable hazards of litigation that possibly could result in the event an adverse verdict were to be sustained against the Company. To the extent these and other underlying assumptions prove to be incorrect, the ultimate amount to resolve these claims could exceed the Company s current reserves, possibly by a material amount. The Company continues to seek reasonable settlements of claims brought under SB 1899 and other Northridge earthquake related theories, but will vigorously defend itself against excessive demands and fraudulent claims. The Company may, however, settle cases in excess of its assessment of its contractual obligations in order to reduce the future cost of litigation.

The Company has received some Northridge earthquake claims reported after the closing of the window established by SB 1899 which are based upon alternative legal theories. The Company is contesting these claims and has only nominal reserves for them. Should the courts determine that these claims, or additional claims brought in the future, are not barred by the applicable statute of limitations and the provisions of SB 1899, additional reserves may be needed to resolve these claims.

Loss and loss adjustment expenses for the homeowner and earthquake lines in runoff were $ 0.2 million and $ 0.5 million for the quarter and six months ended June 30, 2004, respectively, compared to $0 million and $37.0 million for the same periods in 2003.

21ST CENTURY INSURANCE GROUP
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)
June 30, 2004
Unaudited

NOTE 3. COMMITMENTS AND CONTINGENCIES

Litigation. In the normal course of its business, the Company is named as a defendant in lawsuits related to claims and insurance policy issues, both on individual policy files and by class actions seeking to attack the Company s business practices. Many suits seek unspecified extracontractual and punitive damages as well as contractual damages under the Company s insurance policies in excess of the Company s estimates of its obligations under such policies. The Company has not established reserves for potential extracontractual or punitive damages, or for contractual damages in excess of estimates the Company believes are correct and reasonable under its insurance policies. Nevertheless, extracontractual and punitive damages, if assessed against the Company, could be material in an individual case or in the aggregate. The Company may choose to settle litigated cases for amounts in excess of its own estimate of contractual damages to avoid the expense and/or risk of litigation. Other than possibly for contingencies discussed below and in the Company s 2003 audited financial statements, the Company does not believe the ultimate outcome of these matters will be material to its results of operations, financial condition or cash flows.

The Company has recorded its best estimate of liability for outstanding matters where such estimates can be made. A range of potential losses in the event of a negative outcome is discussed where known.

Poss v. 21st Century Insurance Company was filed on June 13, 2003, in Los Angeles Superior Court. The Complaint requests injunctive and restitutionary relief against the Company under Business and Professions Code ("B&P") Sec. 17200 for alleged unfair business practices in violation of California Insurance Code ("CIC") Sec. 1861.02(c) relating to company rating practices. The Superior Court has stayed its decision pending the appellate courts decisions in *Donabedian v. Mercury Insurance Company* and *Poirer v. State Farm Mutual Auto Insurance Company*, which involve issues similar to *Poss*. An appellate court ruled against Mercury in the *Donabedian* case; oral arguments have been completed in *Poirer* but no decision has been announced. Because this matter is in the pleading stages and no discovery has taken place, no estimate of the range of potential losses in the event of a negative outcome can be made at this time. The plaintiffs are seeking injunctive relief and unspecified restitutionary relief. A new case, *Axen v. 21st Century Insurance Company*, contains allegations similar to those in *Poss*. This matter is likewise in the pleading stages and no estimate of potential losses in the event of a negative outcome can be made at this time.

Cecelia Encarnacion, individually and as the Guardian Ad Litem for Nubia Cecelia Gonzalez, a Minor, Hilda Cecelia Gonzalez, a Minor, and Ramon Aguilera v. 20th Century Insurance was filed on July 3, 1997, in Los Angeles Superior Court. Plaintiffs allege bad faith, emotional distress, and estoppel involving 20th Century's (the Company was formerly named 20th Century Insurance) handling of a 1994 homeowner's claim. On March 1, 1994, Ramon Aguilera shot Mr. Gonzalez (the minor children's father) and was later sued by Ms. Encarnacion for wrongful death. On August 30, 1996, judgment was entered against Ramon Aguilera for $5.6 million. The Company paid for Aguilera's defense costs through the civil trial; however, the homeowner's policy did not provide indemnity coverage for the shooting incident, and the Company refused to pay the judgment. After the trial, Aguilera assigned a portion of his action against the Company to Encarnacion and the minor children. Aguilera and the Encarnacion family then sued the Company alleging that 20th Century had promised to pay its bodily injury policy limit if Aguilera pled guilty to involuntary manslaughter. In August 2003, the trial court held a bench trial on the limited issues of promissory and equitable estoppel, and policy forfeiture. On September 26, 2003, the trial court issued a ruling that 20th Century cannot invoke any policy exclusions as a defense to coverage. On May 14, 2004, the court granted the Encarnacion plaintiffs motion for summary adjudication, ordering that 20th Century must pay the full amount of the underlying judgment, plus interest. The Company disagrees with this ruling and currently intends to appeal it at the first opportunity to do so. However, the court also denied 20th Century's motion for summary judgment against Aguilera on the grounds that there are triable issues of fact as to whether Aguilera is precluded from recovering damages as a consequence of his own inequitable conduct. These rulings appear to be legally inconsistent and a motion for clarification will be heard on July 27, 2004. On that same date, the court will schedule a trial on the remaining issues in the case, including punitive damages.

21ST CENTURY INSURANCE GROUP
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)
June 30, 2004
Unaudited

In a December 21, 2000 court ruling, *Ceridian Corporation v. Franchise Tax Board*, a California statute that allowed a tax deduction for the dividends received from wholly owned insurance subsidiaries was held unconstitutional on the grounds that it discriminated against out-of-state insurance holding companies. Subsequent to the court ruling, the staff of the California Franchise Tax Board (FTB) took the position that the discriminatory sections of the statute are not severable and the entire statute is invalid. As a result, the FTB is disallowing dividend-received deductions for all insurance holding companies, regardless of domicile, for open tax years ending on or after December 1, 1997. Although the FTB has not made a formal assessment for tax years 1997 through 2000, the Company anticipates a retroactive disallowance that would result in additional tax assessments.

The amount of any such possible assessments and the ultimate amounts, if any, that the Company may be required to pay, are subject to a wide range of estimates because so many long-settled aspects of California tax law have been thrown into disarray and uncertainty by the action of the courts. In the absence of legislative relief, years of future litigation may be required to determine the ultimate outcome. The possible losses, net of federal tax benefit, range from close to zero to approximately $22.0 million depending on which position future courts may decide to uphold or on whether the California legislature may decide to enact corrective legislation. The Company believes it has adequately provided for this contingency.

NOTE 4. STOCK - BASED COMPENSATION

2004 Stock Option Plan

The stockholders approved the 2004 Stock Option Plan (the 2004 Plan) at the Annual Meeting of Shareholders on May 26, 2004. The 2004 Plan supersedes the 1995 Stock Option Plan, which will remain in effect only as to outstanding awards under it. The 2004 Plan authorizes a Committee of the Board of Directors to grant stock options in respect of 4,000,000 shares to eligible employees and nonemployee directors, subject to the terms of the 2004 Plan. Additionally, under the 2004 Plan, the Committee may grant stock options in respect of shares that were subject to outstanding awards under the 1995 Stock Option Plan to the extent such awards expire, are terminated, are cancelled, or are forfeited for any reason without shares being issued.

At June 30, 2004, 5,236,051 stock options remain available for future grants under the 2004 Plan. Options granted to employees generally have ten-year terms and vest over various periods, generally three years. Options granted to nonemployee directors expire one year after a nonemployee director ceases service with the Company, or ten years from the date of grant, whichever is sooner. Nonemployee director options vest over one year, provided that the nonemployee director is in the service of the Company at that time. Currently, the Company uses the intrinsic-value method to account for stock-based compensation paid to employees for their services.

21ST CENTURY INSURANCE GROUP
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)
June 30, 2004
Unaudited

A summary of securities issuable and issued for the Company s stock option plans and the Restricted Shares Plan at June 30, 2004, follows:

AMOUNTS IN THOUSANDS	*1995 Stock Option Plan*	*2004 Stock Option Plan*	*Restricted Shares Plan*
Total number of securities authorized	10,000	4,000	1,422
Number of securities issued	(511)		(1,049)
Number of securities issuable upon the exercise of all outstanding options	(8,253)		
Number of securities forfeited	1,522		
Number of securities forfeited and returned to plan	(1,522)		156
Unused options assumed by 2004 Stock Option Plan	(1,236)	1,236	
Number of securities remaining available for future grants under each plan		5,236	529

Exercise prices for options outstanding at June 30, 2004 ranged from $11.68 to $29.25. The weighted-average remaining contractual life of those options is 7.5 years.

A summary of the Company s stock option activity for the six months ended June 30, 2004, and related information follows:

AMOUNTS IN THOUSANDS, EXCEPT PRICE DATA	*Number of Options*	*Weighted-Average Exercise Price*
Options outstanding December 31, 2003	6,744	$ 17.05
Granted in 2004	1,630	14.36
Exercised in 2004	(35)	14.25
Forfeited in 2004	(86)	14.23
Options outstanding June 30, 2004	8,253	$ 16.56

Options exercisable numbered 5,171,468 and 3,616,154 at June 30, 2004 and 2003, respectively.

<u>NOTE 5. DEFINED BENEFIT PENSION PLANS</u>

The Company has both funded and unfunded non-contributory defined benefit pension plans, which together cover essentially all employees who have completed at least one year of service. For certain key employees designated by the Board of Directors, the Company sponsors an unfunded nonqualified supplemental executive retirement plan. The supplemental plan benefits are based on years of service and compensation during the three highest of the last ten years of employment prior to retirement and are reduced by the benefit payable from the pension plan and 50% of the social security benefit. For other eligible employees, the pension benefits are based on employees compensation during all years of service. The Company s funding policy is to make annual contributions as required by applicable regulations.

21ST CENTURY INSURANCE GROUP
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)
June 30, 2004
Unaudited

Components of Net Periodic Cost

Net pension costs for all plans were comprised of the following:

	Six Months Ended June 30,	
AMOUNTS IN THOUSANDS	**2004**	2003
Service cost	**$ 2,979**	$ 2,127
Interest cost	**3,221**	2,601
Expected return on plan assets	**(3,223)**	(2,284)
Amortization of prior service cost	**52**	43
Amortization of net loss	**989**	932
Total	**$ 4,018**	$ 3,419

Employer Contributions

The Company previously disclosed in its financial statements for the year ended December 31, 2003 that it did not expect to contribute to its pension plans in 2004. As of June 30, 2004, no contributions have been made. After consideration of currently available information, the Company continues to anticipate that it will not contribute any funds to any of its pension plans in 2004.

NOTE 6. SEGMENT INFORMATION

The Company s Personal Auto Lines reportable segment primarily markets and underwrites personal automobile, motorcycle and umbrella insurance. The Company s Homeowner and Earthquake Lines in Runoff reportable segment, which is in runoff, manages the wind-down of the Company s homeowner and earthquake programs. The Company has not written any earthquake coverage since 1994 and ceased writing homeowner policies in February 2002.

Insurers offering homeowner insurance in California are required to participate in the California FAIR Plan (FAIR Plan). FAIR Plan is a state administered pool of difficult to insure homeowners. Each participating insurer is allocated a percentage of the total premiums written and losses incurred by the pool according to its share of total homeowner direct premiums written in the state. Participation in the current year FAIR Plan operations is based on the pool from two years prior. Since we ceased writing direct homeowners business in 2002, the Company will continue to receive assignments in the 2004 calendar year.

The Company evaluates segment performance based on profit or loss from operations before income taxes (i.e., underwriting profit or loss, which excludes interest income and expense). The accounting policies of the reportable segments are the same as those described in Note 2 of the notes to consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2003. All revenues are generated from external customers.

21ST CENTURY INSURANCE GROUP
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)
June 30, 2004
Unaudited

Segment information is as follows:

AMOUNTS IN THOUSANDS	*Personal Auto Lines*	*Homeowner and Earthquake Lines in Runoff* [1]	*Total*
Three Months Ended June 30, 2004			
Net premiums earned	**$ 326,965**	**$ 56**	**$ 327,021**
Segment profit (loss)	**18,007**	**(168)**	**17,839**
Three Months Ended June 30, 2003			
Net premiums earned	$ 287,231	$	$ 287,231
Segment profit	10,893		10,893
Six Months Ended June 30, 2004			
Net premiums earned	**$ 645,130**	**$ 111**	**$ 645,241**
Segment profit (loss)	**28,843**	**(388)**	**28,455**
Six Months Ended June 30, 2003			
Net premiums earned	$ 558,672	$	$ 558,672
Segment profit (loss)	18,905	(37,000)	(18,095)

The following table reconciles our segment profit (loss) to our consolidated income before provision for income taxes:

AMOUNTS IN THOUSANDS	*Three Months Ended June 30,* **2004**	2003	*Six Months Ended June 30,* **2004**	2003
Segment profit (loss)	**$ 17,839**	$ 10,893	**$ 28,455**	$ (18,095)
Net investment income	**14,315**	11,673	**27,461**	23,311
Net realized investment gains	**1,337**	7,700	**8,983**	12,280
Other revenues		14,065		14,065
Interest and fees expense	**(2,185)**	(833)	**(4,411)**	(1,540)
Income before provision for income taxes	**$ 31,306**	$ 43,498	**$ 60,488**	$ 30,021

[1] Revenue represents premium earned as a result of the Company's participation in the California FAIR Plan.

ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Overview

We primarily market and underwrite personal automobile, motorcycle, and umbrella insurance in California. We also provide personal automobile insurance in four other western states (Arizona, Nevada, Oregon and Washington) and three midwestern states (Illinois, Indiana and Ohio). We began offering personal auto insurance in Illinois, Indiana and Ohio on January 28, 2004.[1] We believe that we have a reputation for high quality customer service and for being among the most efficient and lowest-cost providers of personal auto insurance in the markets we serve.

Net income for the quarter ended June 30, 2004 was $21.4 million, or $0.25 per share, compared to net income of $29.2 million, or $0.34 per share, for the quarter ended June 30, 2003. The 2003 quarterly results included nonrecurring nonoperational items that increased net income by $9.1 million, or $0.11 per share. For the six months ended June 30, 2004, net income was $41.2 million, or $0.48 per share, compared to $22.4 million, or $0.26 per share, for the same period in 2003. The results for the six months ended June 30, 2003 include the second quarter nonrecurring nonoperational income items of $9.1 million after-tax, or $0.11 per share, and a first quarter after-tax charge of $24.1 million, or $0.28 per share, to strengthen reserves on the 1994 Northridge earthquake claims.

Our primary goals include realizing 15% growth in direct premiums written and attaining a 96% combined ratio for our personal auto lines. The Company showed continued strength in its core personal auto lines results:

- Direct premiums written increased 7.9% to $324.8 million in the second quarter ended June 30, 2004, compared to $300.9 million in the second quarter of 2003. For the six months ended June 30, 2004, direct premiums written increased 11.9% to $665.3 million compared to $594.5 million for the same period in 2003.

- The combined ratio improved to 94.5% in the second quarter of 2004 compared to 96.2% for the same quarter a year ago. For the six months ended June 30, 2004, the combined ratio improved to 95.5% from 96.6% in 2003.

- Underwriting profit increased 65.3% for the three months ended June 30, 2004 to $18.0 million from $10.9 million in the second quarter of 2003. For the six months ended June 30, 2004, underwriting profit was $28.8 million, an increase of 52.6% over underwriting profit of $18.9 million for same period in 2003.

Cash flow from operations increased by 25.9% to $58.5 million for the second quarter of 2004 from $46.4 million in the second quarter of 2003. For the six months ended June 30, 2004, cash flow from operations increased by 36.2% to $116.0 million from $85.2 million for the same period in 2003. This resulted in an overall increase in total assets to $1.779 billion at June 30, 2004 from $1.738 billion at December 31, 2003.

Statutory surplus increased by $56.8 million, or 10.6%, to $591.8 million at June 30, 2004 from $535.0 million at December 31, 2003. Stockholders equity and book value per share increased by $5.9 million to $706.6 million and $0.07 to $8.27, respectively, at June 30, 2004 from $700.7 million and $8.20, respectively, at December 31, 2003.

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

[1] Results from these new markets are not expected to be material in 2004.

The remainder of our Management s Discussion and Analysis of Financial Condition and Results of Operations should be read in conjunction with the accompanying financial statements. It includes the following sections:

- Financial Condition
- Liquidity and Capital Resources
- Contractual Obligations and Commitments
- Results of Operations
- Underwriting Results
- Investment Income
- Critical Accounting Policies
- Forward-Looking Statements

Financial Condition

All of our rated investments as of June 30, 2004 were investment-grade. Of our total investments at June 30, 2004, approximately 24.4% were invested in tax-exempt, fixed-income securities, compared to 61.7% at December 31, 2003. We decreased the percentage of total investments in tax-exempt securities to accelerate our net operating loss utilization, improve cash flow and continue to shorten the duration of the portfolio.

As of June 30, 2004, the pre-tax net unrealized loss on investments was $13.8 million (unrealized gains of $15.6 million and unrealized losses of $29.4 million) compared to a pre-tax net unrealized gain of $36.1 million at December 31, 2003 (unrealized gains of $39.5 million and unrealized losses of $3.4 million). Our policy is to investigate, on a quarterly basis, any investment for possible other-than-temporary impairment in the event the fair value of the security falls below its amortized cost, based on all relevant facts and circumstances. No such impairments were recorded in the quarters ended June 30, 2004 or 2003.

Premiums receivable were $107.6 million at June 30, 2004, compared to $104.6 million at December 31, 2003, with the increase mainly attributable to growth in our customer base. Balances past due 90 days or more totaled $0.4 million and $0.6 million at June 30, 2004 and December 31, 2003, respectively. Company policy is to write off receivable balances when they become past due 180 days. At June 30, 2004 and December 31, 2003, we recorded an allowance for doubtful accounts of $1.3 million and $0.9 million, respectively.

Prepaid reinsurance premiums and reinsurance payables were $1.7 million and $0.6 million at June 30, 2004, compared to $1.7 million and $1.8 million at December 31, 2003, respectively. The decline in reinsurance payables is primarily due to the runoff related to the cancellation of the quota share treaty with American International Group, Inc. (AIG) subsidiaries.

Increased advertising, sales and customer service costs through June 30, 2004, associated with increased customer volume, contributed to an increase in deferred policy acquisition costs (DPAC) of $3.0 million to $56.1 million, compared to $53.1 million at December 31, 2003. Our DPAC is estimated to be fully recoverable (see Critical Accounting Policies - Deferred Policy Acquisition Costs).

The following table summarizes unpaid losses and LAE with respect to our lines of business:

	June 30, 2004		*December 31, 2003*	
AMOUNTS IN THOUSANDS	**Gross**	**Net**	Gross	Net
Unpaid Losses and LAE				
Personal auto lines	**$ 449,707**	**$ 445,272**	$ 419,913	$ 413,348
Homeowner and earthquake lines in runoff	**12,242**	**10,910**	18,410	16,011
Total	**$ 461,949**	**$ 456,182**	$ 438,323	$ 429,359

The following table summarizes losses and LAE incurred, net of applicable reinsurance, for the periods indicated:

	Three Months Ended June 30,		*Six Months Ended June 30,*	
AMOUNTS IN THOUSANDS	**2004**	2003	**2004**	2003
Net losses and LAE incurred related to insured events of:				
Current year	**$ 244,406**	$ 228,182	**$ 491,540**	$ 444,525
Prior years	**150**		**530**	37,000
Total	**$ 244,556**	$ 228,182	**$ 492,070**	$ 481,525

At June 30, 2004, unpaid losses and LAE increased $26.8 million from the prior year end to $456.2 million. In the first six months of 2004, net adverse reported loss development for the prior accident years was $0.5 million. The methods used to determine such estimates and to establish the resulting reserves are continually reviewed and updated. Any adjustments resulting therefrom are reflected in current operating income. It is management s belief that the unpaid losses and LAE are adequate to cover unpaid losses and LAE as of June 30, 2004. While we perform quarterly reviews of the adequacy of established unpaid losses and LAE, there can be no assurance that our ultimate unpaid losses and LAE will not develop redundancies or adversely develop and materially differ from our unpaid losses and LAE as of June 30, 2004. In the future, if the unpaid losses and LAE develop redundancies or deficiencies, such redundancy or deficiency would have a positive or adverse impact, respectively, on future results of operations.

The process of making quarterly changes to unpaid losses and LAE begins with the preparation of several point estimates of unpaid losses and LAE, a review of the actual claims experience in the quarter, actual rate changes achieved, actual changes in coverage, mix of business, and changes in certain other factors such as weather and recent tort activity that may affect the loss ratio. Our actuaries prepare several point estimates of unpaid losses and LAE for each of the coverages, and they use their experience and judgment to arrive at an overall actuarial point estimate of the unpaid losses and LAE for that coverage. Meetings are held with appropriate departments to discuss significant issues as a result of the review. This process culminates in a reserve meeting to review the unpaid losses and LAE. The basis for carried unpaid losses and LAE is the overall actuarial point estimate. Other relevant internal and external factors considered include a qualitative assessment of inflation and other economic conditions, changes in the legal, regulatory, judicial and social environments, underlying policy pricing, exposure and policy forms, claims handling, and geographic distribution shifts. As a result of the meeting, unpaid losses and LAE are finalized and we record quarterly changes in unpaid losses and LAE for each of our coverages. The change in unpaid losses and LAE for the quarter for each coverage is the difference between net ultimate losses and LAE and the net paid losses and LAE recorded through the end of the quarter. The overall change in our unpaid losses and LAE is based on the sum of these coverage level changes.

The point estimate methods include the use of paid loss triangles, incurred loss triangles, claim count triangles, severity triangles, as well as expected loss ratio methods. Quantitative techniques frequently have to be supplemented by subjective consideration, including managerial judgment, to assure management satisfaction that the overall unpaid losses and LAE are adequate to meet projected losses. For example, in property damage coverages, repair cost trends by geographic region vary significantly. These factors are periodically reviewed and subsequently adjusted, as appropriate, to reflect emerging trends which are based upon past loss experience. Thus, many factors are implicitly considered in estimating the quarter-to-quarter growth in loss costs recognized.

Judgment is required in analyzing the appropriateness of the various methods and factors to avoid overreacting to data anomalies that may distort such prior trends. For example, changes in limits distributions or development in the most recent accident quarters would require more actuarial judgment. We do not believe disclosure of specific point estimates calculated by the actuaries would be meaningful. Any one actuarial point estimate is based on a particular series of judgments and assumptions of the actuary. Another actuary may make different assumptions, and therefore reach a different point estimate. So long as the series of judgments and assumptions are reasonable, no one such point estimate is necessarily a better estimate than another point estimate.

There is a potential for significant variation in developing unpaid losses and LAE. Most automobile claims are reported within two to three months whereas the estimate of ultimate severities exhibits greater variablility at the same maturity. Generally, actual historical loss development factors are used to project future loss development, and there can be no assurance that future loss development patterns will be the same as in the past. However, we believe that our reserving methodologies are in line with other personal lines insurers and would normally expect ultimate unpaid losses and LAE development to vary by as much as 5% of the carried unpaid losses and LAE.

As a result of the significant growth in the non-Los Angeles County regions, the Company has experienced changes in the mix of business relative to geography and policy limits. We believe that the assumption with the highest likelihood of change that could materially affect carried unpaid losses and LAE is property damage and collision severity in the San Francisco and bay area regions, which have significantly different repair costs and have exhibited significant policy growth. A 5% change in the severity assumption for these regions would result in an increase or decrease in total unpaid losses and LAE of 2.1%, or $9.6 million.

While we have settled a substantial majority of earthquake claims and are making progress in resolving outstanding litigation, estimates of both the litigation costs and ultimate settlement or judgment amounts related to these claims are subject to a high degree of uncertainty. Please see Note 2 of the Notes to Condensed Consolidated Financial Statements for additional background on the Northridge Earthquake and SB 1899.

Stockholders equity and book value per share increased to $706.6 million and $8.27 at June 30, 2004, compared to $700.7 million and $8.20 at December 31, 2003. The net increase in stockholders equity for the six months ended June 30, 2004 was primarily due to net income of $41.2 million, approximately $0.4 million in proceeds from stock option exercises, a decrease in net unrealized investment gains of $32.5 million and dividends to stockholders of $3.4 million.

Liquidity and Capital Resources

21st Century Insurance Group. Our holding company s main sources of liquidity historically have been dividends received from our insurance subsidiaries and proceeds from issuance of debt or equity securities. Apart from the exercise of stock options and restricted stock grants to employees, the effects of which have not been significant, we have not issued any equity securities since 1998 when AIG exercised its warrants to purchase common stock for cash of $145.6 million. Our insurance subsidiaries have not paid any dividends to our holding company since 2001 due to the current uncertainty surrounding the taxability of dividends received by holding companies from their insurance subsidiaries in California. See the discussion of the *Ceridian* case in Note 3 of the Notes to Condensed Consolidated Financial Statements in Item 1.

In December 2003, we completed a private offering of $100 million principal amount of 5.9 % Senior Notes due in December 2013. The effective interest rate on the Senior Notes when all offering costs are taken into account and amortized over the term of the Senior Notes is approximately 6 percent per annum. Of the $99.2 million net proceeds from the offering, $85 million was used to increase the statutory surplus of our wholly-owned insurance subsidiary, 21st Century Insurance Company, and the balance was retained by our holding company.

Effective December 31, 2003, the California Department of Insurance (CDI) approved an intercompany lease whereby 21st Century Insurance Company has leased certain computer software from our holding company. The monthly lease payment, currently $0.4 million, started in January 2004 and is subject to upward adjustment based on the cost incurred by the holding company to complete certain enhancements to the software.

Our holding company s significant cash obligations over the next several years consist of interest payments on the Senior Notes (approximately $5.9 million annually) and the estimated cost to complete our new claims, underwriting and policy servicing system (approximately $23.6 million), exclusive of any dividends to stockholders that our directors may declare, and the repayment of the $100 million principal on the Senior Notes due in 2013. We expect to be able to meet those obligations from sources of cash currently available (i.e., payments received from the intercompany lease and cash and investments at the holding company, which totaled $16.2 million at June 30, 2004) plus additional funds obtained from the capital markets or from dividends received from our insurance subsidiaries. Absent a favorable resolution of the state income tax issue regarding taxability of intercompany dividends received by insurance holding companies, we may have to pay additional California state income taxes of up to approximately 8.9% on the amount of any such dividends received. See the discussion of the *Ceridian* case in Note 3 of the Notes to Condensed Consolidated Financial Statements in Item 1.

Our insurance subsidiaries in 2004 could pay $79.3 million as dividends to us without prior written approval from insurance regulatory authorities. We are unlikely to have our insurance subsidiaries pay dividends to our holding company in 2004 as long as the uncertainty persists over the taxability by California of intercompany dividends.

Insurance Subsidiaries. We have achieved underwriting profits in our core auto insurance operations for the last ten quarters and have thereby enhanced our liquidity. In California, where approximately 97% of our policies are written, we implemented a 3.9% auto premium rate increase effective April 1, 2003. However, there can be no assurance that insurance regulators will grant future rate increases that may be necessary to offset possible future increases in claims cost trends. Also, we remain exposed to possible upward development in previously recorded reserves for claims pursuant to SB 1899. As a result of such uncertainties, underwriting losses could occur in the future. Further, we could be required to liquidate investments to pay claims, possibly during unfavorable market conditions, which could lead to the realization of losses on sales of investments. Adverse outcomes to any of the foregoing uncertainties would create some degree of downward pressure on the insurance subsidiaries earnings, which in turn could negatively impact our liquidity.

As of June 30, 2004, our insurance subsidiaries had a combined statutory surplus of $591.8 million compared to $535.0 million at December 31, 2003. The change in statutory surplus was primarily due to statutory net income of $54.5 million, a decrease in nonadmitted assets of $5.7 million, and a $3.7 million decrease in the deferred income tax asset. Our ratio of net premiums written to statutory surplus was 2.2 at June 30, 2004, compared to 2.3 at December 31, 2003.

On June 15, 2004 the CDI finalized its examination report on the statutory financial statements for the Company s California-domiciled insurance subsidiaries for the three-year period ended December 31, 2002. The report did not require the insurance subsidiaries to restate those financial statements.

Transactions with Related Parties. Transactions with AIG subsidiaries, which are immaterial, have resulted from competitive bidding processes for certain corporate insurance coverages and certain software and data processing services. In October 2003, as a result of a competitive bidding process, we entered into an agreement with an AIG subsidiary to provide investment management services to us; the agreement was subject to approval by the CDI, which granted such approval in October 2003.

Contractual Obligations and Commitments

There were no material changes outside the ordinary course of our business in our contractual obligations during the quarter ended June 30, 2004.

Results of Operations

Overall Results. We reported net income of $21.4 million, or earnings per share (basic and diluted) of $0.25, on direct premiums written of $324.8 million in the quarter ended June 30, 2004, compared to a net income of $29.2 million, or earnings per share (basic and diluted) of $0.34, on direct premiums written of $300.9 million for the same quarter last year. For the six months ended June 30, 2004, net income was $41.2 million, or earnings per share (basic and diluted) of $0.48, on direct premiums written of $665.5 million. Net income for the six months ended June 30, 2003, was $22.4 million, or earnings per share (basic and diluted) of $0.26, on direct premiums written of $594.5 million. These results include: (i) after-tax charges for 1994 Northridge earthquake costs of $24.1 million for the six months ended June 30, 2003 and (ii) after-tax net income of $9.1 million for the quarter ended June 30, 2003 resulting from a non-recurring, non-operational item and a favorable tax settlement with the IRS.

The following table presents the components of our personal auto lines underwriting profit or loss and the components of the combined ratio:

PERSONAL AUTO LINES	*Three Months Ended June 30,*		*Six Months Ended June 30,*	
AMOUNTS IN THOUSANDS	**2004**	2003	**2004**	2003
Direct premiums written	**$ 324,750**	$ 300,924	**$ 665,343**	$ 594,540
Net premiums written	**$ 323,613**	$ 299,743	**$ 663,017**	$ 592,223
Net premiums earned	**$ 326,965**	$ 287,231	**$ 645,130**	$ 558,672
Net loss and loss adjustment expenses	**244,332**	228,182	**491,571**	444,525
Underwriting expenses incurred	**64,626**	48,156	**124,716**	95,242
Personal auto lines underwriting profit	**$ 18,007**	$ 10,893	**$ 28,843**	$ 18,905
Ratios:				
Loss and LAE ratio	**74.7%**	79.4%	**76.2%**	79.6%
Underwriting expense ratio	**19.8%**	16.8%	**19.3%**	17.0%
Combined ratio	**94.5%**	96.2%	**95.5%**	96.6%

The following table reconciles our personal auto lines underwriting profit to our consolidated net income:

AMOUNTS IN THOUSANDS, NET OF TAX	*Three Months Ended June 30,* 2004	2003	*Six Months Ended June 30,* 2004	2003
Personal auto lines underwriting profit	**$ 18,007**	$ 10,893	**$ 28,843**	$ 18,905
Homeowner and earthquake lines in runoff, underwriting loss	**(168)**		**(388)**	(37,000)
Net investment income	**14,315**	11,673	**27,461**	23,311
Realized investment gains	**1,337**	7,700	**8,983**	12,280
Other revenues		14,065		14,065
Interest and fees expense	**(2,185)**	(833)	**(4,411)**	(1,540)
Federal income tax expense	**(9,932)**	(14,347)	**(19,289)**	(7,580)
Net income	**$ 21,374**	$ 29,151	**$ 41,199**	$