Demotech, Inc.

Reviewing Property and Casualty Industry Management Practices – The Financial Perspective

April 21, 2009

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A Demotech, Inc. review and analysis of the Property and Casualty industry focusing on management practices regarding asset management, loss reserving practices, and capital adequacy based on data emanating from current regulatory practices. We utilized The National Association of Insurance Commissioners, Kansas City, Missouri, information derived from Highline Data, by permission. The National Association of Insurance Commissioners and Highline Data do not endorse any analysis or conclusion based upon the use of its data.

Reviewing Property and Casualty Industry Management Practices – The Financial Perspective

Introduction

Demotech, Inc. is a financial analysis and actuarial services firm based in Columbus, Ohio. We serve the insurance industry by providing independent opinions on the financial stability of Property and Casualty insurers and Title underwriters. We believe that financial stability is independent of size. Well-managed, properly reinsured, regional Property and Casualty insurers can be more financially stable than larger, highly leveraged Property and Casualty insurers.

Although no industry, or individual company, is insulated from the effects of an economic downturn, conservative companies that have demonstrated a consistent and long-term lower tolerance for investment risk, will likely fair better in difficult economic times. The Property and Casualty industry, with the exception of several publicly traded companies whose affiliated non-insurance entities have caused them to experience financial difficulties, has remained relatively stable and financially viable.

The recent economic turmoil, and the distress several large financial institutions are experiencing, has re-ignited the federal versus state regulation question. The issue has gained momentum. Industry and non-industry interested parties are preparing to promote and defend their respective positions. Many variations have been discussed. Although there are positive and negative aspects on both sides of the discussion, Demotech has not finalized a position supporting federal regulation, state regulation, or any hybrid version of the two.

The focus of this paper is to observe information emanating from current regulatory processes and procedures. Our focus is on financial stability demonstrated through conservative asset management, adequate loss reserving practices, maintaining and growing surplus, maintaining acceptable leverage ratios, positive underwriting results, and other factors generally accepted as pertinent to the long-term financial stability of Property and Casualty insurance companies.

Our analysis included reviewing more than 2,900 individual, active Property and Casualty insurance companies currently filing statutory financial statements with the National Association of Insurance Commissioners (NAIC). The companies are separated into major types and by classification within each major type. The major types are Pure Mutual, Mutual, Stock (Public), Stock (Private), and Other. The classifications used within the major types reflect those defined in Demotech's research effort with the ***Insurance Journal.*** Please refer to Appendix A for the definitions in Demotech's company classification system.

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The results of our review are presented in two distinct groupings of insurers based on data using type and classification. The first data set is companies based solely on type; Pure Mutual, Mutual, Stock (Public), Stock (Private), and Other. The second data set divides the companies into three groups based on classification. Those three groups are Group A (National and Near National), Group B (Super Regional, Regional, Coverage Specialist, and State Specialist), and Group C (DPW < $1.0MM, Reinsurer, Risk Retention Group, Strategic Subsidiary, and Surplus Lines Carrier). This approach will enable us to observe the overall group by corporate structure as well as company classification.

Asset Management and Return on Investment

One aspect we reviewed was bond quality ratings assigned by the NAIC. The NAIC rating scale assigns a rating of 1 through 6. The highest quality bond is rated 1 while 6 is assigned to the lowest quality bond. Ratings 1 and 2 are typically considered investment grade with ratings 3 through 6 being non-investment grade. We will not address the statutory accounting rules for fixed income securities relative to other than temporary impairment, except to say the information was excerpted from insurer Schedule D filings submitted to the NAIC.

Exhibits A and B show the percentage of bonds rated as 3 through 6 for five years from 2004 to 2008 by company type and classification. Including five years of experience provides insight into the consistency of investment practices by companies within a particular type and classification.

Exhibit A illustrates the National and Near National companies hold a higher percentage of fixed income securities with ratings from 3 to 6 compared to any other group. The respective percentages for these two classifications for the prior five years range from 3.87% to 3.23% for Nationals with a range of 2.51% to 1.93% for Near Nationals. The average percentage for the five year period is 3.56% and 2.43%, respectively. By comparison, for the same five year period, the Super Regional, Regional, and Specialists companies averaged 1.64%, 0.98%, and 1.27%, respectively.

Exhibit A

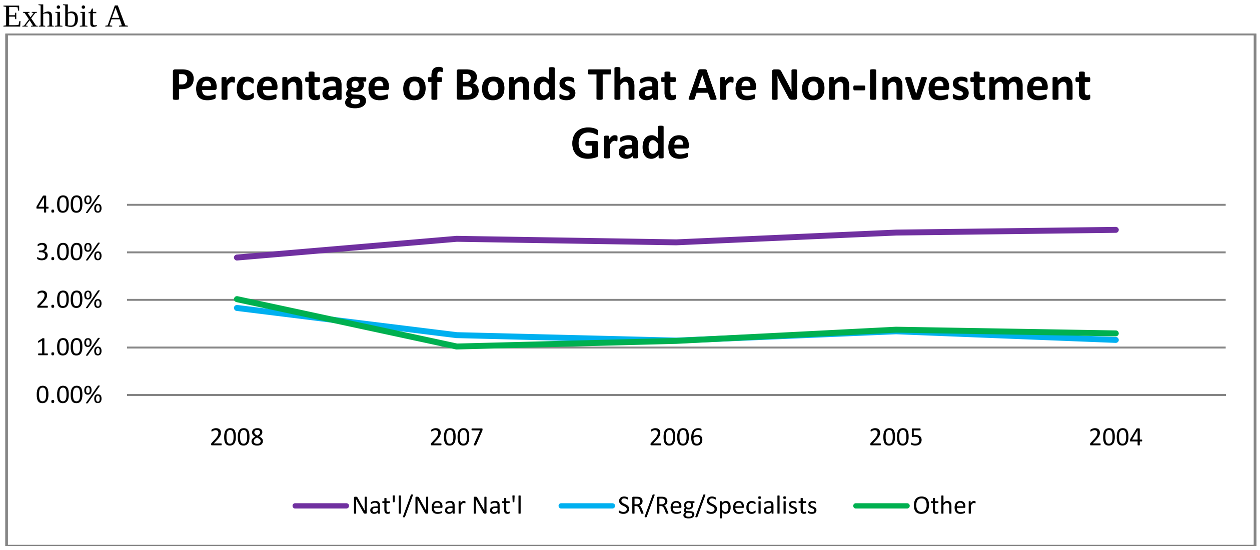

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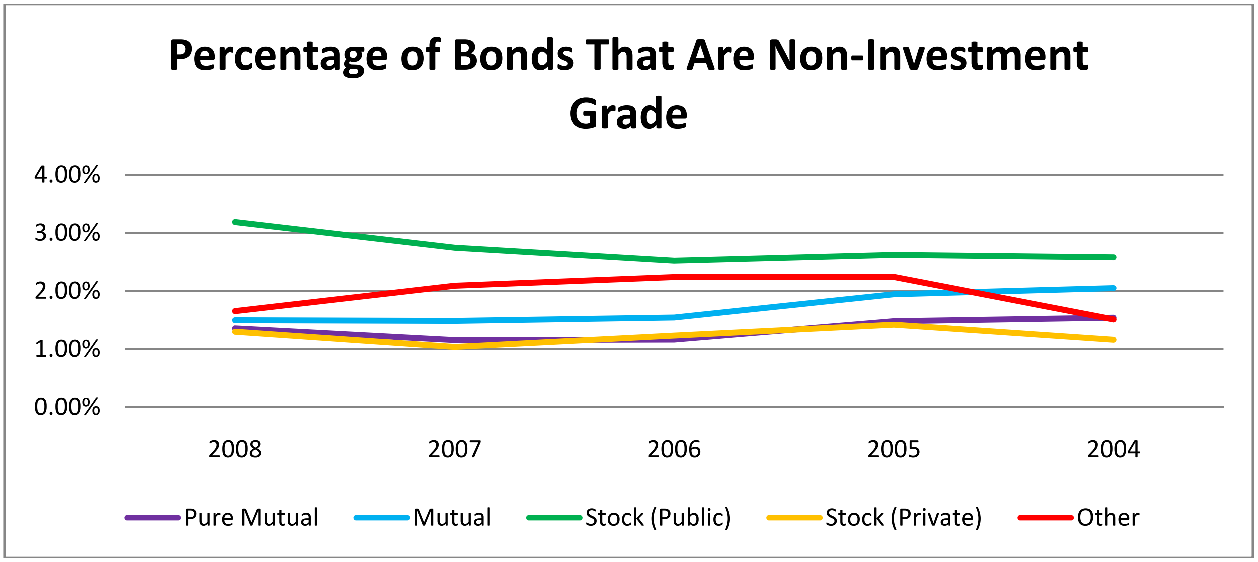
Exhibit B illustrates that Pure Mutual and Mutual companies, which include all company classifications, reflect lower percentages of non-investment grade holdings compared to the Stock (Public) company type. The Pure Mutual companies average 1.34% for the five year period with the Mutual average being 1.69%. For the Stock (Public) companies, the five year average is 2.73%. While these percentages are a relatively low component of the total bonds invested, the dollar volume could be significant relative to surplus. Lower percentages would imply a company has a more conservative investment philosophy.

Exhibit B



The distinction by company size is more pronounced, as reflected in Exhibit A. Companies accepting the greater risk were successful at recording higher investment yields over the same five year period. We reviewed the investment yield for all companies based on the formula used by the NAIC as part of the Insurance Regulatory Information System's (IRIS) ratio analysis. Utilizing this result to compile investment yield provides a readily available, established and consistent measure for all companies.

We acknowledge the investment yield includes more than bond activity. Similarly, yields can be affected by the mix of bonds held. A company that is a current tax payer with a high concentration of tax-free municipal bonds may have an after tax yield similar to a company with a higher pre-tax yield derived from taxable bonds. However, Exhibit C and Exhibit D indicate a pattern of greater investment yields for those companies with higher percentages of non-investment grade bonds.

As illustrated in Exhibit C, the National and Near National companies averaged an investment return of 4.61% for the five year period 2004 through 2008. This contrasts to the non-investment grade bond rating percentage of 3.56% and 2.43%, respectively. The Super Regional, Regional and Specialists average return for the comparable period was 4.10%, with a non-investment grade bond rating percentage of 1.64%, 0.98%, and 1.27% respectively.

Exhibit C

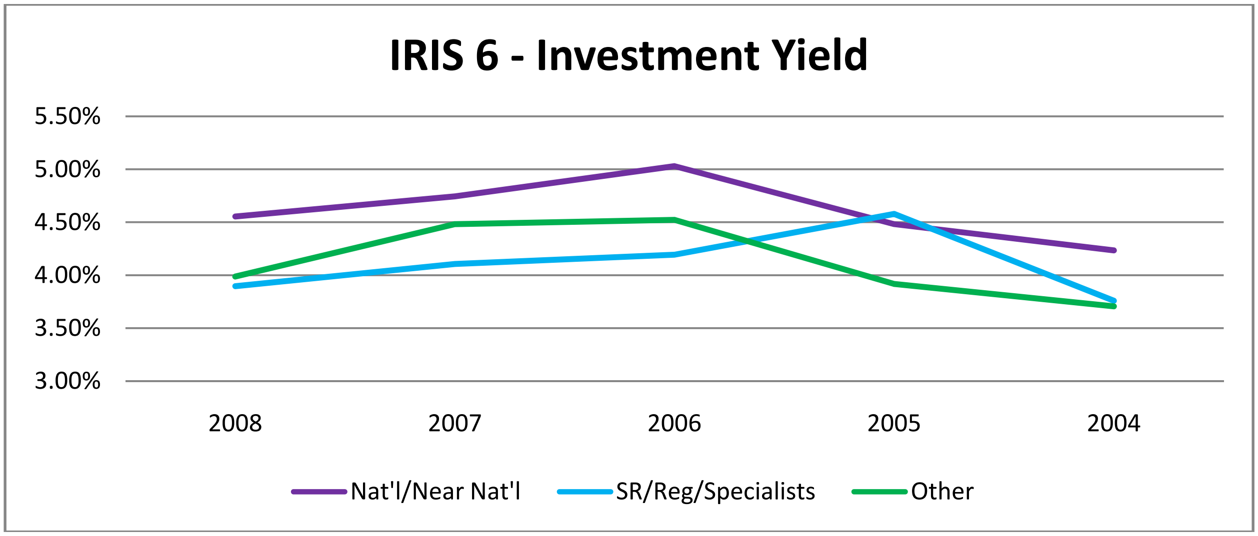
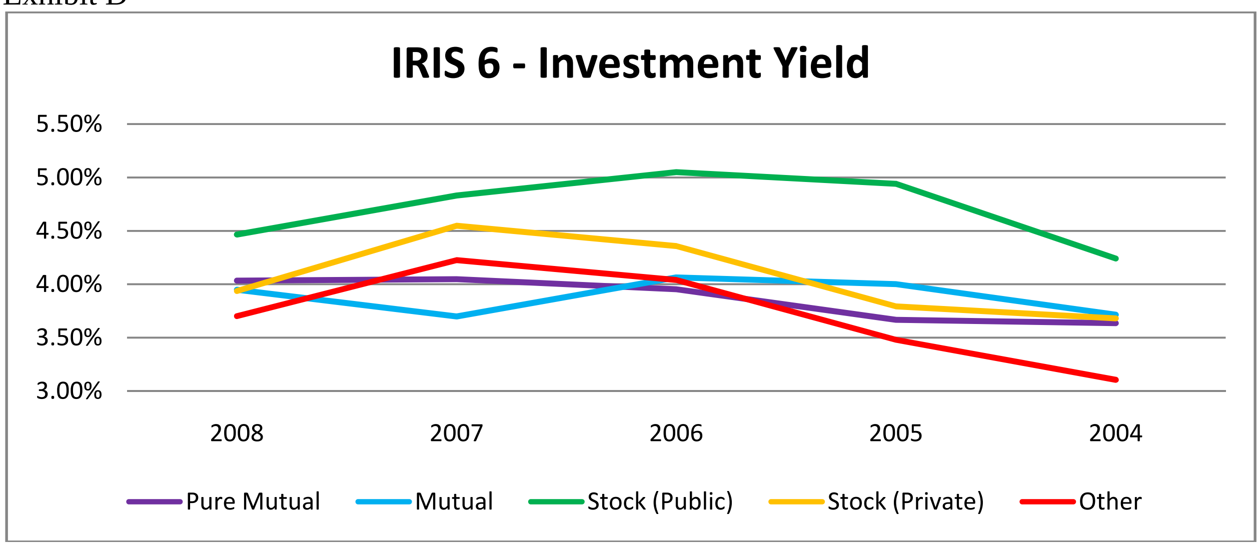


Exhibit D illustrates the Stock (Public) companies reported an average investment yield of 4.71% for the comparable five year period with a non-investment grade bond rating percentage of 2.73%. The Pure Mutual and Mutual companies follow with five year average investment yields of 3.87% for both with non-investment grade bonds yielding 1.34% and 1.69% respectively.

Exhibit D



It would appear that larger companies are more comfortable maintaining greater levels of risk to obtain a higher return. It would appear Mutual companies are conservative compared to Stock (Public) companies. Part of this may be attributed to the propensity for Mutual companies to hold tax exempt bonds in higher concentrations. The data presented implies a distinction between company type and classification and the level of conservatism in bond portfolios. However, based on recent history, no grouping reports an unacceptable level of investment risk in their bond portfolio.

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Loss and Defense and Cost Containment Reserve Development

Schedule P Part 2 Summary of the Property and Casualty annual statement reveals the one year and two year development of Incurred Net Losses and Defense Cost Containment expense. ***Part 2 Summary*** provides insight into the adequacy of reserves for each respective financial reporting period. Demotech believes this is a critical aspect of financial review that reveals information regarding the quality of earnings reported for the period as well as the quality of reported surplus. The development is presented as a percentage of policyholders' surplus for each preceding year-end policyholders' surplus. A company posting habitually inadequate reserve positions has misstated earnings as well as surplus in the previous financial reporting periods.

Exhibits E, F, G, and H display company performance for reserve development over a ten year period. Once again, the Exhibits categorize the companies by type and by classification. Any point above 0% (positive percentage factor) indicates inadequate reserves for that respective year while any point below 0% (negative percentage factor) implies reserve adequacy.

Exhibit E, one year development, and Exhibit F, two year development, illustrate the National and Near National companies with inadequate reserve positions as recently as 2005 with adequate levels reported recently, starting at year-end 2006. Nationals reported a deficiency of 5.33% in 2004 and Near Nationals posted a deficiency of 8.56% in 2005 for one year development with two year development at 19.11% and 12.27% respectively. In contrast, the Super Regional, Regional and Specialists have reported adequate reserve development for the one year and two year measures in almost every year.

Exhibit E

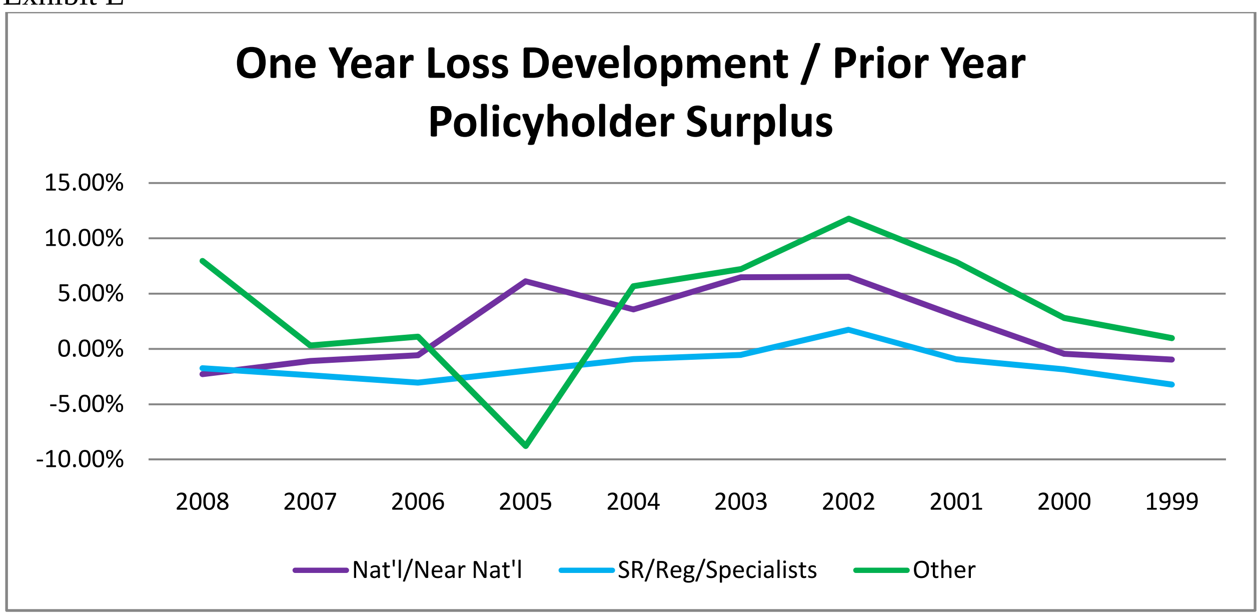

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Exhibit F

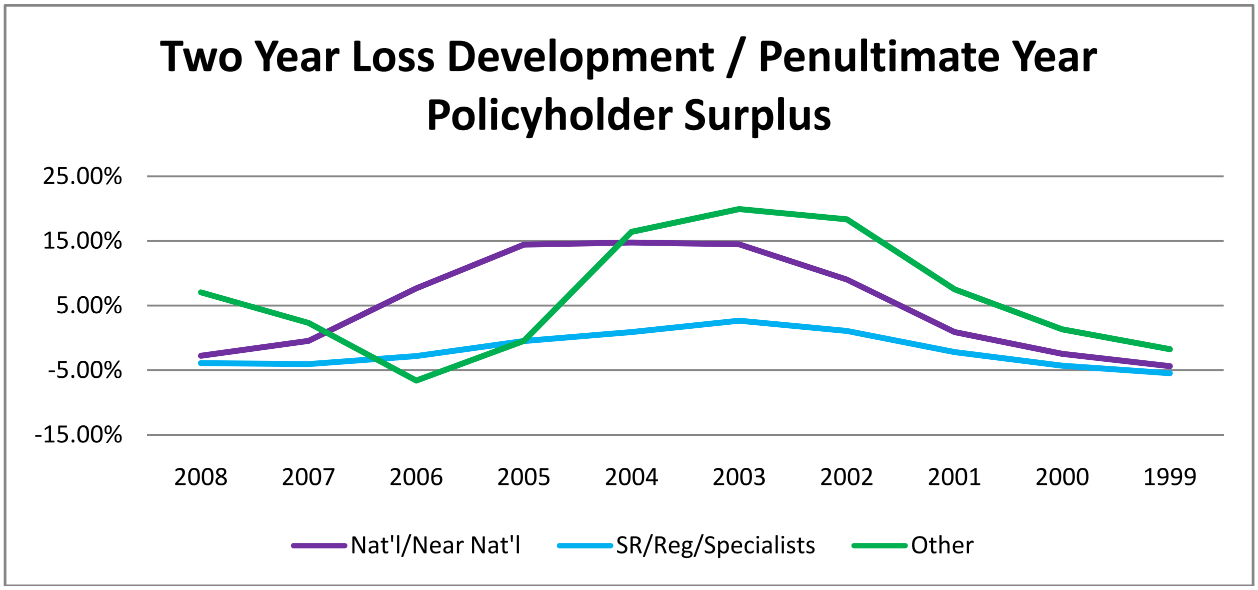

Exhibit G, one year development, and Exhibit H, two year development, illustrate reserve development by company type. The Stock companies (both Public and Private) reflect inadequate reserve development for the majority of the preceding ten year period for one year and two year development. Only in the most recent history, beginning with 2005, have these companies reported adequate reserve development for both one year and two year measures. From 2001 through 2005 the Stock companies reported significant inadequate reserve positions. In comparison, the Pure Mutual companies have consistently reported favorable reserve development for both one year and two year measures over the same ten year period. When the Mutual company group reported unfavorable development for several years subsequent to 2001, the factors were relatively low and the group returned to favorable development in 2005 for both one year and two year development.

Exhibit G

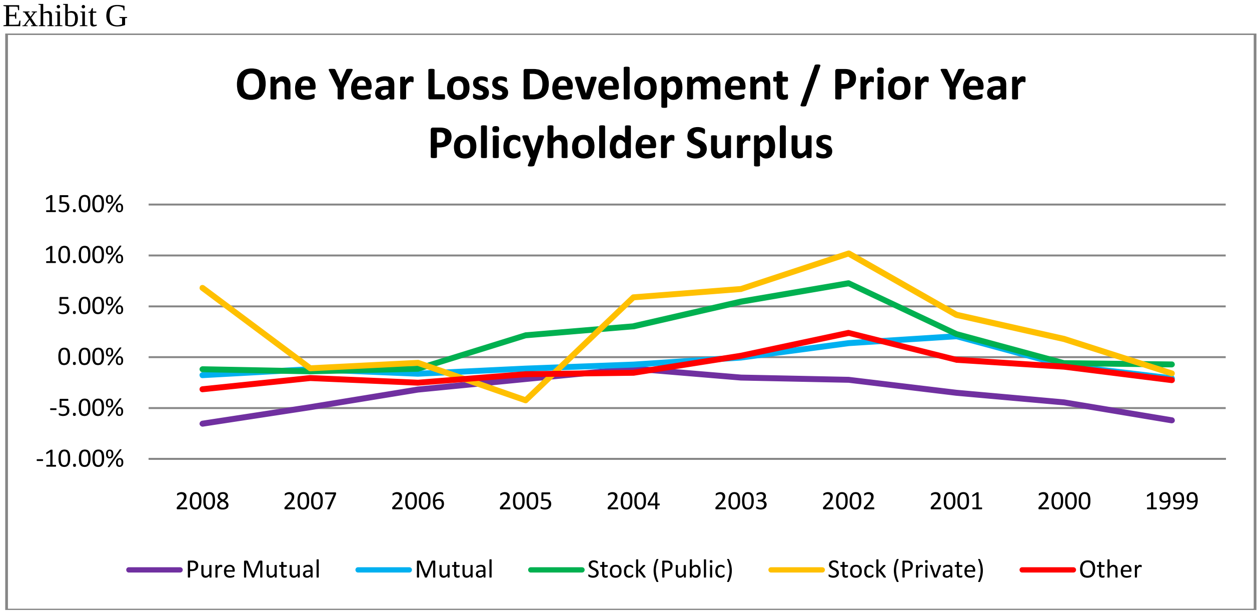

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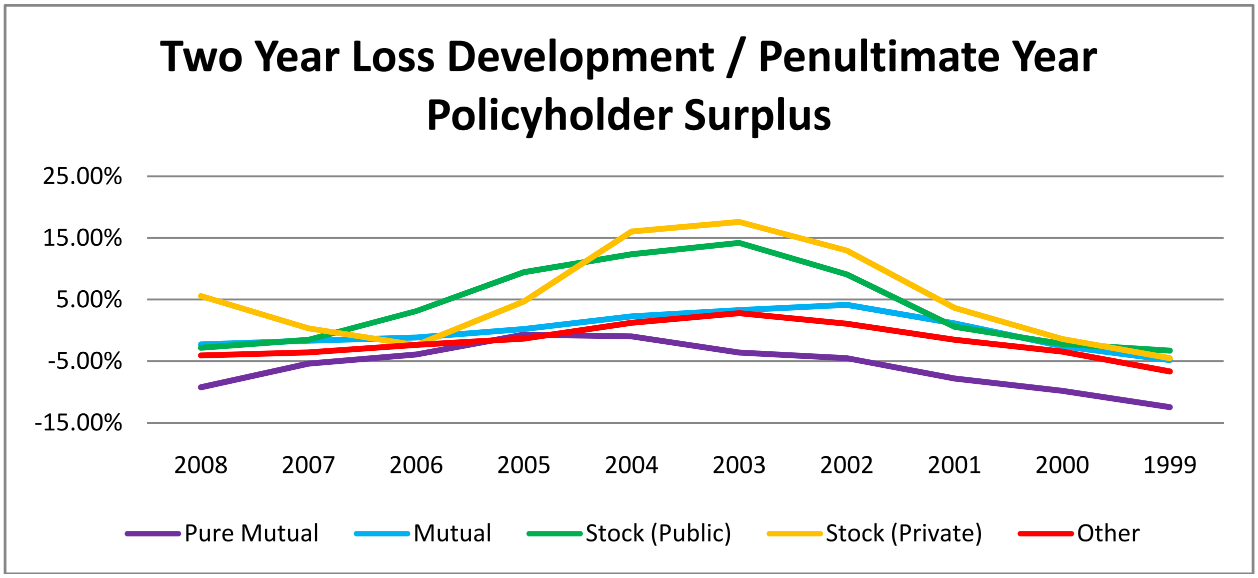
Exhibit H



Grouped by company type, the Stock companies report inadequate reserve positions that are more frequent and more severe when compared to the Mutual companies. In addition, when comparing the companies by classification, the National carriers report more frequent and severe inadequate positions compared to the Super Regional, Regional and Specialists companies. Based on our review, we feel this supports our belief that smaller, regional carriers are more conservative and consistent in their evaluation and reporting of loss and defense and cost containment expense reserves.

Leverage Ratios

We also reviewed and evaluated traditional leverage ratios. We reviewed Net Premium Written to Policyholders' Surplus ratio (NPW/PHS) and the Liabilities to Policyholders' Surplus ratio (L/PHS). These are presented in Exhibits I, J, K and L. Both ratios are common measures utilized within the Property and Casualty industry.

Net Premiums Written to Policyholders' Surplus is one of the IRIS ratios monitored by the NAIC. NAIC publications state "this ratio measures the adequacy of the policyholders' surplus cushion, net of the effects of premiums ceded to reinsurers. The higher the ratio, the more risk the insurer bears in relation to the policyholders' surplus". When reviewing Exhibit I, we observe that the National and Near National companies five year trend closely mirrors that of the Super Regional, Regional and Specialists. All companies share the trend of a continuing improvement in the NPW/PHS ratio from 2004 to 2007 with an expected increase in 2008. The National companies reported a high of 1.06:1 in 2004 with a low of .62:1 reported by the Near National companies in 2007. The Super Regional companies reported a high of 1.19:1 in 2004 with a low of .64:1 reported by the Specialist companies in 2007.

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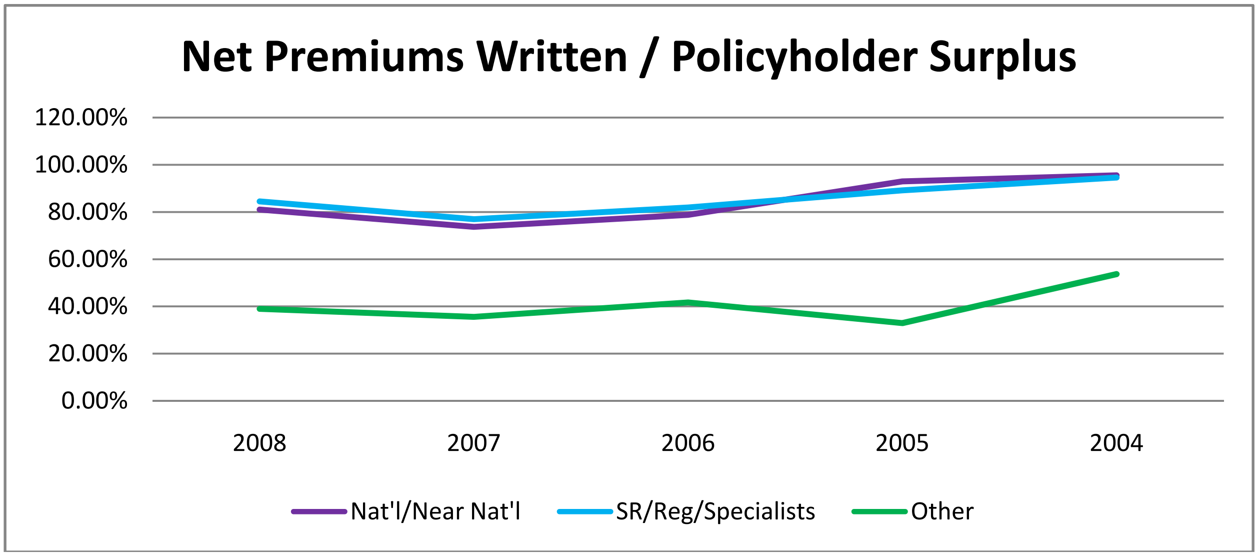
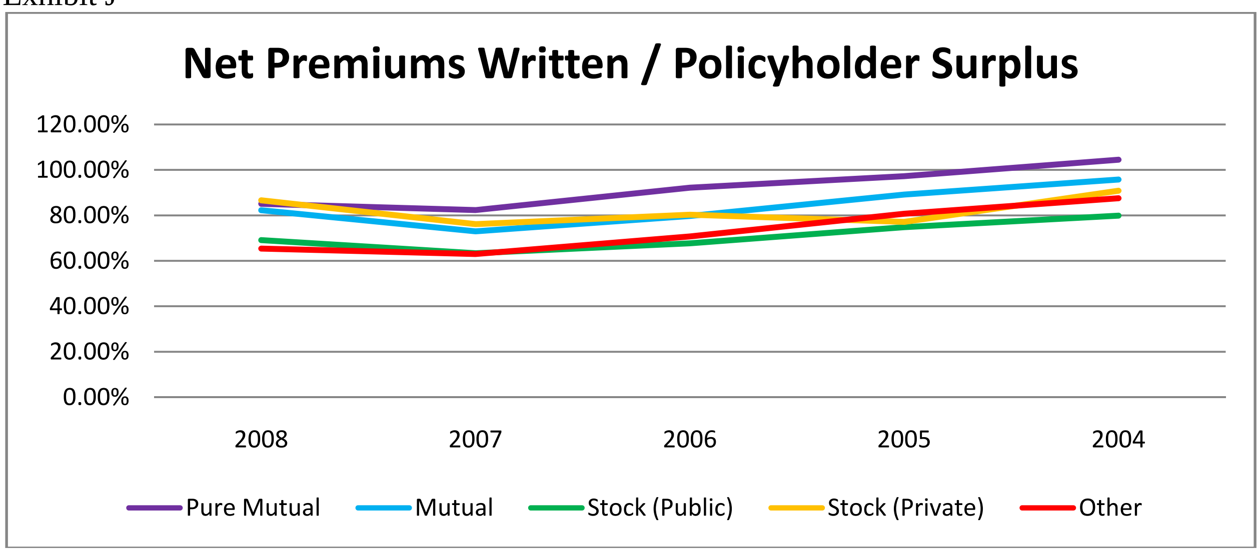
Exhibit I



The NAIC seems to consider a NPW/PHS ratio of 3:1 or lower as acceptable. This does not mean companies with a higher ratio are prohibited from writing business. However, it does imply that a Property and Casualty insurer with a consistently higher ratio is less conservative compared to a company with a lower NPW/PHS ratio. Exhibit J also shows the trend that emerged in the review of Exhibit I. The results are closely grouped with no classification reporting distress with respect to the NPW/PHS ratio.

Exhibit J



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The Liabilities to Policyholders' Surplus ratio shows a comparable trend to the NPW/PHS ratio. Exhibits K and L illustrate the gradual improvement in this ratio for all company groupings for the four years prior to 2008. The National companies' ratio exceeds the Super Regional companies' ratio with a high of 2.15:1 in 2004 compared to high of 1.80:1 for the Super Regional companies. As with the NPW/PHS ratio, smaller, regional companies tend to have lower leverage ratios compared to larger companies. That is, they appear to be more conservative.

Exhibit K

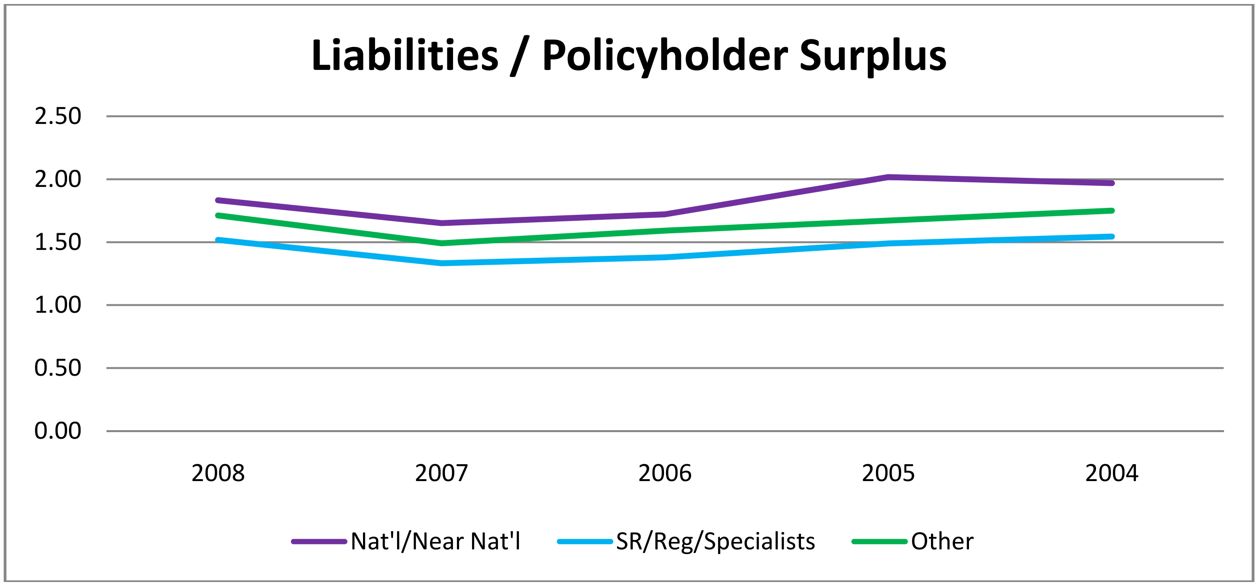
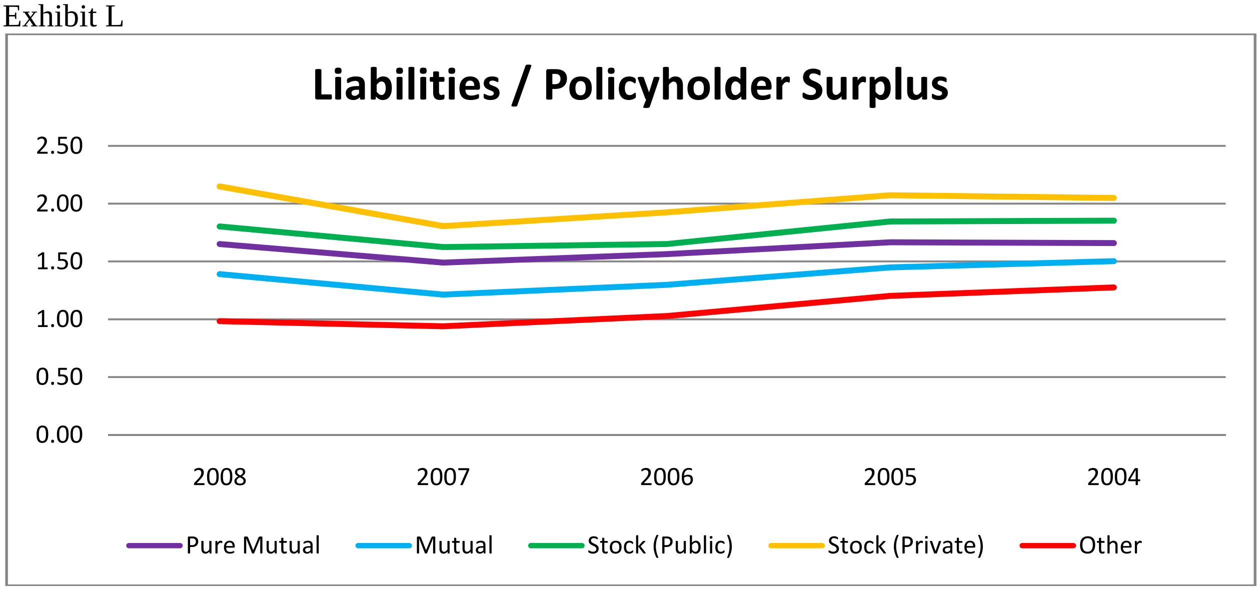


Exhibit L



Underwriting Results and Combined Trade Ratios

Underwriting results represent the performance of the core insurance operation for Property and Casualty companies. The Combined Trade Ratio (CTR) is derived by adding the ratio of loss and loss adjustment expenses to net earned premium to the percentage of other underwriting expense to net premium written. In practice, a CTR of 100% is viewed as breakeven for underwriting results, with a CTR less than 100% being viewed as favorable.

With the exception of 2008, the recent five year history of underwriting results, when compared with longer term industry results, has been much improved. The National and Near National companies have reported an underwriting gain in four of the previous five years, from 2004 through 2008, with underwriting losses recorded the prior five year period. The Super Regional, Regional and Specialists have reported an underwriting gain in four of the preceding five years from 2004 through 2008 and similar to the National and Near National companies posted underwriting losses in four of the preceding five years. Exhibits M and N illustrate the CTR for the groupings by company type and classification for the most recent ten year period and indicate that the ratios trend consistently from year to year with few exceptions.

Exhibit M

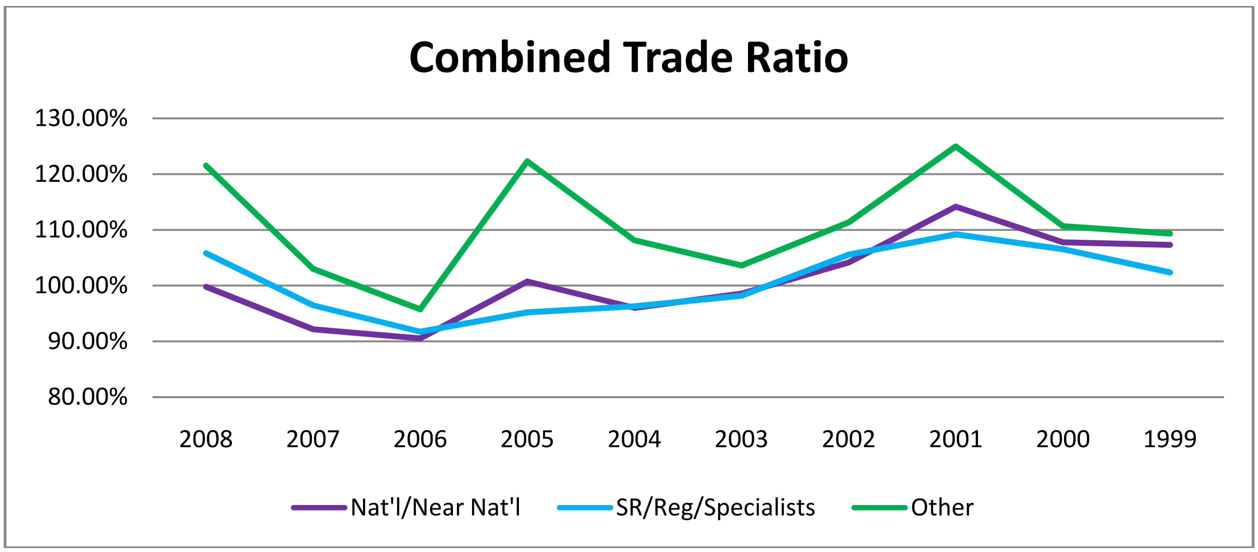


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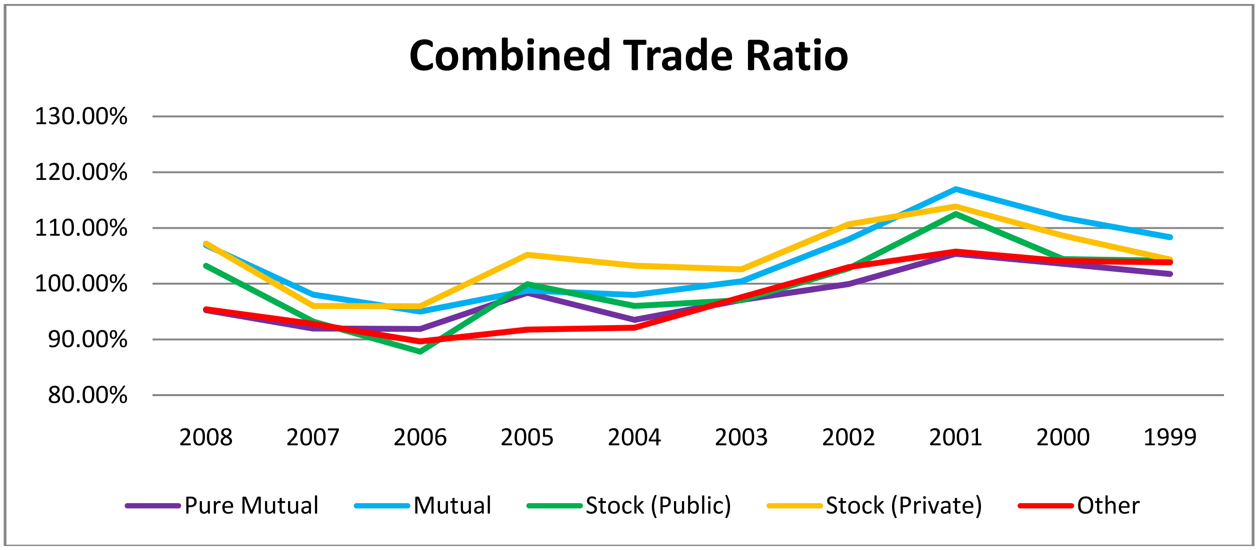
Exhibit N



The ability to rely on investment income may permit the Property and Casualty industry to accept underwriting losses while pursuing premium growth and maintaining, or growing, surplus. With respect to underwriting gains, progress was made recently but 2008 has not been as favorable to the industry compared to recent history. Additionally, investment income has been decreasing in recent years and, considering the current economic environment, the timing and size of a turnaround is uncertain. This may pressure the industry to produce positive underwriting results as the need to maintain and grow surplus will be critical. Companies that have traditionally been more conservatively managed will be in a better position to improve underwriting results due to less reliance on investment income to support current financial stability and future growth.

Growing and Maintaining Surplus

With the exception of 2008, policyholders' surplus (PHS), or net worth, has steadily increased year over year the past ten years. Exhibits O and P illustrate the changes in PHS for that time period. PHS represents the capacity, or ability, of the Property and Casualty industry to support future growth. The national insurers and the regional insurers track closely with respect to growth in PHS the preceding ten year period.

Exhibit O

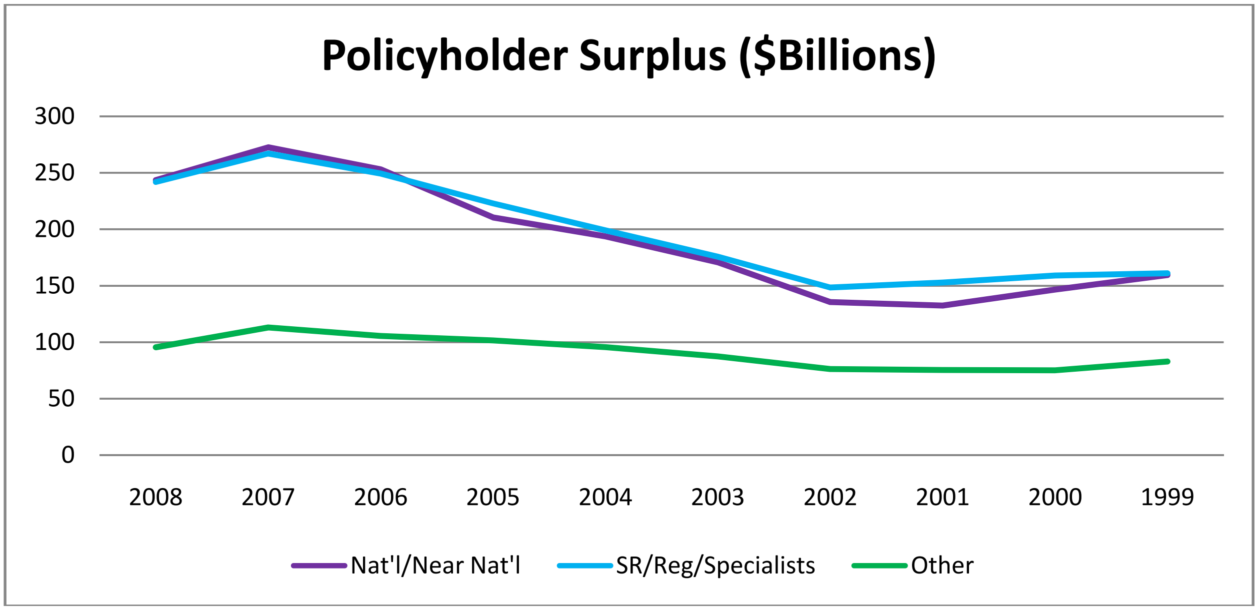
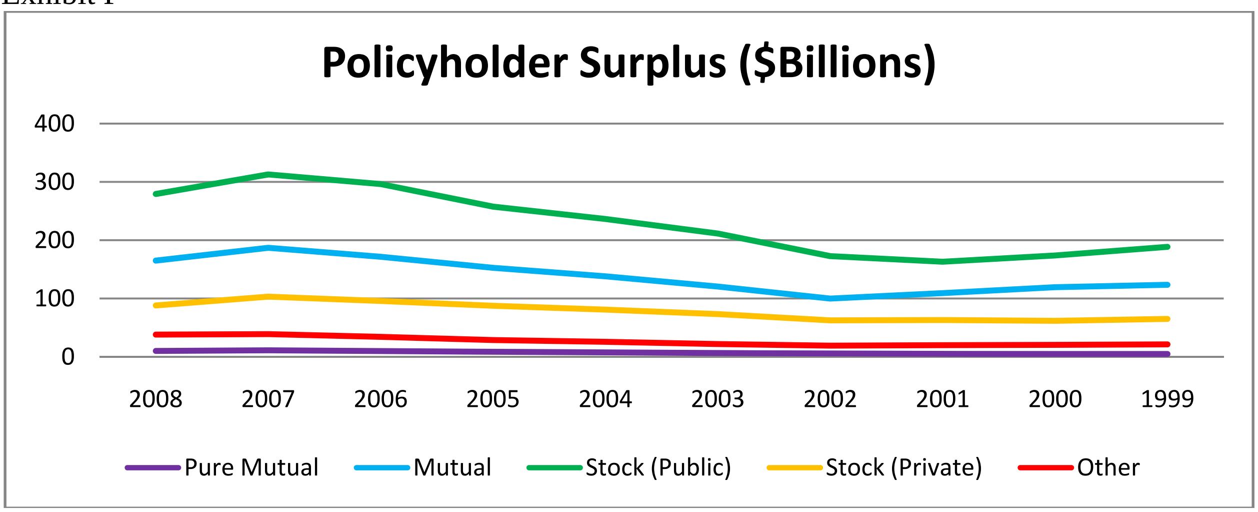


Exhibit P



As noted in the ***Underwriting Results and Combined Trade Ratios*** section, the industry has not always relied on their core business pursuits to increase PHS. The recent growth in PHS has been facilitated by underwriting results while investment income provided consistency to the growth in PHS the past ten years. Our review also included a return on equity computation revealing the industry, until 2008, had posted reasonable returns for the prior ten year period. The national companies posted slightly higher returns compared to the regional companies with Stock (Public) companies leading Mutual companies.

In addition to net income (loss), unrealized investment gains (losses) and deferred tax assets are components of PHS. In our current economic environment these items have the potential to significantly impact PHS and any adverse impact will result in greater pressure on companies to improve and produce more consistent underwriting results.

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Summation

The purpose of our analysis was to present information to determine if one segment of the industry displayed an extraordinary appetite for risk, or was significantly less conservative, when compared to other segments. We have illustrated differences between companies based on corporate structure and within classifications relative to size. This is appropriate as reviewing data based solely on size, independent of corporate structure, might not adequately present results. While we have recognized these differences collectively, there are individual insurers performing differently than their specific type or classification would otherwise suggest. Our review included managed assets and investment returns, loss reserve development, leverage ratios, underwriting results and policyholders' surplus.

We believe the data supports our position that regional and smaller insurers are conservatively managed while at the same time demonstrating they are capable of operating profitably while sustaining growth. In addition, we believe the review indicates that larger, national insurers have collectively demonstrated favorable overall performance in recent history. While Demotech has no formal position regarding state versus federal regulation, based on our review and the information presented in this paper, it appears current regulatory practices implemented and executed at the state level have been effective in monitoring the Property and Casualty insurance industry.

Please recall that this review and analysis represents Demotech's perspective of the Property and Casualty industry focusing on management practices regarding asset management, loss reserving practices, and capital adequacy based on data emanating from current regulatory practices. We utilized The National Association of Insurance Commissioners, Kansas City, Missouri, information derived from Highline Data, by permission. The National Association of Insurance Commissioners and Highline Data do not endorse any analysis or conclusion based upon the use of its data.

Reviewing Conservative Management Practices

Appendix A

Primary Company Types and Classifications

Introduction

The participating companies are divided into five primary types with each primary type further segmented into one of twelve classifications. The definition, or qualifiers, for the five primary types are provided below. The assignment criteria for the twelve classifications follow the definitions previously established through the Insurance Journal and Demotech's Super Regional annual report. The twelve classifications are listed at the end of this document.

Each company we reviewed and included is a single company actively writing Property and Casualty business. There are no group numbers used in our analysis. Demotech assigned each company to the appropriate type and classification based on the most current information available.

Primary Company Types

Pure Mutual
The ***Pure Mutual*** type includes mutual companies that actively write Property and Casualty business on a direct or net basis. This type includes individual mutual companies that may be affiliated with other mutual companies. However, for a company that is part of a group to be listed as a pure mutual, the group must be comprised entirely of mutual companies.

Mutual
The ***Mutual*** type includes mutual companies that actively write Property and Casualty business on a direct or net basis. In addition, this type includes a company that is a subsidiary, affiliate, or majority controlled non-mutual company actively writing Property and Casualty business where the controlling entity is a mutual company.

Stock (Public)
The ***Stock (Public)*** type includes stock companies that are publically traded and actively writing Property and Casualty business on a direct or net basis. In addition, this type includes subsidiary, affiliated, or majority controlled operations actively writing Property and Casualty business on a direct or net basis within the corporate, or group, structure that are not publically traded but are controlled by the publically traded stock entity. This applies regardless of the financial reporting structure for companies within the group.

Stock (Private)
The ***Stock (Private)*** type includes stock companies that are privately held and actively writing Property and Casualty business on a direct or net basis. In addition, this type includes subsidiary, affiliated, or majority controlled operations actively writing Property and Casualty business on a direct or net basis within the corporate, or group, structure that are controlled by the primary entity.

All Other
The ***All Other*** type includes organizations that actively write Property and Casualty business on a direct or net basis that do not qualify as one of the four preceding primary types.

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Classification

Each of the defined company types will be further segmented into the following classifications. These classes will follow the established definitions for the respective class as previously published.

1. National
2. Near National
3. Super Regional
4. Regional
5. Coverage Specialist
6. State Specialist
7. DPW < $1MM
8. Reinsurer
9. Risk Retention Group
10. Strategic Subsidiary
11. Surplus Lines Carrier
12. N/A

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