MERCURY GENERAL CORP
Form 10-Q
May 05, 2010


# UNITED STATES

# SECURITIES AND EXCHANGE COMMISSION

**Washington, D.C. 20549**

# FORM 10-Q

## QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)

## OF THE SECURITIES EXCHANGE ACT OF 1934

**For the Quarter Ended March 31, 2010**

**Commission File No. 001-12257**

# MERCURY GENERAL CORPORATION

**(Exact name of registrant as specified in its charter)**

| | |
|---|---|
| **California** | **95-2211612** |

| | |
|---|---|
| **(State or other jurisdiction of incorporation or organization)** | **(I.R.S. Employer Identification No.)** |
| **4484 Wilshire Boulevard, Los Angeles, California** | **90010** |
| **(Address of principal executive offices)** | **(Zip Code)** |

**Registrant s telephone number, including area code: (323) 937-1060**

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 ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ¨ No ¨

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

| | | | |
|---|---|---|---|
| Large accelerated filer | x | Accelerated filer | ¨ |
| Non-accelerated filer | ¨ (Do not check if a smaller reporting company) | Smaller reporting company | ¨ |

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

At April 30, 2010, the Registrant had issued and outstanding an aggregate of 54,784,958 shares of its Common Stock.

Table of Contents

**MERCURY GENERAL CORPORATION**

**INDEX TO FORM 10-Q**

Table of Contents

## PART I - FINANCIAL INFORMATION

**Item 1. Financial Statements**

### MERCURY GENERAL CORPORATION AND SUBSIDIARIES

### CONSOLIDATED BALANCE SHEETS

(in thousands, except share data)

| ASSETS | March 31, 2010 (unaudited) | December 31, 2009 |
|---|---|---|
| Investments, at fair value: | | |
| Fixed maturities trading (amortized cost $2,655,519; $2,673,079) | $ 2,700,268 | $ 2,704,561 |
| Equity securities trading (cost $298,703; $308,941) | 281,618 | 286,131 |
| Short-term investments (cost $134,269; $156,126) | 134,255 | 156,165 |
| Total investments | 3,116,141 | 3,146,857 |
| Cash | 242,511 | 185,505 |
| Receivables: | | |
| Premiums receivable | 281,822 | 262,278 |
| Premium notes | 9,761 | 14,510 |
| Accrued investment income | 37,985 | 37,405 |
| Other | 11,010 | 13,689 |
| Total receivables | 340,578 | 327,882 |
| Deferred policy acquisition costs | 174,791 | 175,866 |
| Fixed assets, net | 201,091 | 201,862 |
| Current income taxes | 2,195 | 27,268 |
| Deferred income taxes | 32,424 | 36,139 |
| Goodwill | 42,850 | 42,850 |
| Other intangible assets, net | 65,120 | 66,823 |
| Other assets | 19,807 | 21,581 |
| Total assets | $ 4,237,508 | $ 4,232,633 |
| LIABILITIES AND SHAREHOLDERS EQUITY | | |
| Losses and loss adjustment expenses | $ 1,022,721 | $ 1,053,334 |
| Unearned premiums | 856,449 | 844,540 |
| Notes payable | 270,915 | 271,397 |
| Accounts payable and accrued expenses | 118,250 | 114,469 |
| Other liabilities | 169,048 | 177,947 |
| Total liabilities | 2,437,383 | 2,461,687 |
| Commitments and contingencies | | |
| Shareholders equity: | | |
| Common stock without par value or stated value: | | |
| Authorized 70,000,000 shares; issued and outstanding 54,784,958; 54,776,958 | 72,994 | 72,589 |
| Additional paid-in capital | 18 | |
| Accumulated other comprehensive loss | (696) | (597) |

| | | |
|---|---|---|
| Retained earnings | 1,727,809 | 1,698,954 |
| Total shareholders equity | 1,800,125 | 1,770,946 |
| Total liabilities and shareholders equity | $ 4,237,508 | $ 4,232,633 |

See accompanying Condensed Notes to Consolidated Financial Statements.

Table of Contents

**MERCURY GENERAL CORPORATION AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF OPERATIONS**

(in thousands, except per share data)

(unaudited)

| | Three Months Ended March 31, 2010 | Three Months Ended March 31, 2009 |
|---|---|---|
| Revenues: | | |
| Net premiums earned | $ 640,614 | $ 666,063 |
| Net investment income | 35,886 | 37,914 |
| Net realized investment gains | 22,044 | 81,314 |
| Other | 1,293 | 1,667 |
| Total revenues | 699,837 | 786,958 |
| Expenses: | | |
| Losses and loss adjustment expenses | 430,622 | 444,292 |
| Policy acquisition costs | 128,982 | 147,531 |
| Other operating expenses | 57,324 | 53,486 |
| Interest | 1,619 | 1,546 |
| Total expenses | 618,547 | 646,855 |
| Income before income taxes | 81,290 | 140,103 |
| Income tax expense | 20,111 | 43,450 |
| Net income | $ 61,179 | $ 96,653 |
| Net income per share: | | |
| Basic | $ 1.12 | $ 1.76 |
| Diluted | $ 1.12 | $ 1.75 |
| Weighted average shares outstanding: | | |
| Basic | 54,783 | 54,767 |
| Diluted | 54,805 | 55,091 |
| Dividends declared per share | $ 0.59 | $ 0.58 |

See accompanying Condensed Notes to Consolidated Financial Statements.

Table of Contents

**MERCURY GENERAL CORPORATION AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

(in thousands)

(unaudited)

| | Three Months Ended March 31, 2010 | 2009 |
|---|---|---|
| Net income | $ 61,179 | $ 96,653 |
| Other comprehensive (loss) income, before tax: | | |
| (Losses) gains on hedging instrument | (153) | 12 |
| Other comprehensive (loss) income, before tax | (153) | 12 |
| Income tax (benefit) expense related to (losses) gains on hedging instrument | (54) | 4 |
| Comprehensive income, net of tax | $ 61,080 | $ 96,661 |

See accompanying Condensed Notes to Consolidated Financial Statements.

5

**Table of Contents**

**MERCURY GENERAL CORPORATION AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

(in thousands)

(unaudited)

| | Three Months Ended March 31, 2010 | 2009 |
|---|---|---|
| **CASH FLOWS FROM OPERATING ACTIVITIES** | | |
| Net income | $ 61,179 | $ 96,653 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 8,562 | 8,367 |
| Net realized investment gains | (22,044) | (81,314) |
| Bond (accretion) amortization, net | (434) | 494 |
| Excess tax benefit from exercise of stock options | (25) | (2) |
| Increase in premiums receivable | (19,544) | (3,134) |
| Decrease (increase) in premiums notes receivable | 4,749 | (4,491) |
| Decrease in deferred policy acquisition costs | 1,075 | 11,260 |
| Decrease in unpaid losses and loss adjustment expenses | (30,613) | (41,263) |
| Increase in unearned premiums | 11,909 | 4,845 |
| Increase in liability for taxes | 28,866 | 43,384 |
| Increase in accounts payable and accrued expenses | 5,119 | 16,806 |
| Decrease in trading securities in nature, net of realized gains and losses | | 3,209 |
| Share-based compensation | 209 | 164 |
| Decrease in other payables | (24,315) | (6,322) |
| Other, net | 8,188 | 2,202 |
| Net cash provided by operating activities | 32,881 | 50,858 |
| **CASH FLOWS FROM INVESTING ACTIVITIES** | | |
| Fixed maturities available for sale in nature: | | |
| Purchases | (112,172) | (78,862) |
| Sales | 58,457 | 31,791 |
| Calls or maturities | 73,137 | 44,460 |
| Equity securities available for sale in nature: | | |
| Purchases | (27,070) | (63,982) |
| Sales | 38,397 | 58,774 |
| Net increase in payable for securities | 11,507 | 26,255 |
| Net decrease in short-term investments | 21,872 | 110,775 |
| Purchase of fixed assets | (7,431) | (10,315) |
| Sale and write-off of fixed assets | 10 | 783 |
| Business acquisition, net of cash acquired | | (115,048) |
| Other, net | (473) | (509) |
| Net cash provided by investing activities | 56,234 | 4,122 |
| **CASH FLOWS FROM FINANCING ACTIVITIES** | | |
| Dividends paid to shareholders | (32,323) | (31,767) |
| Excess tax benefit from exercise of stock options | 25 | 2 |
| Proceeds from stock options exercised | 189 | 233 |
| Proceeds from bank loan | | 120,000 |
| Net cash (used in) provided by financing activities | (32,109) | 88,468 |

| | | | | |
|---|---|---|---|---|
| Net increase in cash | | 57,006 | | 143,448 |
| Cash: | | | | |
| Beginning of the year | | 185,505 | | 35,396 |
| End of year | $ | 242,511 | $ | 178,844 |
| **SUPPLEMENTAL CASH FLOW DISCLOSURE** | | | | |
| Interest paid | $ | 2,086 | $ | 2,499 |
| Income taxes (received) paid | $ | (8,757) | $ | 66 |
| Net realized gains (losses) from sale of investments | $ | 3,178 | $ | (16,204) |

See accompanying Condensed Notes to Consolidated Financial Statements.

Table of Contents

**MERCURY GENERAL CORPORATION AND SUBSIDIARIES**

**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(unaudited)

**1. General**

***Consolidation and Basis of Presentation***

The condensed consolidated financial statements include the accounts of Mercury General Corporation and its subsidiaries (referred to herein collectively as the Company). The subsidiaries are as follows:

*Insurance Companies*

| | |
|---|---|
| Mercury Casualty Company | Mercury National Insurance Company |
| Mercury Insurance Company | American Mercury Insurance Company |
| California Automobile Insurance Company | American Mercury Lloyds Insurance Company (1) |
| California General Underwriters Insurance Company, Inc. | Mercury County Mutual Insurance Company (2) |
| Mercury Insurance Company of Illinois | Mercury Insurance Company of Florida |
| Mercury Insurance Company of Georgia | Mercury Indemnity Company of America |
| Mercury Indemnity Company of Georgia | |

*Non-Insurance Companies*

| | |
|---|---|
| Mercury Select Management Company, Inc. (1) | Mercury Group, Inc. |
| American Mercury MGA, Inc. | AIS Management LLC |
| Concord Insurance Services, Inc. | Auto Insurance Specialists LLC ( AIS ) |
| Mercury Insurance Services LLC | PoliSeek Insurance Solutions, Inc. |

(1) American Mercury Lloyds Insurance Company is not owned but is controlled by the Company through its attorney-in-fact, Mercury Select Management Company, Inc.

(2) Mercury County Mutual Insurance Company is not owned but is controlled by the Company through a management contract.

The condensed consolidated financial statements have been prepared in conformity with U.S. generally accepted accounting principles ( GAAP ), which differ in some respects from those filed in reports to insurance regulatory authorities. All intercompany transactions have been eliminated.

The financial data of the Company included herein has been prepared without audit. In the opinion of management, all material adjustments of a normal recurring nature necessary to present fairly the Company s financial position at March 31, 2010 and the results of operations, comprehensive income, and cash flows for the periods presented have been made. Operating results and cash flows for the three months ended March 31, 2010 are not necessarily indicative of the results that may be expected for the year ending December 31, 2010.

***Use of Estimates***

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. These estimates require the Company to apply complex assumptions and judgments, and often the Company must make estimates about effects of matters that are inherently uncertain and will likely change in subsequent periods. The most significant assumptions in the preparation of these condensed consolidated financial statements relate to reserves for losses and loss adjustment expenses. Actual results could differ from those estimates (See Note 1 Summary of Significant Accounting Policies of Notes to Consolidated Financial Statements in the Company s Annual Report on Form 10-K for the year ended December 31, 2009).

Table of Contents

**2. Recently Issued Accounting Standards**

In February 2010, the Financial Accounting Standards Board ( FASB ) issued a new accounting standard related to subsequent events, which amends the earlier FASB standard to address certain implementation issues related to an entity s requirement to perform and disclose subsequent events procedures. The new standard requires Securities and Exchange Commission ( SEC ) filers to evaluate subsequent events through the date the financial statements are issued and exempts SEC filers from disclosing the date through which subsequent events have been evaluated. The Company adopted the new standard which became effective for the interim reporting period ended March 31, 2010. The adoption of the new standard did not have a material impact on the Company s condensed consolidated financial statements.

In January 2010, the FASB issued a new standard related to fair value measurements and disclosures, which amends the earlier FASB standard to add new requirements for disclosures about transfers into and out of Levels 1 and 2 fair value measurements and separate disclosures about purchases, sales, issuances, and settlements relating to Level 3 fair value measurements. The new standard also clarifies existing fair value disclosures about the level of disaggregation and about inputs and valuation techniques used to measure the fair value. The Company adopted the new accounting standard which became effective for the interim reporting period ended March 31, 2010, except for the requirement to provide the Level 3 activity of purchases, sales, issuances, and settlements on a gross basis, which will be effective for fiscal years beginning after December 15, 2010, and for interim periods within those fiscal years. The adoption of the new standard did not have a material impact on the Company s condensed consolidated financial statements.

Table of Contents

### 3. Fair Value of Financial Instruments

The financial instruments recorded in the consolidated balance sheets include investments, receivables, interest rate swap agreements, accounts payable, equity contracts, and secured and unsecured notes payable. Due to their short-term maturity, the carrying value of receivables and accounts payable approximate their fair market values. The following table sets forth estimated fair values of financial instruments at March 31, 2010 and December 31, 2009.

| | March 31, 2010 | December 31, 2009 |
|---|---|---|
| | (Amounts in thousands) | |
| Assets | | |
| Investments | $ 3,116,141 | $ 3,146,857 |
| Interest rate swap agreements | $ 7,979 | $ 8,472 |
| Liabilities | | |
| Interest rate swap agreements | $ 3,181 | $ 2,364 |
| Equity contracts | $ 576 | $ 1,043 |
| Secured notes | $ 138,312 | $ 138,103 |
| Unsecured notes | $ 132,443 | $ 130,666 |

Methods and assumptions used in estimating fair values are as follows:

***Investments***

The Company applies the fair value option to all available-for-sale, fixed maturity, equity securities, and short-term investments as of the time the eligible item is first recognized. For additional disclosures regarding methods and assumptions used in estimating fair values of these securities, see Note 5 of Condensed Notes to Consolidated Financial Statements.

***Interest rate swap agreements***

The fair value of interest rate swap agreements reflects the estimated amounts that the Company would pay or receive at March 31, 2010 and December 31, 2009 in order to terminate the contracts based on models using inputs, such as interest rate yield curves, observable for substantially the full term of the contract. For additional disclosures regarding methods and assumptions used in estimating fair values of interest rate swap agreements, see Note 5 of Condensed Notes to Consolidated Financial Statements.

***Equity contracts***

The fair value of equity contracts is based on quoted prices for identical instruments in active markets. For additional disclosures regarding methods and assumptions used in estimating fair values of equity contracts, see Note 5 of Condensed Notes to Consolidated Financial Statements.

***Secured notes***

The fair value of the Company s $120 million and $18 million secured notes is estimated based on assumptions and inputs, such as reset rates, for similar termed notes that are observable in the market.

***Unsecured note***

The fair value of the Company s publicly traded $125 million unsecured note is based on the unadjusted quoted price for similar notes in active markets.

Table of Contents

**4. Fair Value Option**

Gains and losses due to changes in fair value for items measured at fair value pursuant to application of the fair value option are included in net realized investment gains in the Company s consolidated statements of operations, while interest and dividend income on the investment holdings are recognized on an accrual basis on each measurement date and are included in net investment income in the Company s consolidated statements of operations. The primary reasons for electing the fair value option were simplification and cost-benefit considerations as well as expansion of use of fair value measurement consistent with the long-term measurement objectives of the FASB for accounting for financial instruments.

The following table reflects gains (losses) due to changes in fair value for items measured at fair value pursuant to application of the fair value option:

| | Three Months Ended March 31, | |
|---|---|---|
| | 2010 | 2009 |
| | (Amounts in thousands) | |
| Fixed maturity securities | $ 13,267 | $ 101,015 |
| Equity securities | 5,725 | (10,279) |
| Short-term investments | (53) | (3) |
| Total | $ 18,939 | $ 90,733 |

**5. Fair Value Measurement**

The Company employs a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The fair value of a financial instrument is the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (the exit price). Accordingly, when market observable data is not readily available, the Company s own assumptions are set to reflect those that market participants would be presumed to use in pricing the asset or liability at the measurement date. Assets and liabilities recorded on the consolidated balance sheets at fair value are categorized based on the level of judgment associated with inputs used to measure fair value and the level of market observability, as follows:

***Level 1*** Unadjusted quoted prices are available in active markets for identical assets or liabilities as of the reporting date.

***Level 2*** Pricing inputs are other than quoted prices in active markets, which are based on the following:

Quoted prices for similar assets or liabilities in active markets;

Quoted prices for identical or similar assets or liabilities in non-active markets; or

Either directly or indirectly observable inputs as of the reporting date and fair value is determined through the use of models or other valuation methods

***Level 3*** Pricing inputs are unobservable and significant to the overall fair value measurement, and the determination of fair value requires significant management judgment or estimation.

In certain cases, inputs used to measure fair value may fall into different levels of the fair value hierarchy. In such cases, the level in the fair value hierarchy within which the fair value measurement in its entirety falls has been determined based on the lowest level input that is significant to the fair value measurement in its entirety. The Company s assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment and consideration of factors specific to the asset or liability.

The Company uses prices and inputs that are current as of the measurement date, including during periods of market disruption. In periods of market disruption, the ability to observe prices and inputs may be reduced for many instruments. This condition could cause an instrument to be reclassified from Level 1 to Level 2, or from Level 2 to Level 3. The Company recognizes transfers between levels at either the actual date of the event or a change in circumstances that caused the transfer.

**Table of Contents**

**Summary of Significant Valuation Techniques for Financial Assets and Financial Liabilities**

The Company s fair value measurements are based on a combination of the market approach and the income approach. The market approach utilizes market transaction data for the same or similar instruments. The income approach is based on a discounted cash flow methodology, where expected cash flows are discounted to present value.

The Company obtained unadjusted fair values on approximately 98% of its portfolio from an independent pricing service. For approximately 2% of its portfolio, the Company obtained specific unadjusted broker quotes from at least one knowledgeable outside security broker to determine the fair value.

***Level 1 Measurements*** - Fair values of financial assets and financial liabilities are obtained from an independent pricing service, and are based on unadjusted quoted prices for identical assets or liabilities in active markets. Additional pricing services and closing exchange values are used as a comparison to ensure realistic fair values are used in pricing the investment portfolio.

U.S. government bonds and agencies: Priced using unadjusted quoted market prices for identical assets in active markets.

Common stock/Other: Comprised of actively traded, exchange listed U.S. and international equity securities and valued based on unadjusted quoted prices for identical assets in active markets.

Money market instruments: Valued based on unadjusted quoted prices for identical assets.

Equity contracts: Comprised of free-standing exchange listed derivatives that are actively traded and valued based on quoted prices for identical instruments in active markets.

***Level 2 Measurements*** - Fair values of financial assets and financial liabilities are obtained from an independent pricing service or outside brokers, and are based on prices for similar assets or liabilities in active markets or valuation models whose inputs are observable, directly or indirectly, for substantially the full term of the asset or liability. Additional pricing services are used as a comparison to ensure reliable fair values are used in pricing the investment portfolio.

Municipal securities: Valued based on models or matrices using inputs including quoted prices for identical or similar assets in active markets.

Mortgage-backed securities: Comprised of securities that are collateralized by residential mortgage loans. Valued based on models or matrices using multiple observable inputs, such as benchmark yields, reported trades and broker/dealer quotes, for identical or similar assets in active markets. At March 31, 2010 and December 31, 2009, the Company had no holdings in commercial mortgage-backed securities.

Corporate securities/Short-term bonds: Valued based on a multi-dimensional model using multiple observable inputs, such as benchmark yields, reported trades, broker/dealer quotes and issue spreads, for identical or similar assets in active markets.

Non-redeemable preferred stock: Valued based on observable inputs, such as underlying and common stock of same issuer and appropriate spread over a comparable U.S. Treasury security, for identical or similar assets in active markets.

Interest rate swap agreements: Valued based on models using inputs, such as interest rate yield curves, observable for substantially the full term of the contract.

***Level 3 Measurements*** - Fair values of financial assets are based on discounted cash flow price modeling performed by management with inputs that are both unobservable and significant to the overall fair value measurement, including any items in which the evaluated prices obtained elsewhere were deemed to be of a distressed trading level.

Municipal securities: Comprised of certain distressed municipal securities for which valuation is based on models that are widely accepted in the financial services industry and require projections of future cash flows that are not market observable. Included in this category are $1.8 million of auction rate securities ( ARS ).

Collateralized debt obligations: Valued based on underlying debt instruments and the appropriate benchmark spread for similar assets in active markets; taking into consideration unobservable inputs related to liquidity assumptions.

The Company s total financial instruments at fair value are reflected in the consolidated balance sheets on a trade-date basis. Related unrealized gains or losses are recognized in net realized investment gains in the consolidated statements of operations. Fair value measurements are not adjusted for transaction costs.

**Table of Contents**

The following tables present information about the Company s assets and liabilities measured at fair value on a recurring basis as of March 31, 2010 and December 31, 2009, and indicate the fair value hierarchy based on the inputs and the valuation techniques utilized by the Company to determine such fair value:

| | March 31, 2010 | | | |
|---|---|---|---|---|
| | Level 1 | Level 2 | Level 3 | Total |
| | (Amounts in thousands) | | | |
| **Assets** | | | | |
| Fixed maturity securities: | | | | |
| U.S. government bonds and agencies | $ 8,716 | $ | $ | $ 8,716 |
| Municipal securities | | 2,459,829 | 1,797 | 2,461,626 |
| Mortgage-backed securities | | 88,714 | | 88,714 |
| Corporate securities | | 86,681 | | 86,681 |
| Collateralized debt obligations | | | 54,531 | 54,531 |
| Equity securities: | | | | |
| Common stock: | | | | |
| Public utilities | 21,598 | | | 21,598 |
| Banks, trusts and insurance companies | 11,777 | | | 11,777 |
| Industrial and other | 234,144 | | | 234,144 |
| Non-redeemable preferred stock | | 14,099 | | 14,099 |
| Short-term bonds | | 8,001 | | 8,001 |
| Money market instruments | 126,254 | | | 126,254 |
| Interest rate swap agreements | | 7,979 | | 7,979 |
| Total assets at fair value | $ 402,489 | $ 2,665,303 | $ 56,328 | $ 3,124,120 |
| **Liabilities** | | | | |
| Equity contracts | $ 576 | $ | $ | $ 576 |
| Interest rate swap agreements | | 3,181 | | 3,181 |
| Total liabilities at fair value | $ 576 | $ 3,181 | $ | $ 3,757 |

| | December 31, 2009 | | | |
|---|---|---|---|---|
| | Level 1 | Level 2 | Level 3 | Total |
| | (Amounts in thousands) | | | |
| **Assets** | | | | |
| Fixed maturity securities: | | | | |
| U.S. government bonds and agencies | $ 8,977 | $ 1,003 | $ | $ 9,980 |
| Municipal securities | | 2,437,744 | 3,322 | 2,441,066 |
| Mortgage-backed securities | | 114,408 | | 114,408 |
| Corporate securities | | 91,634 | | 91,634 |
| Collateralized debt obligations | | | 47,473 | 47,473 |
| Equity securities: | | | | |
| Common stock: | | | | |
| Public utilities | 28,780 | | | 28,780 |
| Banks, trusts and insurance companies | 13,291 | | | 13,291 |
| Industrial and other | 230,406 | | | 230,406 |
| Non-redeemable preferred stock | | 13,654 | | 13,654 |
| Short-term bonds | | 6,039 | | 6,039 |
| Money market instruments | 150,126 | | | 150,126 |
| Interest rate swap agreements | | 8,472 | | 8,472 |
| Total assets at fair value | $ 431,580 | $ 2,672,954 | $ 50,795 | $ 3,155,329 |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| **Liabilities** | | | | | | | | |
| Equity contracts | $ | 1,043 | $ | | $ | | $ | 1,043 |
| Interest rate swap agreements | | | | 2,364 | | | | 2,364 |
| Total liabilities at fair value | $ | 1,043 | $ | 2,364 | $ | | $ | 3,407 |

Table of Contents

When the inputs used to measure fair value fall within different levels of the hierarchy, the level within which the fair value measurement is categorized is based on the lowest level input that is significant to the fair value measurement in its entirety. Thus, a Level 3 fair value measurement may include inputs that are observable (Level 1 or Level 2) and unobservable (Level 3).

The following tables provide a summary of changes in fair value of Level 3 financial assets and financial liabilities held at fair value at March 31, 2010 and 2009.

| | Three Months Ended March 31, 2010 | |
|---|---|---|
| | Municipal Securities | Collateralized Debt Obligations |
| Beginning Balance | $ 3,322 | $ 47,473 |
| Realized gains included in earnings | 65 | 7,058 |
| Purchase, issuances, and settlements | (1,590) | |
| Ending Balance | $ 1,797 | $ 54,531 |
| The amount of total gains for the period included in earnings attributable to assets still held at March 31, 2010 | $ 89 | $ 7,058 |

| | Three Months Ended March 31, 2009 | |
|---|---|---|
| | Municipal Securities | Collateralized Debt Obligations |
| Beginning Balance | $ 2,984 | $ |
| Realized gains included in earnings | 285 | |
| Purchase, issuances, and settlements | (5) | |
| Ending Balance | $ 3,264 | $ |
| The amount of total gains for the period included in earnings attributable to assets still held at March 31, 2009 | $ 285 | $ |

There were no transfers between Levels 1, 2, and 3 of the fair value hierarchy during the three months ended March 31, 2010 and 2009.

At March 31, 2010, the Company did not have any nonrecurring measurements of nonfinancial assets or nonfinancial liabilities.

**6. Derivative Financial Instruments**

The Company is exposed to certain risks relating to its ongoing business operations. The primary risks managed by using derivative instruments are equity price risk and interest rate risk. Equity contracts on various equity securities are entered into to manage the price risk associated with forecasted purchases or sales of such securities. Interest rate swaps are entered into to manage interest rate risk associated with the Company s loans with fixed or floating rates.

On February 6, 2009, the Company entered into an interest rate swap of its floating LIBOR rate on the $120 million credit facility, which was used for the acquisition of AIS, for a fixed rate of 1.93%, resulting in a total fixed rate of 3.18%. The purpose of the swap is to offset the variability of cash flows resulting from the variable interest rate. The swap is not designated as a hedge and changes in the fair value are adjusted through the consolidated statement of operations in the period of change.

Effective January 2, 2002, the Company entered into an interest rate swap on the $125 million senior notes for a floating rate of LIBOR plus 107 basis points. The swap agreement terminates on August 15, 2011 and includes an early termination option exercisable by either party on the fifth anniversary or each subsequent anniversary by providing

13

Table of Contents

sufficient notice, as defined. The swap is designated as a fair value hedge and qualifies for the shortcut method as the hedge is deemed to have no ineffectiveness. The fair market value of the interest rate swap was $8.0 million as of March 31, 2010, and has been recorded in other assets in the consolidated balance sheets with a corresponding increase in notes payable. The Company includes the gain or loss on the hedged item in the same line item, other revenue, as the offsetting loss or gain on the related interest rate swaps as follows:

| | Three Months Ended March 31, | | | |
|---|---|---|---|---|
| | 2010 | | 2009 | |
| Income Statement Classification | Gain (Loss) on Swap | Gain (Loss) on Loan | Gain (Loss) on Swap | Gain (Loss) on Loan |
| | (Amounts in thousands) | | | |
| Other revenue | $ (493) | $ 493 | $ (1,399) | $ 1,399 |

On March 3, 2008, the Company entered into an interest rate swap of its floating LIBOR rate on the $18 million bank loan for a fixed rate of 3.75%, resulting in a total fixed rate of 4.25%. The swap agreement terminates on March 1, 2013. The swap is designated as a cash flow hedge. The fair market value of the interest rate swap was $(1.1) million as of March 31, 2010, and has been reported as a component of other comprehensive income and amortized into earnings over the life of the hedged transaction. The interest rate swap was determined to be highly effective, and no amount of ineffectiveness was recorded in earnings during the three months ended March 31, 2010 and 2009.

**Fair value amounts, and gains and losses on derivative instruments**

The following tables provide the location and amounts of derivative fair values in the consolidated balance sheets and derivative gains and losses in the consolidated statements of operations:

| | Asset Derivatives | | Liability Derivatives | |
|---|---|---|---|---|
| | March 31, 2010 | December 31, 2009 | March 31, 2010 | December 31, 2009 |
| **Hedging derivatives** | | | | |
| Interest rate contracts - Other assets (liabilities) | $ 7,979 | $ 8,472 | $ (1,071) | $ (918) |
| **Non-hedging derivatives** | | | | |
| Interest rate contracts - Other liabilities | $ | $ | $ (2,110) | $ (1,446) |
| Equity contracts - Short-term investments (Other liabilities) | | | (576) | (1,043) |
| **Total non-hedging derivatives** | | | | |