SVB FINANCIAL GROUP
Form 10-Q
August 09, 2006

# UNITED STATES
# SECURITIES AND EXCHANGE COMMISSION

**Washington, D.C. 20549**

# FORM 10-Q

**(Mark One)**

| | |
|---|---|
| ý | **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934** |
| | **For the quarterly period ended June 30, 2006** |
| | **OR** |
| 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: 000-15637**

# SVB FINANCIAL GROUP

(Exact name of registrant as specified in its charter)

| | |
|---|---|
| **Delaware**<br>(State or other jurisdiction of incorporation or organization) | **91-1962278**<br>(I.R.S. Employer Identification No.) |
| **3003 Tasman Drive, Santa Clara, California**<br>(Address of principal executive offices) | **95054-1191**<br>(Zip Code) |

**(408) 654-7400**

(Registrant s telephone number, including area code)

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 ý No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large accelerated filer ý Accelerated filer o Non-accelerated filer o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes o No ý

At July 31, 2006, 34,531,095 shares of the registrant s common stock ($0.001 par value) were outstanding.

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**PART I - FINANCIAL INFORMATION**

**ITEM 1. INTERIM CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

**SVB FINANCIAL GROUP AND SUBSIDIARIES**

**INTERIM CONSOLIDATED BALANCE SHEETS (UNAUDITED)**

| (Dollars in thousands, except par value and share data) | June 30, 2006 | December 31, 2005 |
|---|---|---|
| **Assets** | | |
| Cash and due from banks | $ 321,334 | $ 286,446 |
| Federal funds sold, securities purchased under agreement to resell and other short-term investment securities | 222,937 | 175,652 |
| Investment securities | 1,759,387 | 2,037,270 |
| Loans, net of unearned income | 2,950,626 | 2,843,353 |
| Allowance for loan and lease losses | (37,907) | (36,785) |
| Net loans | 2,912,719 | 2,806,568 |
| Premises and equipment, net of accumulated depreciation and amortization | 31,328 | 25,099 |
| Goodwill | 17,204 | 35,638 |
| Accrued interest receivable and other assets | 206,742 | 175,042 |
| Total assets | $ 5,471,651 | $ 5,541,715 |
| | | |
| **Liabilities, Minority Interest, and Stockholders Equity** | | |
| Liabilities: | | |
| Deposits: | | |
| Noninterest-bearing demand | $ 2,758,391 | $ 2,934,278 |
| Negotiable order of withdrawal (NOW) | 46,489 | 39,573 |
| Money market | 777,327 | 961,052 |
| Time | 331,097 | 317,827 |
| Total deposits | 3,913,304 | 4,252,730 |
| Federal funds purchased and securities sold under agreement to repurchase | 533,811 | 279,464 |
| Contingently convertible debt | 147,990 | 147,604 |
| Junior subordinated debentures | 49,857 | 48,228 |
| Other borrowings | | 11 |
| Other liabilities | 105,535 | 124,921 |
| Total liabilities | 4,750,497 | 4,852,958 |
| | | |
| Commitments and contingencies | | |
| Minority interest in capital of consolidated affiliates | 153,033 | 119,456 |
| | | |
| Stockholders equity: | | |
| Preferred stock, $0.001 par value, 20,000,000 shares authorized; no shares issued and outstanding | | |
| Common stock, $0.001 par value, 150,000,000 shares authorized; 34,858,110 and 35,103,145 shares outstanding at June 30, 2006 and December 31, 2005, respectively | 35 | 35 |
| Additional paid-in capital | 8,876 | 8,439 |
| Retained earnings | 596,128 | 587,713 |
| Unearned compensation | | (5,792) |
| Accumulated other comprehensive loss | (36,918) | (21,094) |
| Total stockholders equity | 568,121 | 569,301 |
| Total liabilities, minority interest, and stockholders equity | $ 5,471,651 | $ 5,541,715 |

See accompanying notes to interim consolidated financial statements (unaudited).

**SVB FINANCIAL GROUP AND SUBSIDIARIES**

**INTERIM CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)**

| (Dollars in thousands, except per share amounts) | Three Months Ended June 30, 2006 | Three Months Ended June 30, 2005 | Six Months Ended June 30, 2006 | Six Months Ended June 30, 2005 |
|---|---|---|---|---|
| Interest income: | | | | |
| Loans | $ 70,219 | $ 51,306 | $ 136,367 | $ 98,762 |
| Investment securities: | | | | |
| Taxable | 19,600 | 20,935 | 39,994 | 41,680 |
| Non-taxable | 781 | 947 | 1,604 | 1,970 |
| Federal funds sold, securities purchased under agreement to resell and other short-term investments | 2,530 | 2,025 | 4,570 | 4,984 |
| Total interest income | 93,130 | 75,213 | 182,535 | 147,396 |
| Interest expense: | | | | |
| Deposits | 2,336 | 2,848 | 4,661 | 5,110 |
| Other borrowings | 5,032 | 931 | 8,233 | 1,726 |
| Total interest expense | 7,368 | 3,779 | 12,894 | 6,836 |
| Net interest income | 85,762 | 71,434 | 169,641 | 140,560 |
| Provision for (recovery of) loan and lease losses | 4,602 | 814 | 2,128 | (3,000) |
| Net interest income after provision for (recovery of) loan and lease losses | 81,160 | 70,620 | 167,513 | 143,560 |
| | | | | |
| Noninterest income: | | | | |
| Client investment fees | 10,972 | 7,805 | 20,609 | 15,201 |
| Gains on derivative instruments, net | 12,727 | 10,115 | 14,954 | 14,141 |
| Corporate finance fees | 2,775 | 6,935 | 5,213 | 11,749 |
| Letter of credit and standby letter of credit income | 2,642 | 2,423 | 4,992 | 4,793 |
| Deposit service charges | 2,310 | 2,378 | 4,488 | 4,882 |
| Gains (losses) on investment securities, net | 4,080 | (1,631) | 4,019 | (429) |
| Other | 5,472 | 2,364 | 10,104 | 5,421 |
| Total noninterest income | 40,978 | 30,389 | 64,379 | 55,758 |
| | | | | |
| Noninterest expense: | | | | |
| Compensation and benefits (including share-based payment expense of $5.6, $2.2, $11.5 and $3.4, respectively (in millions)) | 48,675 | 44,280 | 93,196 | 84,548 |
| Impairment of goodwill | 18,434 | | 18,434 | |
| Professional services | 10,074 | 5,653 | 18,429 | 10,723 |
| Net occupancy | 4,298 | 4,215 | 8,503 | 8,873 |
| Furniture and equipment | 3,671 | 3,300 | 7,375 | 6,019 |
| Business development and travel | 2,987 | 2,702 | 5,741 | 4,792 |
| Correspondent bank fees | 1,452 | 1,475 | 2,582 | 2,696 |
| Data processing services | 861 | 952 | 1,989 | 1,965 |
| Telephone | 880 | 1,061 | 1,787 | 1,950 |
| (Reduction of) provision for unfunded credit commitments | (3,325) | (1,074) | (3,821) | (1,259) |
| Other | 5,631 | 3,761 | 10,111 | 6,833 |
| Total noninterest expense | 93,638 | 66,325 | 164,326 | 127,140 |
| | | | | |
| Income before minority interest in net (income) loss of consolidated affiliates, income tax expense and cumulative effect of change in accounting principle | 28,500 | 34,684 | 67,566 | 72,178 |
| | (5,814) | 372 | (6,058) | 813 |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Minority interest in net (income) loss of consolidated affiliates | | | | | | | | |
| Income before income tax expense | | 22,686 | | 35,056 | | 61,508 | | 72,991 |
| Income tax expense | | 9,092 | | 14,160 | | 25,835 | | 29,159 |
| Net income before cumulative effect of change in accounting principle | | 13,594 | | 20,896 | | 35,673 | | 43,832 |
| Cumulative effect of change in accounting principle, net of tax (1) | | | | | | 192 | | |
| Net income | $ | 13,594 | $ | 20,896 | $ | 35,865 | $ | 43,832 |
| Earnings per common share basic, before cumulative effect of change in accounting principle | $ | 0.39 | $ | 0.60 | $ | 1.02 | $ | 1.24 |
| Earnings per common share diluted, before cumulative effect of change in accounting principle | $ | 0.36 | $ | 0.54 | $ | 0.93 | $ | 1.13 |
| Earnings per common share basic | $ | 0.39 | $ | 0.60 | $ | 1.02 | $ | 1.24 |
| Earnings per common share diluted | $ | 0.36 | $ | 0.54 | $ | 0.94 | $ | 1.13 |

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**(1)** The cumulative effect of change in accounting principle and taxes on previously granted share-based compensation for the effect of adopting Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment* .

See accompanying notes to interim consolidated financial statements (unaudited).

**SVB FINANCIAL GROUP AND SUBSIDIARIES**

**INTERIM CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (UNAUDITED)**

| (Dollars in thousands) | Three Months Ended June 30, 2006 | 2005 | Six Months Ended June 30, 2006 | 2005 |
|---|---|---|---|---|
| Net income | $ 13,594 | $ 20,896 | $ 35,865 | $ 43,832 |
| Other comprehensive (loss) income, net of tax: | | | | |
| Cumulative translation (losses) gains: | | | | |
| Foreign currency translation gains (losses), net of tax | 175 | (32) | 213 | (32) |
| Change in unrealized (losses) gains on available-for-sale investment securities: | | | | |
| Unrealized holding (losses) gains, net of tax | (5,571) | 11,854 | (16,107) | (2,197) |
| Reclassification adjustment for (gains) losses included in net income, net of tax | (29) | (1,087) | 70 | (1,290) |
| Total other comprehensive (loss) income, net of tax | (5,425) | 10,735 | (15,824) | (3,519) |
| Total comprehensive income | $ 8,169 | $ 31,631 | $ 20,041 | $ 40,313 |

See accompanying notes to interim consolidated financial statements (unaudited).

**SVB FINANCIAL GROUP AND SUBSIDIARIES**

**INTERIM CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)**

| (Dollars in thousands) | Six Months Ended June 30, 2006 | 2005 |
|---|---|---|
| **Cash flows from operating activities:** | | |
| Net income | $ 35,865 | $ 43,832 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Provision for (recovery of) loan losses | 2,128 | (3,000) |
| Impairment of goodwill | 18,434 | |
| Changes in fair values of derivatives, net | (8,520) | 1,601 |
| (Gains) losses on investment securities, net | (4,019) | 429 |
| Depreciation and amortization | 4,075 | 4,173 |
| Minority interest | 6,058 | (813) |
| Tax benefits of share-based compensation and other | 6,807 | 7,198 |
| Amortization of share-based compensation | 11,545 | 3,441 |
| Amortization of deferred warrant-related loan fees | (3,491) | (3,504) |
| Deferred income tax (benefit) expense | (672) | 1,310 |
| Changes in other assets and liabilities: | | |
| Decrease (increase) in accrued interest receivable | 1,600 | (4,624) |
| (Increase) decrease in accounts receivable | (86) | 867 |
| Increase in income tax receivable, net | (12,800) | (6,442) |
| Decrease in accrued retention, incentive plans, other compensation benefits payable | (20,583) | (14,037) |
| Reduction of provision for unfunded credit commitments | (3,821) | (1,259) |
| Other, net | 6,957 | 13,704 |
| **Net cash provided by operating activities** | **39,477** | **42,876** |
| **Cash flows from investing activities:** | | |
| Purchases of available-for-sale securities | (11,763) | (306,155) |
| Proceeds from sales of available-for-sale securities | 123,049 | 1,860 |
| Proceeds from maturities and pay-downs of available-for-sale securities | 180,656 | 207,045 |
| Purchases of nonmarketable securities (cost and equity method accounting) | (15,210) | (9,641) |
| Proceeds from sales of nonmarketable securities (cost and equity method accounting) | 2,335 | 3,515 |
| Proceeds from maturities of nonmarketable securities (cost and equity method accounting) | 1,442 | 2,404 |
| Purchases of nonmarketable securities (investment fair value accounting) | (37,965) | (33,436) |
| Proceeds from sales of nonmarketable securities (investment fair value accounting) | 8,890 | 2,527 |
| Proceeds from pay-downs of nonmarketable securities (investment fair value accounting) | 7,140 | 671 |
| Net increase in loans | (115,141) | (123,415) |
| Proceeds from recoveries of charged-off loans | 6,204 | 7,829 |
| Purchases of premises and equipment | (10,304) | (8,245) |
| **Net cash provided by (used for) investing activities** | **139,333** | **(255,041)** |
| **Cash flows from financing activities:** | | |
| Net (decrease) increase in deposits | (339,426) | 153,605 |
| Increase in borrowings, net | 254,336 | 1,598 |
| Capital contributions from minority interest participants, net of distributions | 27,519 | 28,208 |
| Stock compensation related tax benefits | 4,107 | |
| Proceeds from issuance of common stock | 26,146 | 12,921 |
| Repurchases of common stock | (69,319) | (73,140) |
| **Net cash (used for) provided by financing activities** | **(96,637)** | **123,192** |
| Net increase (decrease) in cash and cash equivalents | 82,173 | (88,973) |
| Cash and cash equivalents at beginning of year | 462,098 | 627,218 |
| **Cash and cash equivalents at end of period** | **$ 544,271** | **$ 538,245** |

| **Supplemental disclosures:** | | | | |
| --- | --- | --- | --- | --- |
| Cash paid during the period for: | | | | |
| Interest paid | $ | 12,330 | $ | 6,799 |
| Income taxes paid | $ | 29,695 | $ | 27,043 |

See accompanying notes to interim consolidated financial statements (unaudited).

**SVB FINANCIAL GROUP AND SUBSIDIARIES**

**NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

## 1. Description of Business

SVB Financial Group and its subsidiaries (collectively referred to as we , our or us in this Form 10-Q) offer clients financial products and services through four primary strategic business groups: Commercial Banking, SVB Capital, SVB Alliant, and Other Business Services, which include SVB Global, Private Client Services and other business service units (see Note 11. Segment Reporting). The Parent company of SVB Financial Group itself is referenced to as SVB Financial Group or the Parent company .

The Parent company is a bank holding company and financial holding company whose principal subsidiary is Silicon Valley Bank (the Bank ), a California-chartered bank, founded in 1983, and headquartered in Santa Clara, California. We serve more than 11,000 clients worldwide, through our 28 regional offices in the United States and four subsidiaries outside the United States. The Bank has 13 offices throughout California and operates regional offices across the country in Arizona, Colorado, Georgia, Illinois, Massachusetts, Minnesota, New York, North Carolina, Oregon, Pennsylvania, Utah, Texas, Virginia, and Washington and three international offices located in Bangalore, India; Shanghai, China; and London, England.

Through our Commercial Banking business group which includes the Bank and its subsidiaries, we serve clients in all stages of maturity ranging from emerging-growth companies to established, private and public companies in the technology, life science and premium wine industries. We define emerging-growth clients as companies in the start-up or early stages of their lifecycle; these companies tend to be privately held and backed by venture capital; they generally have few employees, are primarily engaged in research and development, have brought relatively few products or services to market, and have no or little revenue. By contrast, we define established or corporate technology clients as companies that tend to be more mature; these companies may be publicly traded, and more established in the markets in which they participate. In 2006, we began using Silicon Valley Bank to refer to our Commercial Banking activities.

SVB Capital focuses on the business needs of our venture capital and private equity clients, establishing and maintaining relationships with those firms domestically and internationally. Through this segment, we provide banking services and financial solutions, including traditional deposit and checking accounts, loans, letters of credit, and cash management services to venture capital and private equity clients. SVB Capital also makes investments in venture capital and other private equity firms and in companies in the niches we serve. The group manages five venture funds and oversees investments, as well as investments in several sponsored limited partnerships, such as Gold Hill Venture Lending Partners 03, LP, and its parallel funds, which primarily provide secured debt, typically to emerging-growth clients in their earliest stages; and the Partners for Growth funds, which are special situation debt funds that provide secured debt to, primarily, higher-risk, middle market clients in their later stages.

SVB Alliant, our investment banking subsidiary, provides merger and acquisition advisory services, private placement advisory services, strategic alliance services, and specialized financial studies such as valuations and fairness opinions. SVB Alliant is a broker-dealer registered with the U.S. Securities and Exchange Commission ( SEC ) and a member of the National Association of Securities Dealers, Inc. In 2005, we established SVB Alliant Europe Limited, a subsidiary based in London, England, in order to provide investment advisory services to companies in Europe. SVB Alliant Europe Limited did not commence full operations until May 2, 2006, when it received its license from the Financial Services Authority, which is an independent body that regulates the financial services industry in the United Kingdom.

Other Business Services include SVB Global, Private Client Services, and other business service units. SVB Global includes our foreign subsidiaries, which facilitate our clients   global expansion into major technology centers around the world. SVB Global provides a variety of services, including consulting and business services, referrals, and knowledge sharing, as well as identifying business opportunities for us. Private Client Services provides a wide range of credit services to high-net-worth individuals using both long-term secured and short-term unsecured lines of credit. Private Client Services helps our clients meet their cash management needs by providing deposit account products and services, including checking accounts, deposit accounts, money market accounts, and certificates of deposit.

## 2. Summary of Significant Accounting Policies

***Basis of Presentation***

The accompanying unaudited interim consolidated financial statements reflect all adjustments (of a normal and recurring nature) that are, in the opinion of management, necessary to fairly present our financial position, results of operations and cash flows in accordance with accounting principles generally accepted in the United States of America (   GAAP   ). Such interim financial statements have been prepared in accordance with the instructions to Form 10-Q pursuant

to the rules and regulations of the Securities and Exchange Commission ( SEC ). Certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to such rules and regulations. The results of operations for the three and six months ended June 30, 2006 are not necessarily indicative of results to be expected for any future periods. These interim consolidated financial statements should be read in conjunction with our Annual Report on Form 10-K for the year ended December 31, 2005 ( 2005 Form 10-K ).

The consolidated balance sheet at December 31, 2005 has been derived from the audited consolidated financial statements at that date, but does not include all of the information and footnotes required by GAAP for complete financial statements. The accompanying interim consolidated financial statements have been prepared on a consistent basis with the accounting policies described in Part II, Item 8. Consolidated Financial Statements and Supplementary Data -Note 2. Summary of Significant Accounting Policies presented in our Annual Report on Form 10-K for the year ended December 31, 2005.

The preparation of interim consolidated financial statements in conformity with GAAP in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

***Recent Accounting Pronouncements***

In March 2006, the Financial Accounting Standards Board ( FASB ) issued SFAS No. 156, Accounting for Servicing of Financial Assets, an amendment of SFAS 140 . The Statement clarifies when an entity should separately recognize servicing assets and servicing liabilities when it undertakes an obligation to service a financial asset by entering into a servicing contract. The Statement requires that all separately recognized servicing assets and servicing liabilities be initially measured at fair value and subsequently measured using either the amortization method as previously permitted under SFAS 140 or the fair value measurement method. Entities are permitted to make an election to subsequently remeasure classes of separately recognized servicing assets and liabilities. Once the fair value measurement method is elected for a class, the election should be applied prospectively to all new and existing separately recognized servicing assets and servicing liabilities within that class. The effect of remeasuring an existing class of separately recognized servicing assets and servicing liabilities at fair value would be reported as a cumulative-effect adjustment to retained earnings as of the beginning of the fiscal year of adoption. The Statement is effective as of the beginning of an entity s first fiscal year that begins after September 15, 2006. Earlier adoption is permitted as of the beginning of an entity s fiscal year, provided the entity has not yet issued interim financial statements for that fiscal year. In the first quarter of 2006, we elected not to early adopt this Statement and accordingly, will adopt as of January 1, 2007. We do not expect the adoption of SFAS 156 to have a material impact on our consolidated financial position and results of operations.

In February 2006, the FASB issued SFAS No. 155, Accounting for Certain Hybrid Financial Instruments, an amendment of FASB Statements No. 133 and 140 ( SFAS 155 ). Hybrid financial instruments are financial instruments that contain an embedded derivative within a single instrument. SFAS 155 permits entities an option to elect to record hybrid financial instruments at fair value as one financial instrument. Prior to this amendment, hybrid financial instruments were required to be separated into two instruments, a derivative and host, and generally only the derivative was recorded at fair value. SFAS 155 requires that beneficial interests in securitized assets be evaluated for derivatives, either freestanding or embedded. SFAS 155 is effective for all financial instruments acquired or issued after January 1, 2007. Additionally, SFAS 155 provides a one-time opportunity to apply the fair value election to hybrid financial instruments existing at the date of implementation at fair value as one financial instrument, with any difference between the carrying amount of the existing hybrid financial instruments and the fair value of the single financial instrument being recorded as a cumulative effect adjustment to beginning retained earnings. We are currently assessing the impact of SFAS 155 on our consolidated financial position and results of operations.

In July 2006, the FASB issued FASB Interpretation ( FIN ) No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 , to clarify the accounting for uncertain tax positions. FIN 48 prescribes that a two-step benefit recognition model be applied to initially recognize and measure the benefit amount of a tax position. The first step requires that a tax benefit be recognized only when the tax position is more-likely-than-not of being sustained based on the technical merits of the position. Assuming the first step is met, the second step requires that the benefit amount be measured at the largest amount that has at least a more-likely-than-not likelihood of being the ultimate outcome based on a cumulative-probability approach. Tax positions that previously failed to meet the more-likely-than-not recognition threshold should be subsequently recognized in the period in which the threshold is subsequently met, the tax matter is resolved or the statute of limitation for examining the tax position has expired. FIN 48 requires that a previously recognized tax benefit be derecognized in the period it becomes more-likely-than-not that the tax position would not be sustained on audit. The impact of applying FIN 48 should be recognized as a cumulative-effect adjustment to beginning retained earnings

at the adoption date. The Interpretation is effective for fiscal years beginning after December 15, 2006. We are currently assessing the impact of FIN 48 on our consolidated financial position and results of operations.

### 3. Earnings Per Share (EPS)

The following is a reconciliation of basic EPS to diluted EPS for the three and six months ended June 30, 2006 and 2005:

| (Dollars and shares in thousands, except per share amounts) | Three Months Ended June 30, Net Income | Three Months Ended June 30, Weighted Average Shares | Three Months Ended June 30, Per Share Amount | Six Months Ended June 30, Net Income | Six Months Ended June 30, Weighted Average Shares | Six Months Ended June 30, Per Share Amount |
|---|---|---|---|---|---|---|
| **2006:** | | | | | | |
| **Basic EPS:** | | | | | | |
| Income available to common stockholders | $ 13,594 | 34,968 | $ 0.39 | $ 35,865 | 35,030 | $ 1.02 |
| Effect of dilutive securities: | | | | | | |
| Stock options, restricted stock awards, restricted stock units and convertible debt | | 3,023 | | | 3,186 | |
| **Diluted EPS:** | | | | | | |
| Income available to common stockholders and assumed conversions | $ 13,594 | 37,991 | $ 0.36 | $ 35,865 | 38,216 | $ 0.94 |
| **2005:** | | | | | | |
| **Basic EPS:** | | | | | | |
| Income available to common stockholders | $ 20,896 | 35,010 | $ 0.60 | $ 43,832 | 35,339 | $ 1.24 |
| Effect of dilutive securities: | | | | | | |
| Stock options, restricted stock awards, restricted stock units and convertible debt | | 3,464 | | | 3,288 | |
| **Diluted EPS:** | | | | | | |
| Income available to common stockholders and assumed conversions | $ 20,896 | 38,474 | $ 0.54 | $ 43,832 | 38,627 | $ 1.13 |

For the three months ended June 30, 2006 and 2005, approximately 5.4 million and 4.6 million average potential common stock equivalents (including stock options, restricted stock and warrants), respectively, were excluded from the calculation, as they were anti-dilutive. For the six months ended June 30, 2006 and 2005, approximately 5.3 million and 4.6 million average potential common stock equivalents (including stock options, restricted stock and warrants), respectively, were excluded from the calculation, as they were anti-dilutive.

In September 2004, the Emerging Issues Task Force ( EITF ) reached final consensus on EITF No. 04-8, *The Effect of Contingently Convertible Instruments on Diluted Earnings per Share* , that contingently convertible debt should be treated as convertible debt and included in the calculation of diluted EPS. The potential dilutive effect of our contingently convertible debt using the treasury stock method was approximately 1.4 million shares and 1.3 million shares for the three months ended June 30, 2006 and 2005, respectively, and 1.4 million shares and 1.2 million shares for the six months ended June 30, 2006 and 2005, respectively. The assumed proceeds under the treasury stock method were calculated by subtracting the aggregate weighted average conversion price from the average market price of the shares related to the contingently convertible debt. We included the dilutive effect of the $150.0 million zero-coupon, convertible subordinated notes (see Note 8. Borrowings) in our diluted EPS calculation using the treasury stock method, in accordance with the provisions of EITF No. 90-19, *Convertible Bonds With*

*Issuer Option to Settle in Cash Upon Conversion* and SFAS No. 128, *Earnings Per Share*. However, the exposure draft of SFAS No. 128(R), if adopted in its proposed form, will require us to change our accounting for the calculation of EPS on our contingently convertible debt to the if converted method. The if converted treatment of the contingently convertible debt would have decreased diluted EPS by $0.03 and $0.07 for the three and six months ended June 30, 2006, respectively.

**4. Share-Based Compensation**

**Impact of Adopting SFAS 123R**

Prior to January 1, 2006, we accounted for employee stock-based compensation using the intrinsic value method supplemented by pro forma disclosures in accordance with APB 25 and SFAS 123, Accounting for Stock-Based Compensation, as amended by SFAS No. 148 Accounting for Stock-Based Compensation Transition and Disclosures. Under the intrinsic value method, stock options granted with exercise prices equal to the grant date fair value of our stock have no intrinsic value and therefore no expense was actually recorded for these options under APB 25. For pro forma

disclosure only, we measured the fair value of our stock options using the Black-Scholes option-pricing model and expensed the value over the corresponding service period using the straight-line amortization approach. Equity-based awards for which stock-based compensation expense was actually recorded were generally grants of restricted stock awards and restricted stock units which were measured at fair value on the date of grant based on the number of shares granted and the quoted price of our common stock. Such value was then recognized as an expense over the corresponding service period using an accelerated amortization approach in accordance with FASB Interpretation No. 28 Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans.

Effective January 1, 2006, we adopted SFAS 123(R) using the modified prospective transition method and accordingly prior periods have not been restated to reflect the impact of SFAS 123(R). Under SFAS 123(R), stock-based awards that were granted prior to January 1, 2006 are being expensed over the remaining portion of their vesting period under the same amortization method and, for stock options, using the same fair value measurements which were used in calculating pro forma stock-based compensation expense under SFAS 123. Under SFAS 123(R), the fair value of stock options are being measured using the Black-Scholes option-pricing model while the fair value for our restricted stock awards and restricted stock units are based on the quoted price of our common stock on the date of grant. For all stock-based awards granted on or after January 1, 2006, stock-based compensation expense is being amortized on a straight-line basis over the requisite service period. SFAS 123(R) requires that the deferred stock-based compensation on the consolidated balance sheet on the date of adoption be netted against additional paid-in capital. As of December 31, 2005, there was a balance of $5.8 million of deferred stock-based compensation that was netted against additional paid-in capital on January 1, 2006.

For the six months ended June 30, 2006, we recorded share-based compensation expense of $11.5 million, resulting in the recognition of $2.5 million in related tax benefits. For the six months ended June 30, 2005, we recognized $3.4 million of share-based compensation expense under the intrinsic value method of APB 25, resulting in the recognition of $1.4 million in related tax benefits. As a result of adopting SFAS 123(R) on January 1, 2006, our income before income taxes and net income for the six months ended June 30, 2006 were $8.5 million and $7.3 million lower, respectively, than if we had continued to account for share-based compensation under APB 25. Basic and diluted earnings per share for the six months ended June 30, 2006 were $0.24 and $0.19 lower, respectively, than if we had continued to account for share-based compensation under APB 25.

SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from initial estimates. Stock-based compensation expense was recorded net of estimated forfeitures for the six months ended June 30, 2006 such that expense was recorded only for those stock-based awards that are expected to vest. Previously under APB 25 to the extent awards were forfeited prior to vesting, the corresponding previously recognized expense was reversed in the period of forfeiture. Upon adoption of FAS 123(R) as of January 1, 2006, we recorded a cumulative adjustment of $0.2 million to account for the expected forfeitures of restricted stock awards and restricted stock units granted prior to January 1, 2006, for which we previously recorded an expense.

**Equity Incentive Plans**

On May 11, 2006, shareholders approved the 2006 Equity Incentive Plan (the 2006 Incentive Plan ). Our existing 1997 Equity Incentive Plan was set to expire in December 2006. The 2006 Incentive Plan provides for the grant of the following types of incentive awards: (i) stock options, (ii) stock appreciation rights, (iii) restricted stock, (iv) restricted stock units, (v) performance shares and performance units, and (vi) and other stock awards.

Subject to the provisions of Section 14 of the 2006 Incentive Plan, the maximum aggregate number of shares that may be awarded and sold thereunder is 3,000,000 shares plus 1,488,361 shares comprised of (i) any shares which have been reserved but not issued under our 1997 Equity Incentive Plan as of May 11, 2006, and (ii) any shares subject to stock options or similar awards granted under the 1997 Equity Incentive Plan that expire or otherwise terminate without having been exercised in full and shares issued pursuant to awards granted under the 1997 Equity Incentive Plan that are forfeited to or repurchased by us. No further awards will be made under the 1997 Equity Incentive Plan, but it will continue to govern awards previously granted thereunder.

Restricted stock awards and restricted stock units will be counted against the numerical limits of the Incentive Plan as two shares for every one share subject thereto. Further, if shares acquired pursuant to any such award are forfeited or repurchased by us and would otherwise return to the Incentive Plan pursuant to the terms thereof, two times the number of shares so forfeited or repurchased will return to the Incentive Plan and will again become available for issuance.

Eligible participants in the 2006 Incentive Plan include directors, employees, and consultants. Options granted under the 2006 Incentive Plan generally expire 7 years after the grant date. Options generally become exercisable over various periods, typically 4 years, from date of grant based on continued employment and typically vest annually. Restricted stock awards generally vest over the passage of time and continued employment through the vesting period. Restricted stock units generally vest upon meeting certain performance-based objectives or the passage of time, or a combination of both, and continued employment through the vesting period. The vesting period for restricted stock units cannot be less than three years unless they are subject to certain performance-based objectives, in which case the vesting period can be 12 months or longer.

**Employee Stock Purchase Plan**

We maintain an employee stock purchase plan ( ESPP ) under which participating employees may annually contribute up to 10% of their gross compensation to purchase shares of our common stock at 85% of its fair market value at either the beginning or end of each six-month offering period, whichever price is less. All employees are eligible to participate in the ESPP on the first day of hire. To be eligible, an employee must, among other requirements, be age 18 or above and complete at least one hour of service as an employee of us or any of our affiliates. There were 71,036 shares issued under the ESPP for the period ended June 30, 2006. At June 30, 2006, a total of 915,577 shares of our common stock were still available for future issuance under the ESPP. The next purchase will be on December 29, 2006 at the end of the current six-month offering period. Effective January 1, 2006, we began recognizing compensation expense in accordance with SFAS 123(R).

**Pro forma Information for Periods Prior to the Adoption of SFAS No. 123(R)**

Prior to the adoption of SFAS No. 123(R), we provided the pro forma disclosures required under SFAS No. 123, as amended by SFAS No. 148, *Accounting for Stock-Based Compensation Transition and Disclosures* . Previously reported amounts have not been restated.

| (Dollars in thousands, except per share amounts) | | Three Months Ended June 30, 2005 | Six Months Ended June 30, 2005 |
|---|---|---|---|
| Net income, as reported | $ | 20,896 | 43,832 |
| Add: Stock-based compensation expense, net of tax reported in net income | | 1,257 | 1,919 |
| Less: Total stock-based employee compensation expense determined under fair value based method, net of tax | | (5,591) | (10,909) |
| Net income, pro forma | $ | 16,562 | 34,842 |
| | | | |
| Earnings per common share basic: | | | |
| As reported | $ | 0.60 | 1.24 |
| Pro forma | | 0.48 | 0.99 |
| Earnings per diluted share diluted: | | | |
| As reported | $ | 0.54 | 1.13 |
| Pro forma | | 0.45 | 0.93 |

**Unrecognized Compensation Expense**

As of June 30, 2006, unrecognized share-based compensation expense is as follows:

| | As of June 30, 2006 | | |
|---|---|---|---|
| (Dollars in thousands) | | Unrecognized Expense | Average Expected Recognition Period in Years |
| Stock option awards | $ | 21,181 | 1.33 |
| Restricted stock awards | | 1,644 | 1.03 |

| | | | |
|---|---|---|---|
| Restricted stock units | | 8,224 | 1.87 |
| Employee stock purchase plan | | | |
| Total unrecognized share-based compensation expense | $ | 31,049 | |

**Valuation Assumptions**

As of June 30, 2006 and 2005, the fair values of share-based awards for employee stock options and employee stock

purchases made under our ESPP were estimated using the Black-Scholes option pricing model. The fair values of our restricted stock awards and restricted stock units were based on our closing quoted market price on date of grant. The following weighted average assumptions were used:

| | Three Months Ended June 30, 2006 | Three Months Ended June 30, 2005 | Six Months Ended June 30, 2006 | Six Months Ended June 30, 2005 |
|---|---|---|---|---|
| **Equity Incentive Plan Awards** | | | | |
| Expected term of options in years | 5.3 | 5.1 | 5.3 | 5.1 |
| Expected volatility of the Company s underlying common stock | 29.3% | 37.0% | 29.4% | 37.1% |
| Risk-free interest rate | 4.82% | 4.06% | 4.79% | 4.05% |
| Expected dividend yield | % | % | % | % |
| Weighted average grant date fair value-stock options | $ 18.75 | $ 17.58 | $ 18.69 | $ 17.60 |
| Weighted average grant date fair value-restricted stock awards and restricted stock units | $ 51.21 | $ 45.08 | $ 51.17 | $ 45.09 |
| **ESPP** | | | | |
| Expected term in years | 0.5 | 0.5 | 0.5 | 0.5 |
| Expected volatility of the Company s underlying common stock | 22.5% | 24.8% | 22.5% | 24.8% |
| Risk-free interest rate | 4.40% | 2.63% | 4.40% | 2.63% |
| Expected dividend yield | % | % | % | % |
| Weighted average fair value | $ 10.23 | $ 10.01 | $ 10.23 | $ 10.01 |

The expected term was based on the implied term of the stock options using a lattice option-pricing model with early exercise factors based on historic employee exercise behavior. The expected volatilities for the 2006 Equity Incentive Plan for the three and six months ended June 30, 2006 and 2005 were calculated using a blended rate consisting of equal measures of our historic volatility and our expected volatility over a five-year term. The expected volatilities for the ESPP for the three and six months ended June 30, 2006 and 2005 are equal to the historical volatility for the previous six month periods. The expected risk-free interest rates for all periods were based on the yields of U.S. Treasury Securities, as reported by the Federal Reserve Bank of New York, with maturities equal to the expected terms of the employee stock options.

**Share-Based Payment Award Activity**

The table below provides stock option information related to the 1989 Stock Option Plan, the 1997 Equity Incentive Plan and the 2006 Equity Incentive Plan for the three and six months ended June 30, 2006 and 2005:

| | Three Months Ended June 30, 2006 | | Six Months Ended June 30, 2006 | |
|---|---|---|---|---|
| | Shares | Weighted-Average Exercise Price | Shares | Weighted-Average Exercise Price |
| Outstanding at beginning of period | 5,150,631 | $ 29.81 | 6,023,080 | $ 28.87 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Granted | 275,297 | | 52.00 | 314,847 | | 51.84 |
| Exercised | (253,508) | | 25.91 | (1,046,446) | | 23.77 |
| Forfeited | (85,469) | | 37.87 | (203,325) | | 35.63 |
| Cancelled | (500) | | 48.88 | (1,705) | | 40.56 |
| Outstanding at June 30 | 5,086,451 | $ | 31.06 | 5,086,451 | $ | 31.06 |
| Exercisable at June 30 | 3,273,528 | $ | 27.27 | 3,273,528 | $ | 27.27 |

| | **Three Months Ended June 30, 2005** | | | **Six Months Ended June 30, 2005** | | |
|---|---|---|---|---|---|---|
| | **Shares** | | **Weighted-Average Exercise Price** | **Shares** | | **Weighted-Average Exercise Price** |
| Outstanding at beginning of period | 6,387,083 | $ | 27.54 | 6,645,385 | $ | 27.41 |
| Granted | 428,790 | | 44.79 | 446,990 | | 44.78 |
| Exercised | (325,368) | | 22.58 | (540,408) | | 22.58 |
| Forfeited | (160,794) | | 30.57 | (215,280) | | 31.20 |
| Cancelled | (4,000) | | 49.27 | (10,976) | | 51.63 |
| Outstanding at June 30 | 6,325,711 | $ | 28.87 | 6,325,711 | $ | 28.87 |
| Exercisable at June 30 | 3,299,123 | $ | 24.85 | 3,299,123 | $ | 24.85 |

| | Shares | | Weighted-Average Exercise Price | Weighted-Average Remaining Contractual Life in Years | | Aggregate Intrinsic Value of In-The-Money Options ($) |
|---|---|---|---|---|---|---|
| Outstanding at June 30, 2006 | 5,086,451 | $ | 31.06 | 4.51 | $ | 75,644,014 |
| Exercisable at June 30, 2006 | 3,273,528 | $ | 27.27 | 4.31 | $ | 59,875,068 |

The aggregate intrinsic value of outstanding options shown in the table above represents the pretax intrinsic value as of June 30, 2006. This value is based on our closing stock price of $45.46 as of June 30, 2006. The total intrinsic value of options exercised during the three and six months ended June 30, 2006 was $6.6 million and $28.1 million, respectively, and the total intrinsic value of options exercised during the three and six months ended June 30, 2005 was $8.1 million and $12.7 million, respectively. Cash received from stock option exercises was $6.8 million and $7.2 million during the six months ended June 30, 2006 and 2005, respectively. The tax benefit of stock options exercised was $4.1 million and $0 for the six months ended June 30, 2006 and 2005.

The following table summarizes information regarding stock options outstanding as of June 30, 2006:

| Ranges of Exercise Prices | | | | Shares | Outstanding Options<br>Weighted-Average Remaining Contractual Life in Years | | Weighted-Average Exercise Price | Vested Options<br>Shares | | Weighted-Average Exercise Price |
|---|---|---|---|---|---|---|---|---|---|---|
| $ | 8.25- | $ | 17.07 | 642,276 | 3.94 | $ | 13.81 | 546,432 | $ | 13.31 |
| | 17.20- | | 23.69 | 531,435 | 4.98 | | 22.36 | 449,848 | | 22.54 |
| | 23.90- | | 25.17 | 524,486 | 2.36 | | 25.05 | 374,518 | | 25.05 |
| | 25.29- | | | | | | | | | |

| | | | | | |
|---|---|---|---|---|---|
| Loss ratio **(2) (3)** | 64.3 | 93.5 | 45.4 | 56.2 | 79.8 |
| Expense ratio | 39.9 | 40.8 | 41.2 | 40.1 | 37.3 |
| Combined ratio **(2) (3)** | 104.2 | 134.3 | 86.6 | 96.3 | 117.1 |
| Net / gross premiums written | 90.0 | 91.1 | 85.8 | 85.3 | 81.6 |
| **Financial Position as of Last Day of Period:** | | | | | |
| Total investments and cash and cash equivalents | $ 1,533,989 | $ 1,647,723 | $ 1,717,186 | $ 1,731,314 | $ 1,599,528 |
| Reinsurance receivables, net of allowance | 241,827 | 287,986 | 422,844 | 543,351 | 679,277 |
| Total assets | 1,903,703 | 2,072,916 | 2,290,728 | 2,441,913 | 2,473,967 |
| | 54,000 | 72,000 | 90,000 | 90,000 | 90,000 |

| | | | | | |
|---|---|---|---|---|---|
| Senior notes payable | | | | | |
| Junior subordinated debentures | 30,929 | 30,929 | 30,929 | 30,929 | 30,929 |
| Unpaid losses and loss adjustment expenses | 879,114 | 971,377 | 1,052,743 | 1,257,741 | 1,506,429 |
| Total shareholders equity | 806,618 | 839,063 | 924,769 | 828,108 | 628,901 |

**(1)** The Company s insurance operating ratios are non-GAAP financial measures that are generally viewed in the insurance industry as indicators of underwriting profitability. The loss ratio is the ratio of net losses and loss adjustment expenses to net premiums earned. The expense ratio is the ratio of acquisition costs and other underwriting expenses to net premiums earned. The combined ratio is the sum of the loss and expense ratios. The ratios presented here represent the consolidated results of both the Company s Insurance Operations and Reinsurance Operations.

**(2)** The Company s 2012 loss and combined ratios were impacted by a $4.4 million increase of net losses and loss adjustment expenses for prior accident years. The Company s 2011 loss and combined ratios were impacted by a $3.4 million increase of net losses and loss adjustment expenses for prior accident years. The Company s 2010 loss and combined ratios were impacted by a $54.1 million reduction of net losses and loss adjustment expenses for prior accident years. The Company s 2009 loss and combined ratios were impacted by a $9.1 million reduction of net losses and loss adjustment expenses for prior accident years. The Company s 2008 loss and combined ratios were impacted by a $34.9 million increase of net losses and loss adjustment expenses for prior accident years. See Results of Operations in Item 7 of Part II of this report for details of these items and their impact on the loss and combined ratios.

**(3)** The Company s loss and combined ratios for 2012, 2011, 2010, 2009, and 2008 include $14.2 million, $20.6 million, $2.8 million, $5.8 million, and $21.5 million, respectively, of catastrophic losses from the Insurance Operations. See Results of Operations in Item 7 of Part II of this report for a discussion of the impact of these losses on the loss and combined ratios.

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**Item 7. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

The following discussion and analysis of the Company s financial condition and results of operations should be read in conjunction with the consolidated financial statements and accompanying notes of Global Indemnity included elsewhere in this report. Some of the information contained in this discussion and analysis or set forth elsewhere in this report, including information with respect to the Company s plans and strategy, constitutes forward-looking statements that involve risks and uncertainties. Please see Cautionary Note Regarding Forward-Looking Statements at the end of this Item 7 and Risk Factors in Item 1A above for more information. You should review Risk Factors in Item 1A above for a discussion of important factors that could cause actual results to differ materially from the results described in or implied by the forward-looking statements contained herein.

**Recent Developments**

***Superstorm Sandy***

In late October, 2012, Superstorm Sandy made landfall in the northeastern United States. While we are still evaluating the ultimate impact of this event, our current estimate of ultimate loss is approximately $12 million. Actual losses from this event may vary materially from our current estimates due to the inherent uncertainties resulting from several factors, including the preliminary nature of the loss data available and potential inaccuracies and inadequacies in the data provided.

***Mary R. Hennessy***

On November 14, 2012, Mary R. Hennessy resigned from the Company s Board of Directors.

***Share Repurchase Program***

On August 28, 2012, the Board of Directors authorized the Company to repurchase up to $25.0 million of its A ordinary shares. The Company repurchased and retired an aggregate 386,289 of its A ordinary shares in the open market and in privately negotiated transactions at an aggregate price of $8.1 million or an average of $21.10 per share. The Company does not have authorization from the Board of Directors to repurchase any additional A ordinary shares as of December 31, 2012. The excess cost of the repurchased shares over their par value was classified to additional paid-in capital as of December 31, 2012.

**Overview**

The Company s Insurance Operations distribute property and casualty insurance products through a group of approximately 100 professional general agencies that have limited quoting and binding authority, as well as a number of wholesale insurance brokers who in turn sell the Company s insurance products to insureds through retail insurance brokers. The Company operates predominantly in the excess and surplus lines marketplace. To manage its operations, the Company differentiates them by product classification. These product classifications are: 1) Penn-America, which includes property and general liability products for small commercial businesses distributed through a select network of wholesale general agents with specific binding authority; 2) United National, which includes property, general liability, and professional lines products distributed through program administrators with specific binding authority; and 3) Diamond State, which includes property, casualty, and professional lines products distributed through wholesale brokers and program administrators with specific binding authority.

The Company s Reinsurance Operations segment provides reinsurance solutions through brokers, program managers and primary writers, including regional insurance companies, and consists solely of the operations of

Wind River Reinsurance. Wind River Reinsurance is a Bermuda based treaty reinsurer of excess and surplus lines carriers, specialty property and casualty insurance companies and U.S. regional insurance writers. Wind River Reinsurance conducts business in Bermuda and is focused on using its capital capacity to write catastrophe-oriented placements and other niche or specialty-focused treaties meeting the Company s risk tolerance and return thresholds. Given the current pricing environment, Wind River Reinsurance continues to cautiously deploy and manage its capital while seeking to position itself as a niche reinsurance solution provider.

The Company derives its revenues primarily from premiums paid on insurance policies that it writes and from income generated by its investment portfolio, net of fees paid for investment management services. The amount of insurance premiums that the Company receives is a function of the amount and type of policies it writes, as well as of prevailing market prices.

The Company s expenses include losses and loss adjustment expenses, acquisition costs and other underwriting expenses, corporate and other operating expenses, interest, investment expenses, and income taxes. Losses and loss adjustment expenses are estimated by management and reflect the Company s best estimate of ultimate losses and costs arising during the reporting period and revisions of prior period estimates. The Company records losses and loss adjustment expenses based on an actuarial analysis of the estimated losses the Company expects to incur on the insurance policies it writes. The ultimate losses and loss adjustment expenses will depend on the actual costs to resolve claims. Acquisition costs consist principally of commissions and premium taxes that are typically a percentage of the premiums on the insurance policies the Company writes, net of ceding commissions earned from reinsurers. Other underwriting expenses consist primarily of personnel expenses and general operating expenses. Corporate and other operating expenses are comprised primarily of outside legal fees, other professional and accounting fees, directors fees, management fees, salaries and benefits for company personnel whose services relate to the support of corporate activities, and capital duty taxes incurred. Interest expense consists primarily of interest on senior notes payable, junior subordinated debentures, and funds held on behalf of others.

**Critical Accounting Estimates and Policies**

The Company s consolidated financial statements are prepared in conformity with United States of America generally accepted accounting principles ( GAAP ), which requires it to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. See Note 6 of the notes to consolidated financial statements contained in Item 8 of Part II of this report. Actual results could differ from those estimates and assumptions.

Effective January 1, 2012, the Company adopted new accounting guidance that modified the definition of costs that can be capitalized in the acquisition of new and renewal business for insurance companies. Under the new guidance, only direct incremental costs associated with successful insurance contract acquisitions or renewals are deferrable. This guidance was adopted retrospectively and has been applied to all prior period information contained in this Form 10-K. For further information please see Note 2 of the notes to the consolidated financial statements in Item 8 of Part II of this report.

The Company believes that of the Company s significant accounting policies, the following may involve a higher degree of judgment and estimation.

***Liability for Unpaid Losses and Loss Adjustment Expenses***

Although variability is inherent in estimates, the Company believes that the liability for unpaid losses and loss adjustment expenses reflects its best estimate for future amounts needed to pay losses and related loss adjustment expenses and the impact of its reinsurance coverage with respect to insured events.

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In developing loss and loss adjustment expense ( loss or losses ) reserve estimates for the Company s Insurance Operations, its actuaries perform detailed reserve analyses each quarter. To perform the analysis, the data is organized at a reserve category level. A reserve category can be a line of business such as commercial automobile liability, or it can be a particular type of claim such as construction defect. The reserves within a reserve category level are characterized as short-tail through long-tail. For long-tail business, it will generally be several years between the time the business is written and the time when all claims are settled. The Company s long-tail exposures include general liability, professional liability, products liability, commercial automobile liability, and excess and umbrella. Short-tail exposures include property, commercial automobile physical damage, and equine mortality. To manage its insurance operations, the Company differentiates them by product classifications, which are Penn-America, United National, and Diamond State. For further discussion about the Company s product classifications, see General Business Segments Insurance Operations in Item 1 of Part I of this report. Each of the Company s product classifications contain both long-tail and short-tail exposures. Every reserve category is analyzed by the Company s actuaries each quarter. The analyses generally include reviews of losses gross of reinsurance and net of reinsurance.

Loss reserve estimates for the Company s Reinsurance Operations are developed by independent, external actuaries; however management is responsible for the final determination of loss reserve selections. The data for this analysis is organized by treaty and treaty year. As with the Company s reserves for its Insurance Operations, reserves for its Reinsurance Operations are characterized as short-tail through long-tail. Long-tail exposures include workers compensation, professional liability, and excess and umbrella liability. Short-tail exposures are primarily catastrophe exposed property accounts. Every treaty is reviewed each quarter, both gross and net of reinsurance.

In addition to the Company s internal reserve analysis, independent external actuaries perform a full, detailed review of the Insurance Operations reserves annually. The Company does not rely upon the review by the independent actuaries to develop its reserves; however, the data is used to corroborate the analysis performed by the in-house actuarial staff. The Company s independent external actuaries also perform a full, detailed review of the Reinsurance Operations reserves annually.

The methods used to project ultimate losses for both long-tail and short-tail exposures include, but are not limited to, the following:

- Paid Development method;
- Incurred Development method;
- Expected Loss Ratio method;
- Bornhuetter-Ferguson method using premiums and paid loss;
- Bornhuetter-Ferguson method using premiums and incurred loss; and
- Average Loss method.

The Paid Development method estimates ultimate losses by reviewing paid loss patterns and applying them to accident years with further expected changes in paid loss. Selection of the paid loss pattern requires analysis of several factors including the impact of inflation on claims costs, the rate at which claims professionals make claim payments and close claims, the impact of judicial decisions, the impact of underwriting changes, the impact of large claim payments and other factors. Claim cost inflation itself requires evaluation of changes in the cost of repairing or replacing property, changes in the cost of medical care, changes in the cost of wage replacement, judicial decisions, legislative changes and other factors. Because this method assumes that losses are paid at a consistent rate, changes in any of these factors can impact the results. Since the method does not rely on case reserves, it is not directly influenced by changes in the adequacy of case reserves.

For many reserve categories, paid loss data for recent periods may be too immature or erratic for accurate predictions. This situation often exists for long-tail exposures. In addition, changes in the factors described above

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may result in inconsistent payment patterns. Finally, estimating the paid loss pattern subsequent to the most mature point available in the data analyzed often involves considerable uncertainty for long-tail reserve categories.

The Incurred Development method is similar to the Paid Development method, but it uses case incurred losses instead of paid losses. Since this method uses more data (case reserves in addition to paid losses) than the Paid Development method, the incurred development patterns may be less variable than paid development patterns. However, selection of the incurred loss pattern requires analysis of all of the factors listed in the description of the Paid Development method. In addition, the inclusion of case reserves can lead to distortions if changes in case reserving practices have taken place and the use of case incurred losses may not eliminate the issues associated with estimating the incurred loss pattern subsequent to the most mature point available.

The Expected Loss Ratio method multiplies premiums by an expected loss ratio to produce ultimate loss estimates for each accident year. This method may be useful if loss development patterns are inconsistent, losses emerge very slowly, or there is relatively little loss history from which to estimate future losses. The selection of the expected loss ratio requires analysis of loss ratios from earlier accident years or pricing studies and analysis of inflationary trends, frequency trends, rate changes, underwriting changes, and other applicable factors.

The Bornhuetter-Ferguson method using premiums and paid losses is a combination of the Paid Development method and the Expected Loss Ratio method. This method normally determines expected loss ratios similar to the method used for the Expected Loss Ratio method and requires analysis of the same factors described above. The method assumes that only future losses will develop at the expected loss ratio level. The percent of paid loss to ultimate loss implied from the Paid Development method is used to determine what percentage of ultimate loss is yet to be paid. The use of the pattern from the Paid Development method requires consideration of all factors listed in the description of the Paid Development method. The estimate of losses yet to be paid is added to current paid losses to estimate the ultimate loss for each year. This method will react very slowly if actual ultimate loss ratios are different from expectations due to changes not accounted for by the expected loss ratio calculation.

The Bornhuetter-Ferguson method using premiums and incurred losses is similar to the Bornhuetter-Ferguson method using premiums and paid losses except that it uses case incurred losses. The use of case incurred losses instead of paid losses can result in development patterns that are less variable than paid development patterns. However, the inclusion of case reserves can lead to distortions if changes in case reserving practices have taken place. The method requires analysis of all the factors that need to be reviewed for the Expected Loss Ratio and Incurred Development methods.

The Average Loss method multiplies a projected number of ultimate claims by an estimated ultimate average loss for each accident year to produce ultimate loss estimates. Since projections of the ultimate number of claims are often less variable than projections of ultimate loss, this method can provide more reliable results for reserve categories where loss development patterns are inconsistent or too variable to be relied on exclusively. In addition, this method can more directly account for changes in coverage that impact the number and size of claims. However, this method can be difficult to apply to situations where very large claims or a substantial number of unusual claims result in volatile average claim sizes. Projecting the ultimate number of claims requires analysis of several factors including the rate at which policyholders report claims to the Company, the impact of judicial decisions, the impact of underwriting changes and other factors. Estimating the ultimate average loss requires analysis of the impact of large losses and claim cost trends based on changes in the cost of repairing or replacing property, changes in the cost of medical care, changes in the cost of wage replacement, judicial decisions, legislative changes and other factors.

For many exposures, especially those that can be considered long-tail, a particular accident year may not have a sufficient volume of paid losses to produce a statistically reliable estimate of ultimate losses. In such a case, the Company s actuaries typically assign more weight to the Incurred Development method than to the Paid

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Development method. As claims continue to settle and the volume of paid losses increases, the actuaries may assign additional weight to the Paid Development method. For most of the Company s reserve categories, even the incurred losses for accident years that are early in the claim settlement process will not be of sufficient volume to produce a reliable estimate of ultimate losses. In these cases, the Company will not assign any weight to the Paid and Incurred Development methods and will use the Bornhuetter-Ferguson and Expected Loss Ratio methods. For short-tail exposures, the Paid and Incurred Development methods can often be relied on sooner primarily because the Company s history includes a sufficient number of years to cover the entire period over which paid and incurred losses are expected to change. However, the Company may also use the Expected Loss Ratio, Bornhuetter-Ferguson and Average Loss methods for short-tail exposures.

Generally, reserves for long-tail lines use the Expected Loss Ratio method for the most recent accident year, shift to the Bornhuetter-Ferguson methods for the next two years, and then shift to the Incurred and/or Paid Development method. Claims related to umbrella business are usually reported later than claims for other long-tail lines. For umbrella business, the Expected Loss Ratio and Bornhuetter-Ferguson methods are used for as many as six years before shifting to the Incurred Development method. Reserves for short-tail lines use the Bornhuetter-Ferguson methods for the most recent accident year and shift to the Incurred and/or Paid Development method in subsequent years.

For other more complex reserve categories where the above methods may not produce reliable indications, the Company uses additional methods tailored to the characteristics of the specific situation. Such reserve categories include losses from construction defects and A&E.

For construction defect losses, the Company s actuaries organize losses by the year in which they were reported. To estimate losses from claims that have not been reported, various extrapolation techniques are applied to the pattern of claims that have been reported to estimate the number of claims yet to be reported. This process requires analysis of several factors including the rate at which policyholders report claims to the Company, the impact of judicial decisions, the impact of underwriting changes and other factors. An average claim size is determined from past experience and applied to the number of unreported claims to estimate reserves for these claims.

Establishing reserves for A&E and other mass tort claims involves considerably more judgment than other types of claims due to, among other things, inconsistent court decisions, an increase in bankruptcy filings as a result of asbestos-related liabilities, and judicial interpretations that often expand theories of recovery and broaden the scope of coverage. The insurance industry continues to receive a substantial number of asbestos-related bodily injury claims, with an increasing focus being directed toward other parties, including installers of products containing asbestos rather than against asbestos manufacturers. This shift has resulted in significant insurance coverage litigation implicating applicable coverage defenses or determinations, if any, including but not limited to, determinations as to whether or not an asbestos-related bodily injury claim is subject to aggregate limits of liability found in most comprehensive general liability policies. In response to these continuing developments, management increased gross and net A&E reserves during 2008 to reflect its best estimate of A&E exposures. In 2009, one of the Company s insurance companies was dismissed from a lawsuit seeking coverage from it and other unrelated insurance companies. The suit involved issues related to approximately 3,900 existing asbestos related bodily injury claims and future claims. The dismissal was the result of a settlement of a disputed claim related to accident year 1984. The settlement is conditioned upon certain legal events occurring which may trigger financial obligations by the insurance company.

On October 9, 2012, The United States District Court for the Northern District of California (District Court) issued an order confirming an amended plan of reorganization (Plan) for a named insured that included an injunction under 11 U.S.C. Section 524(g) (US bankruptcy code) related to the suit above. The injunction, also called a channeling injunction, precludes, inter alia, non-settling insurers from asserting claims against one of the Company s insurance companies and asbestos related claims by third parties against one of the Company s insurance companies that are related to the named insured. An appeal from the District Court order has been filed

with the 9th Circuit Court of Appeals. A motion for stay to prevent the Plan and the channeling injunction from taking effect has been denied by the District Court. Management will continue to monitor the developments of the litigation to determine if any additional financial exposure is present.

Reserve analyses performed by the Company s internal and external actuaries result in actuarial point estimates. The results of the detailed reserve reviews were summarized and discussed with the Company s senior management to determine the best estimate of reserves. This group considered many factors in making this decision. The factors included, but were not limited to, the historical pattern and volatility of the actuarial indications, the sensitivity of the actuarial indications to changes in paid and incurred loss patterns, the consistency of claims handling processes, the consistency of case reserving practices, changes in the Company s pricing and underwriting, and overall pricing and underwriting trends in the insurance market.

Management s best estimate at December 31, 2012 was recorded as the loss reserve. Management s best estimate is as of a particular point in time and is based upon known facts, the Company s actuarial analyses, current law, and the Company s judgment. This resulted in carried gross and net reserves of $879.1 million and $638.5 million, respectively, as of December 31, 2012. A breakout of the Company s gross and net reserves, excluding the effects of the Company s intercompany pooling arrangements and intercompany stop loss and quota share reinsurance agreements, as of December 31, 2012 is as follows:

| | | **Gross Reserves** | |
|---|---|---|---|
| **(Dollars in thousands)** | **Case** | **IBNR (1)** | **Total** |
| Insurance Operations | $ 256,784 | $ 507,832 | $ 764,616 |
| Reinsurance Operations | 41,181 | 73,317 | 114,498 |
| Total | $ 297,965 | $ 581,149 | $ 879,114 |

| | | **Net Reserves (2)** | |
|---|---|---|---|
| **(Dollars in thousands)** | **Case** | **IBNR (1)** | **Total** |
| Insurance Operations | $ 169,440 | $ 356,116 | $ 525,556 |
| Reinsurance Operations | 41,181 | 71,811 | 112,992 |
| Total | $ 210,621 | 427,927 | 638,548 |

**(1)** Losses incurred but not reported, including the expected future emergence of case reserves.

**(2)** Does not include reinsurance receivable on paid losses.

The Company continually reviews these estimates and, based on new developments and information, includes adjustments of the estimated ultimate liability in the operating results for the periods in which the adjustments are made. The establishment of loss and loss adjustment expense reserves makes no provision for the possible broadening of coverage by legislative action or judicial interpretation, or the emergence of new types of losses not sufficiently represented in the Company s historical experience or that cannot yet be quantified or estimated. The Company regularly analyzes its reserves and reviews pricing and reserving methodologies so that future adjustments to prior year reserves can be minimized. However, given the complexity of this process, reserves require continual updates and the ultimate liability may be higher or lower than previously indicated. Changes in estimates for loss and loss adjustment expense reserves are recorded in the period that the change in these estimates is made. See Note 12 to the consolidated financial statements in Item 8 of Part II of this report for details concerning the changes in the estimate for incurred loss and loss adjustment expenses related to prior accident years.

The detailed reserve analyses that the Company s internal and external actuaries complete use a variety of generally accepted actuarial methods and techniques to produce a number of estimates of ultimate loss. The Company determines its best estimate of ultimate loss by reviewing the various estimates and assigning weight to each estimate given the characteristics of the reserve category being reviewed. The reserve estimate is the

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difference between the estimated ultimate loss and the losses paid to date. The difference between the estimated ultimate loss and the case incurred loss (paid loss plus case reserve) is considered to be IBNR. IBNR calculated as such includes a provision for development on known cases (supplemental development) as well as a provision for claims that have occurred but have not yet been reported (pure IBNR).

In light of the many uncertainties associated with establishing the estimates and making the assumptions necessary to establish reserve levels, the Company reviews its reserve estimates on a regular basis and makes adjustments in the period that the need for such adjustments is determined. The anticipated future loss emergence continues to be reflective of historical patterns, and the selected development patterns have not changed significantly from those underlying the Company s most recent analyses.

The key assumptions fundamental to the reserving process are often different for various reserve categories and accident years. Some of these assumptions are explicit assumptions that are required of a particular method, but most of the assumptions are implicit and cannot be precisely quantified. An example of an explicit assumption is the pattern employed in the Paid Development method. However, the assumed pattern is itself based on several implicit assumptions such as the impact of inflation on medical costs and the rate at which claim professionals close claims. Loss frequency is a measure of the number of claims per unit of insured exposure, and loss severity is a measure of the average size of claims. Each reserve segment has an implicit frequency and severity for each accident year as a result of the various assumptions made.

Previous reserve analyses have resulted in the Company s identification of information and trends that have caused it to increase or decrease frequency and severity assumptions in prior periods and could lead to the identification of a need for additional material changes in loss and loss adjustment expense reserves, which could materially affect results of operations, equity, business and insurer financial strength and debt ratings. Factors affecting loss frequency include, among other things, the effectiveness of loss controls and safety programs and changes in economic activity or weather patterns. Factors affecting loss severity include, among other things, changes in policy limits and deductibles, rate of inflation and judicial interpretations. Another factor affecting estimates of loss frequency and severity is the loss reporting lag, which is the period of time between the occurrence of a loss and the date the loss is reported to the Company. The length of the loss reporting lag affects the Company s ability to accurately predict loss frequency (loss frequencies are more predictable for short-tail lines) as well as the amount of reserves needed for IBNR.

If the actual levels of loss frequency and severity are higher or lower than expected, the ultimate losses will be different than management s best estimate. For most of its reserving classes, the Company believes that frequency can be predicted with greater accuracy than severity. Therefore, the Company believes management s best estimate is more sensitive to changes in severity than frequency. The following table, which the Company believes reflects a reasonable range of variability around its best estimate based on historical loss experience and management s judgment, reflects the impact of changes (which could be favorable or unfavorable) in frequency and severity on the Company s current accident year net loss estimate of $149.2 million for claims occurring during the year ended December 31, 2012:

| **(Dollars in thousands)** | | | | **Severity Change** | | |
|---|---|---|---|---|---|---|
| | | **-10%** | **-5%** | **0%** | **5%** | **10%** |
| Frequency Change | -5% | $ (21,632) | $ (14,545) | $ (7,459) | $ (373) | $ 6,713 |
| | -3% | (18,946) | (11,711) | (4,476) | 2,760 | 9,995 |
| | -2% | (17,604) | (10,294) | (2,984) | 4,326 | 11,636 |
| | -1% | (16,261) | (8,876) | (1,492) | 5,893 | 13,277 |
| | 0% | (14,918) | (7,459) | | 7,459 | 14,918 |
| | 1% | (13,576) | (6,042) | 1,492 | 9,026 | 16,559 |
| | 2% | (12,233) | (4,625) | 2,984 | 10,592 | 18,200 |
| | 3% | (10,890) | (3,207) | 4,476 | 12,158 | 19,841 |
| | 5% | (8,205) | (373) | 7,459 | 15,291 | 23,124 |

The Company s net reserves for losses and loss expenses of $638.5 million as of December 31, 2012 relate to multiple accident years. Therefore, the impact of changes in frequency and severity for more than one accident year could be higher or lower than the amounts reflected above.

***Recoverability of Reinsurance Receivables***

The Company regularly reviews the collectability of its reinsurance receivables, and includes adjustments resulting from this review in earnings in the period in which the adjustment arises. A.M. Best ratings, financial history, available collateral, and payment history with the reinsurers are several of the factors that the Company considers when judging collectability. Changes in loss reserves can also affect the valuation of reinsurance receivables if the change is related to loss reserves that are ceded to reinsurers. Certain amounts may be uncollectible if the Company s reinsurers dispute a loss or if the reinsurer is unable to pay. If its reinsurers do not pay, the Company is still legally obligated to pay the loss.

See Note 10 of the notes to consolidated financial statements in Item 8 of Part II of this report for further information surrounding the Company s reinsurance receivable balances and collectability as of December 31, 2012 and 2011. For a listing of the ten reinsurers for which the Company has the largest reinsurance asset amounts as of December 31, 2012, see Reinsurance of Underwriting Risk in Item 1 of Part I of this report.

***Investments***

The carrying amount of the Company s investments approximates their estimated fair value. The Company regularly performs various analytical valuation procedures with respect to investments, including reviewing each fixed maturity security in an unrealized loss position to determine the amount of unrealized loss related to credit loss and the amount related to all other factors, such as changes in interest rates. The credit loss represents the portion of the amortized book value in excess of the net present value of the projected future cash flows discounted at the effective interest rate implicit in the debt security prior to impairment. The credit loss component of the other than temporary impairment is recorded through earnings, whereas the amount relating to factors other than credit losses are recorded in other comprehensive income, net of taxes. During its review, the Company considers credit rating, market price, and issuer specific financial information, among other factors, to assess the likelihood of collection of all principal and interest as contractually due. Securities for which the Company determines that a credit loss is likely are subjected to further analysis to estimate the credit loss to be recognized in earnings, if any. See Note 6 of the notes to consolidated financial statements in Item 8 of Part II of this report for the specific methodologies and significant assumptions used by asset class. Upon identification of such securities and periodically thereafter, a detailed review is performed to determine whether the decline is considered other than temporary. This review includes an analysis of several factors, including but not limited to, the credit ratings and cash flows of the securities, and the magnitude and length of time that the fair value of such securities is below cost.

For an analysis of the Company s securities with gross unrealized losses as of December 31, 2012 and 2011, and for other than temporary impairment losses that the Company recorded for the years ended December 31, 2012, 2011, and 2010, please see Note 7 of the notes to the consolidated financial statements in Item 8 of Part II of this report.

***Fair Value Measurements***

The Company categorizes its assets that are accounted for at fair value in the consolidated statements into a fair value hierarchy. The fair value hierarchy is directly related to the amount of subjectivity associated with the inputs utilized to determine the fair value of these assets. See Note 8 of the notes to the consolidated financial statements in Item 8 of Part II of this report for further information about the fair value hierarchy and the Company s assets that are accounted for at fair value.

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*Goodwill and Intangible Assets*

The Company tests for impairment of goodwill at least annually and more frequently as circumstances warrant in accordance with applicable accounting guidance. Recent accounting guidance allows for the testing of goodwill for impairment using both qualitative and quantitative factors. Impairment of goodwill is recognized only if the carrying amount of the business unit, including goodwill, exceeds the fair value of the reporting unit. The amount of the impairment loss would be equal to the excess carrying value of the goodwill over the implied fair value of the reporting unit goodwill. Based on the analysis performed in 2012, there was no impairment of goodwill as of December 31, 2012.

The Company tests for impairment of intangible assets with an indefinite useful life at least annually and more frequently as circumstances warrant in accordance with applicable accounting guidance. Recent accounting guidance allows for the testing of indefinite lived intangible assets for impairment using both qualitative and quantitative factors. Impairment of indefinite lived intangible assets is recognized only if the carrying amount of the intangible assets exceeds the fair value of said assets. The amount of the impairment loss would be equal to the excess carrying value of the assets over the fair value of said assets. Based on the analysis performed in 2012, there were no impairments of indefinite lived intangible assets as of December 31, 2012.

Intangible assets that are not deemed to have an indefinite useful life are amortized over their estimated useful lives. The carrying amounts of definite lived intangible assets are regularly reviewed for indicators of impairment in accordance with applicable accounting guidance. Impairment is recognized only if the carrying amount of the intangible asset is in excess of its undiscounted projected cash flows. The impairment is measured as the difference between the carrying amount and the estimated fair value of the asset. Based on the analysis performed in 2012, there were no impairments of definite lived intangible assets as of December 31, 2012.

See Note 9 of the notes to the consolidated financial statements in Item 8 of Part II of this report for more details concerning the Company s goodwill and intangible assets.

*Deferred Acquisition Costs*

The costs of acquiring new and renewal insurance and reinsurance contracts include commissions, premium taxes and certain other costs that vary with and are directly related to the successful acquisition of new and renewal insurance and reinsurance contracts. The excess of the Company s costs of acquiring new and renewal insurance and reinsurance contracts over the related ceding commissions earned from reinsurers is capitalized as deferred acquisition costs and amortized over the period in which the related premiums are earned.

In accordance with accounting guidance for insurance enterprises, the method followed in computing such amounts limits them to their estimated realizable value that gives effect to the premium to be earned, related investment income, losses and loss adjustment expenses, and certain other costs expected to be incurred as the premium is earned. A premium deficiency is recognized if the sum of expected loss and loss adjustment expenses and unamortized acquisition costs exceeds related unearned premium. Any future expected loss on the related unearned premium is recorded first by impairing the unamortized acquisition costs on the related unearned premium followed by an increase to loss and loss adjustment expense reserves on additional expected loss in excess of unamortized acquisition costs.

Effective January 1, 2012, the Company adopted new accounting guidance that modified the definition of costs that can be capitalized in the acquisition of new and renewal business for insurance companies. Under the new guidance, only direct incremental costs associated with successful insurance contract acquisitions or renewals are deferrable. This guidance was adopted retrospectively and has been applied to all prior period information contained in this Form 10-K. For further information please see Note 2 of the notes to the consolidated financial statements in Item 8 of Part II of this report.

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As of December 31, 2012, the Company s deferred acquisition costs were $0.5 million lower than they would have been due to premium deficiencies. As of December 31, 2011, the Company s deferred acquisition costs were $4.8 million lower than they would have been and loss and loss adjustment expense reserves were $4.1 million higher than they would have been due to premium deficiencies.

***Taxation***

The Company provides for income taxes in accordance with applicable accounting guidance. The Company s deferred tax assets and liabilities primarily result from temporary differences between the amounts recorded in the consolidated financial statements and the tax basis of the Company s assets and liabilities.

At each balance sheet date, management assesses the need to establish a valuation allowance that reduces deferred tax assets when it is more likely than not that all, or some portion, of the deferred tax assets will not be realized. A valuation allowance would be based on all available information including the Company s assessment of uncertain tax positions and projections of future taxable income from each tax-paying component in each jurisdiction, principally derived from business plans and available tax planning strategies. There are no valuation allowances as of December 31, 2012. The deferred tax asset balance is analyzed regularly by management. Based on these analyses, the Company has determined that its deferred tax asset is recoverable. Projections of future taxable income incorporate several assumptions of future business and operations that are apt to differ from actual experience. If, in the future, the Company s assumptions and estimates that resulted in the forecast of future taxable income for each tax-paying component prove to be incorrect, a valuation allowance may be required. This could have a material adverse effect on the Company s financial condition, results of operations, and liquidity.

The Company applies a more likely than not recognition threshold for all tax uncertainties, only allowing the recognition of those tax benefits that have a greater than 50% likelihood of being sustained upon examination by the taxing authorities. Please see Note 11of the notes to the consolidated financial statements in Item 8 of Part II of this report for a discussion of the Company s tax uncertainties.

**Business Segments**

The Company manages its business through two business segments: Insurance Operations, which includes the operations of United National Insurance Company, Diamond State Insurance Company, United National Casualty Insurance Company, United National Specialty Insurance Company, Penn-America Insurance Company, Penn-Star Insurance Company, Penn-Patriot Insurance Company, American Insurance Adjustment Agency, Inc., Collectibles Insurance Services, LLC, Global Indemnity Insurance Agency, LLC, and J.H. Ferguson & Associates, LLC, and Reinsurance Operations, which includes the operations of Wind River Reinsurance Company, Ltd.

The Company evaluates the performance of its Insurance Operations and Reinsurance Operations segments based on gross and net premiums written, revenues in the form of net premiums earned, and expenses in the form of (1) net losses and loss adjustment expenses, (2) acquisition costs, and (3) other underwriting expenses.

See Business Segments in Item 1 of Part I of this report for a description of the Company s segments.

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The following table sets forth an analysis of financial data for the Company s segments during the periods indicated:

| (Dollars in thousands) | Years Ended December 31, | | |
|---|---|---|---|
| | 2012 | 2011 | 2010 |
| Insurance Operations premiums written: | | | |
| Gross premiums written | $ 201,790 | $ 229,148 | $ 245,481 |
| Ceded premiums written | 23,958 | 26,831 | 49,416 |
| Net premiums written | $ 177,832 | $ 202,317 | $ 196,065 |
| Reinsurance Operations premiums written: | | | |
| Gross premiums written | $ 42,263 | $ 78,755 | $ 100,282 |
| Ceded premiums written | 548 | 502 | (157) |
| Net premiums written | $ 41,715 | $ 78,253 | $ 100,439 |
| Revenues: **(1)** | | | |
| Insurance Operations | $ 179,721 | $ 228,687 | $ 194,820 |
| Reinsurance Operations | 58,983 | 81,748 | 92,247 |
| Total revenues | $ 238,704 | $ 310,435 | $ 287,067 |
| Expenses: **(2)** | | | |
| Insurance Operations **(3)** | $ 198,425 | $ 283,033 | $ 162,676 |
| Reinsurance Operations **(5)** | 50,606 | 117,142 | 85,897 |
| Net expenses | $ 249,031 | $ 400,175 | $ 248,573 |
| Income (loss) from segments: | | | |
| Insurance Operations | $ (18,704) | $ (54,346) | $ 32,144 |
| Reinsurance Operations **(5)** | 8,377 | (35,394) | 6,350 |
| Total income (loss) from segments | $ (10,327) | $ (89,740) | $ 38,494 |
| Insurance combined ratio analysis: **(4)** | | | |
| Insurance Operations | | | |
| Loss ratio | 66.1 | 86.9 | 36.6 |
| Expense ratio | 44.6 | 43.7 | 47.1 |
| Combined ratio | 110.7 | 130.6 | 83.7 |
| Reinsurance Operations | | | |
| Loss ratio | 58.8 | 111.1 | 63.9 |
| Expense ratio | 25.9 | 33.0 | 28.8 |
| Combined ratio | 84.7 | 144.1 | 92.7 |
| Consolidated | | | |
| Loss ratio | 64.3 | 93.5 | 45.4 |
| Expense ratio | 39.9 | 40.8 | 41.2 |
| Combined ratio | 104.2 | 134.3 | 86.6 |

**(1)** Excludes net investment income and net realized investment gains, which are not allocated to the Company s segments.
**(2)** Excludes corporate and other operating expenses and interest expense, which are not allocated to the Company s segments.
**(3)** Includes excise tax of $936, $1,125, and $1,021 related to cessions from the Company s Insurance Operations to its Reinsurance Operations for 2012, 2011, and 2010, respectively.
**(4)** The Company s insurance combined ratios are non-GAAP financial measures that are generally viewed in the insurance industry as indicators of underwriting profitability. The loss ratio is the ratio of net losses and loss adjustment expenses to net premiums earned. The expense ratio is the ratio of acquisition costs and other underwriting expenses to net premiums earned. The combined ratio is the sum of the loss and expense ratios.
**(5)** Results for the year to date 2012 include the impact of an out-of-period adjustment which reduced Reinsurance Operations segment income by $1.6 million.

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**Results of Operations**

Effective January 1, 2012, the Company adopted new accounting guidance that modified the definition of costs that can be capitalized in the acquisition of new and renewal business for insurance companies. Under the new guidance, only direct incremental costs associated with successful insurance contract acquisitions or renewals are deferrable. This guidance was adopted retrospectively and has been applied to all prior period information contained in this Form 10-K. For further information please see Note 2 of the notes to the consolidated financial statements in Item 8 of Part II of this report.

All percentage changes included in the text below have been calculated using the corresponding amounts from the applicable tables.

**Year Ended December 31, 2012 Compared with the Year Ended December 31, 2011**

**Insurance Operations**

The components of income from the Company s Insurance Operations segment and corresponding underwriting ratios are as follows:

| (Dollars in thousands) | Years Ended December 31, 2012 | 2011 | Increase / (Decrease) $ | % |
|---|---|---|---|---|
| Gross premiums written | $ 201,790 | $ 229,148 | $ (27,358) | (11.9%) |
| Net premiums written | $ 177,832 | $ 202,317 | $ (24,485) | (12.1%) |
| Net premiums earned | $ 179,153 | $ 216,549 | $ (37,396) | (17.3%) |
| Other income | 568 | 12,138 | (11,570) | (95.3%) |
| Total revenues | $ 179,721 | $ 228,687 | $ (48,966) | (21.4%) |
| Losses and expenses: | | | | |
| Net losses and loss adjustment expenses | 118,515 | 188,358 | (69,843) | (37.1%) |
| Acquisition costs and other underwriting expenses **(1)** | 79,910 | 94,675 | (14,765) | (15.6%) |
| Loss from segment | $ (18,704) | $ (54,346) | $ 35,642 | 65.6% |
| Underwriting Ratios: | | | | |
| Loss ratio: | | | | |
| Current accident year | 68.5 | 91.4 | (22.9) | |
| Prior accident year | (2.4) | (4.5) | 2.1 | |
| Calendar year | 66.1 | 86.9 | (20.8) | |
| Expense ratio | 44.6 | 43.7 | 0.9 | |
| Combined ratio | 110.7 | 130.6 | (19.9) | |

**(1)** Includes excise tax of $936 and $1,125 related to cessions from the Company s Insurance Operations to its Reinsurance Operations for 2012 and 2011, respectively.

***Premiums***

Gross premiums written, which represents the amount received or to be received for insurance policies written without reduction for reinsurance costs or other deductions, was $201.8 million for 2012, compared with $229.1 million for 2011, a decrease of $27.4 million or 11.9%. In the second half of 2011 the Company began exiting certain unprofitable classes of business which contributed to the decrease in 2012. This was partially offset by increases in the Company s small business class, property brokerage class, and commercial auto class, which is included in

Other in the table below.

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Net premiums written, which equals gross premiums written less ceded premiums written, was $177.8 million for 2012, compared with $202.3 million for 2011, a decrease of $24.5 million or 12.1%. The decrease was primarily due to the decrease in gross premiums written noted above. The ratio of net premiums written to gross premiums written was 88.1% for 2012 and 88.3% for 2011, a decrease of 0.2 points.

Net premiums earned were $179.2 million for 2012, compared with $216.5 million for 2011, a decrease of $37.4 million or 17.3%. Property net premiums earned for 2012 and 2011 were $94.8 million and $97.6 million, respectively. Casualty net premiums earned for 2012 and 2011 were $84.3 million and $118.9 million, respectively.

The Company s Insurance Operations gross written, net written, and net earned premiums by product line are as follows:

| (Dollars in thousands) | Year Ended December 31, 2012 | | | Year Ended December 31, 2011 | | |
|---|---|---|---|---|---|---|
| | Gross Written | Net Written | Net Earned | Gross Written | Net Written | Net Earned |
| Small Business Binding Authority | $ 90,741 | $ 84,892 | $ 80,014 | $ 87,446 | $ 80,285 | $ 82,071 |
| Property Brokerage | 35,124 | 24,379 | 23,172 | 30,957 | 22,910 | 20,938 |
| Programs | 56,872 | 52,055 | 49,028 | 54,990 | 50,671 | 51,061 |
| Other | 19,053 | 16,506 | 26,939 | 55,754 | 48,451 | 62,479 |
| Total | $ 201,790 | $ 177,832 | $ 179,153 | $ 229,148 | $ 202,317 | $ 216,549 |

***Other Income***

Other income was $0.6 million and $12.1 million for the years ended December 31, 2012 and 2011, respectively. Other income is primarily comprised of fee income and for 2011, $11.5 million received from the Company s settlement with AON, net of attorney s fees. Income from the AON settlement is non-recurring. Please see Note 16 to the consolidated financial statements in Item 8 of Part II of this report for additional details regarding income and related tax expense from this settlement.

***Net Losses and Loss Adjustment Expenses***

The loss ratio for the Company s Insurance Operations was 66.1% for 2012 compared with 86.9% for 2011. The loss ratio is a non-GAAP financial measure that is generally viewed in the insurance industry as an indicator of underwriting profitability and is calculated by dividing net losses and loss adjustment expenses by net premiums earned.

The current accident year loss ratio decreased 22.9 points to 68.5% in 2012 from 91.4% in 2011:

The current accident year property loss ratio decreased 12.5 points from 77.5% in 2011 to 65.0% in 2012.

The non-catastrophe loss ratio decreased 6.4 points from 56.4% in 2011 to 50.0% in 2012. Non-catastrophe losses were $47.4 million and $55.1 million for the years ended December 31, 2012 and 2011, respectively.

The catastrophe loss ratio decreased 6.1 points from 21.1% in 2011 to 15.0% in 2012. The decrease in the catastrophe loss ratio is primarily due to a decrease in severe losses when compared to prior year. Results for 2011 included losses from tornados and severe weather in the Midwest, Hurricane Irene and Tropical Storm Lee while 2012 included losses from Superstorm Sandy. Catastrophe losses were $14.2 million and $20.6 million for the years ended December 31, 2012 and 2011, respectively.

The current accident year casualty loss ratio decreased 30.5 points from 102.9% in 2011 to 72.4% in 2012 primarily due to the Company exiting certain unprofitable classes of business in the second half of 2011.

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The prior accident year loss ratio increased by 2.1 points resulting from a decrease of net losses and loss adjustment expenses for prior accident years of $4.2 million in 2012 compared to a decrease of net losses and loss adjustment expenses for prior accident years of $9.7 million in 2011. When analyzing loss reserves and prior year development, the Company considers many factors, including the frequency and severity of claims, loss credit trends, case reserve settlements that may have resulted in significant development, and any other additional or pertinent factors that may impact reserve estimates.

In 2012, the Company reduced its prior accident year loss reserves by $4.2 million, which primarily consisted of the following:

**General liability:** A $6.3 million reduction primarily due to favorable emergence of $4.7 million on small business binding and $3.3 million on casualty brokerage exposures primarily in accident years 2002 through 2005. Partially offsetting these reductions were increases of $2.0 million on construction defect reserves in accident year 2007. The Company also decreased its reinsurance allowance by $0.7 million in this line due to changes in its reinsurance exposure on specifically identified claims and general decreases in ceded reserves.

**Umbrella:** A $0.7 million reduction primarily due to continued favorable emergence. Umbrella coverage typically attaches to other coverage lines, so these net decreases follow the decreases in general liability above.

**Property:** A $1.2 million increase primarily related to accident year 2011 due to greater than expected loss emergence on a large sinkhole claim.

**Auto liability:** A $1.2 million increase primarily driven by continued loss emergence on casualty brokerage exposures.

In 2011, the Company reduced its prior accident year loss reserves by $9.7 million, which primarily consisted of the following:

**General Liability:** A $12.9 million reduction in general liability lines primarily consisted of net reductions of $25.5 million in accident years 2008 and prior due to continued favorable emergence. Incurred losses for these years have developed at a rate lower than the Company s historical averages. The Company also decreased its reinsurance allowance by $1.3 million in this line due to changes in reinsurance exposure on specifically identified claims and general decreases in ceded reserves. Offsetting these decreases were increases of $13.9 million in accident years 2009 and 2010 primarily driven by loss emergence as well as revised exposure estimates for construction defect liability. Increased estimates for construction defect were primarily the result of a methodology change during the year, with some increases in recent years due to a slight increase in claim frequency in one of the reviewed segments. The Company has addressed profitability concerns by exiting certain classes of business within this line.

**Property:** A $2.5 million reduction in property lines primarily related to accident years 2009 and 2010 related to subrogation on a large equine mortality claim as well as favorable development on prior year catastrophe claims.

**Umbrella:** A $1.7 million reduction in umbrella lines primarily related to accident years 2010 and prior primarily due to continued favorable emergence. Umbrella coverage typically attaches to other coverage lines, so these net decreases follow the decreases in general liability above.

**Professional Liability:** A $5.7 million increase in professional liability lines primarily consisted of increases of $19.0 million related to accident years 1998, 2009 and 2010, offset partially by decreases of $13.2 million related to all other accident years. In 2011, the Company exited certain professional liability classes where the volume of premium was low and loss volatility was high. The Company is focused on writing business where it expects to realize profit that meets return on investment thresholds.

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**Auto Liability:** A $1.8 million increase in auto liability lines is primarily related to accident year 2010 due to higher than expected severity.

Net losses and loss adjustment expenses were $118.5 million for 2012, compared with $188.4 million for 2011, a decrease of $69.8 million or 37.1%. Excluding the impact of prior accident year adjustments, the current accident year net losses and loss adjustment expenses were $122.7 million and $198.0 million for 2012 and 2011, respectively. This decrease is primarily attributable to a decrease in catastrophe losses incurred in 2012 and the Company exiting certain unprofitable classes of business in the second half of 2011, as described above.

***Acquisition Costs and Other Underwriting Expenses***

Acquisition costs and other underwriting expenses were $79.9 million for 2012, compared with $94.7 million for 2011, a decrease of $14.8 million or 15.6%. The decrease is primarily due to a decrease in commissions related to the decrease in net earned premiums and a decrease in property and office costs.

***Expense and Combined Ratios***

The expense ratio for the Company s Insurance Operations was 44.6% for 2012, compared with 43.7% for 2011. The expense ratio is a non-GAAP financial measure that is calculated by dividing the sum of acquisition costs and other underwriting expenses by net premiums earned.

The combined ratio for the Company s Insurance Operations was 110.7% for 2012, compared with 130.6% for 2011. The combined ratio is a non-GAAP financial measure and is the sum of the Company s loss and expense ratios. Excluding the impact of prior accident year adjustments, the combined ratio decreased from 135.1% in 2011 to 113.1% in 2012. See discussion of loss ratio included in Net Losses and Loss Adjustment Expenses above and discussion of expense ratio in preceding paragraph above for an explanation of this decrease.

***Loss from Segment***

The factors described above resulted in a loss from underwriting for the Company s Insurance Operations of $18.7 million for 2012, compared with a loss from underwriting of $54.3 million for 2011, a decrease in loss of $35.6 million.

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**Reinsurance Operations**

The components of income from the Company s Reinsurance Operations segment and corresponding underwriting ratios are as follows:

| (Dollars in thousands) | Years Ended December 31, 2012 | 2011 | Increase / (Decrease) $ | % |
|---|---|---|---|---|
| Gross premiums written **(2)** | $ 42,263 | $ 78,755 | $ (36,492) | (46.3%) |
| Net premiums written **(2)** | $ 41,715 | $ 78,253 | $ (36,538) | (46.7%) |
| Net premiums earned **(2)** | $ 59,709 | $ 81,305 | $ (21,596) | (26.6%) |
| Other income (loss) | (726) | 443 | (1,169) | (263.9%) |
| Total revenues | $ 58,983 | $ 81,748 | $ (22,765) | (27.8%) |
| Losses and expenses: | | | | |
| Net losses and loss adjustment expenses | 35,113 | 90,326 | (55,213) | (61.1%) |
| Acquisition costs and other underwriting expenses **(1)** | 15,493 | 26,816 | (11,323) | (42.2%) |