

THE GRAY INSURANCE COMPANY

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METAIRIE, LOUISIANA 70002

Management's Discussion and Analysis for the Year Ended December 31, 2001

This discussion, presented by management, provides an assessment of the current financial position, results of operations, cash flow and liquidity, and changes in financial position for The Gray Insurance Company. Information presented in this discussion supplements the financial statements, schedules and exhibits in the Company's 2001 Annual Statement.

The Gray Insurance Company provides excess coverages for workers' compensation, general liability and commercial auto liability for insureds in energy production and heavy construction. The Company insured 128 insureds at year-end in some twenty-eight states. Business outside of Louisiana grew such that it now accounts for about a third of the business written. This builds on the trend of the previous years. In 2001, the Company was admitted to three additional states, and as of the writing of this document, the Company has been admitted to two additional states raising the total of admitted states to 40.

In the third quarter of 2000, the exit of Reliance sponsored markets from workers' compensation led to a rise in submissions. This has been followed by the hardening of the reinsurance markets in 2001, which has again increased submissions. As a result both the number of insureds has increased as has the written premium. The year 2001, saw an increase of 55% in written premium to \$38,527,052. This is below the previous high in written premium of \$42,963,180 for 1993.

	<u>2001</u>	<u>2000</u>
Insureds	128	98
Written Premium	\$38,527,052	\$24,828,703

Financial Position

Assets:

	<u>2001</u>	<u>2000</u>
Bonds	81,990,071	78,850,345
Common stock – unaffiliated	9,131,302	6,404,405
Common stock – affiliates		
The Gray Casualty Co.	10,738,361	9,927,185
The Gray Oil & Gas Co.	0	5,956,636
Mortgages	8,918,312	0
Real estate – home office	2,456,204	2,250,042
Cash and certificates of deposit	7,548,674	3,322,145

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The Company has historically invested in U.S. Treasury bonds and notes. The Company has identified solid local companies for acquisition of stock.

Investments in U.S. Treasury bonds increased for year 2001 over 2000. Increases in the U.S. Treasury portfolio are due to the increase in written premium. Cash inflows are outpacing loss and expenses. This reverses the trends of the past several years.

The increase in real estate holdings results from costs of the completion of the renovation to the home office. Increases in certificates of deposit resulted from excess cash at year-end.

In 1998, the Company created a new subsidiary, The Gray Oil & Gas Company, to own oil and gas royalty interests. Statutory accounting and limits were applied to the accounting of this subsidiary.

In October of 2001, The Board of Directors authorized the sale of The Gray Oil & Gas Company to Gray & Company, Inc. for its book value of \$6,500,000. The prospects for the subsidiary would require growth to levels that would exceed statutory limits. The Company took a ten-year mortgage secured by the stock of the subsidiary. At year-end the balance outstanding was \$6,416,616. The Company now receives interest on the mortgage. Previously, income from the subsidiary was reflected in unrealized gains. This will improve the return on invested assets.

With the sale of the subsidiary, the Company cancelled the guarantee of a line of credit in favor of the former subsidiary with a local bank. This line of credit has been replaced with a mortgage on oil & gas royalty properties. The balance outstanding at year end totaled \$2,500,000.

All mortgages were current as to principle and interest at year-end.

Operations

As indicated above, the market continued to harden in 2001. Growth and the cost associated with new business placed pressure on operations of the Company. In light of this, the Company's combined ratio weakened to a combined ratio of 103.3 from the 100.3 of the previous year. This is still about 7 points better than the rest of the industry. The Company again maintained loss reserves above actuary's best estimate. Experience from prior years continues to have favorable development.

	<u>2001</u>	<u>2000</u>
Written Premium	38,572,052	24,828,703
Earned Premium	32,256,562	21,978,269
Losses & LAE Incurred	22,499,610	13,692,010
Other underwriting expenses	10,830,876	7,389,754
Policyholders Surplus	44,047,817	40,469,154

The Gray Insurance Company
Management's Discussion and Analysis
For the Year Ended December 31, 2001
Page 3

For 2001 over 2000, written premium rose by 55% fueled by the traffic created by the reduced writings of others in the market. This allowed the Company to adjust insureds with poor performance and the opportunity to write new business.

The increase to Policyholders Surplus resulted from the good performance of investments and increases in investment income from the increase in invested assets. Unrealized losses were reversed to gains in 2001. The dividend to its parent was reduced to \$1,750,000 in 2001 versus \$2,500,000 in 2000.

	<u>2001</u>	<u>2000</u>
Net underwriting income	(1,073,924)	(68,874)
Investment income	5,271,150	4,797,457
Capital gains	1,273,000	(402,361)
Unrealized gain/(loss)	2,808,437	(646,348)
Federal income tax	(2,095,000)	(1,169,000)
Dividends to parent	<u>(1,750,000)</u>	<u>(2,500,000)</u>
Change in policyholders surplus	3,578,663	10,874

A capital gain was realized on the sale of subsidiary The Gray Oil & Gas Company. At year-end 2000, the deferred tax liability on gains in stocks and bonds was offset by deferred tax assets from the federal tax requirement of discounting of loss reserves. The increases in loss reserves and recognition of the gain on the sale of the subsidiary resulted in a recognition of a deferred tax liability of \$855,000 for 2001.

Policyholder's Surplus grew by almost 9% taking it to \$44,047,817 for 2001 from \$40,469,154 for 2000.

The growth of written premium and loss reserves resulted in an increase to the Risk Based Capital Authorization Level. The table below outlines the change. Policyholder's Surplus remains well above the Authorization Level.

	<u>2001</u>	<u>2000</u>
Policyholder's Surplus	44,047,817	40,469,154
RBC Authorization Level	5,466,069	4,376,066
Percent		
Policyholder's Surplus/RBCAL	806%	925%

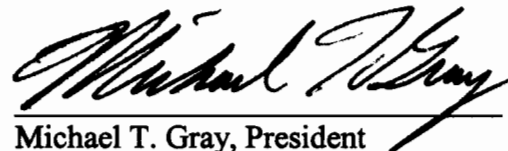
The Company had unusual values on two IRIS ratios. For Ratio 3, "Change in Net Writings", the Company had 58 versus the indicated value of 33. This was consistent with the growth in earned premium by the amount indicated. For IRIS ratio 12, "Estimated Current Reserve Deficiency to Policyholders Surplus", the Company scored a 99 versus the value indicated of 25. The documentation supplied by NAIC indicates that this ratio is distorted if the Company experiences large growth. The Company discussed both of these ratios with actuaries and found no concerns. The Company and its actuaries will monitor these.

The Gray Insurance Company
Management's Discussion and Analysis
For the Year Ended December 31, 2001
Page 4

During 2001, the Company's book reserves remained above the actuary's best estimates at 100.1% and 101.4% for 2001 and 2000, respectively. The Company has increased loss and loss expenses as a percent of written premium in response to the new business written. The decreases in book reserves are reversing due to increased business.

Year	<u>2001</u>	<u>2000</u>
GIC Book Reserve	83,126,185	77,894,617
Actuary's Best Estimate	83,040,639	76,825,988
Percent	100.1%	101.4%

As the Company enters its 25th year in business, underwriting will continue to guide our efforts to expand outside our base region and manage the current market. Growth outside Louisiana has been a result of the Company's current insureds expansion outside the state and the acceptance of insureds based in this region with operations outside the area. Superior loss control services, claims management and financial stability are at the heart of our customer loyalty and a 95% renewal rate this year.


Michael T. Gray, President
March 25, 2002