



THE GRAY INSURANCE COMPANY

3601 N. I-10 SERVICE RD. W.

TELEPHONE 504-888-7790

★

★

METAIRIE, LOUISIANA 70002

Management's Discussion and Analysis for the Year Ended December 31, 2002

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 2002 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. During 2002, the Company's insureds grew from 128 to 162. Growth outside Louisiana moderated in 2002, with business outside of Louisiana accounting for about a third of the business written. In 2002, the Company was admitted to three additional states, raising the total of admitted states to 43.

The hard market that was signaled by the exit of Reliance sponsored markets from workers' compensation continued into 2002. While reinsurance markets had more structure for the 2002 anniversary, prices remain high. This again resulted in increased submissions received by the Company in 2002. As a result both the number of insureds has increased as has the written premium. The year 2002, saw an increase of 50% in net written premium to \$51,917,299. This tops the previous high in net written premium of \$38,936,157 for 1993.

	<u>2002</u>	<u>2001</u>
Insureds	162	128
Net Written Premium	\$51,917,299	\$34,616,440

Financial Position

Assets:

	<u>2002</u>	<u>2001</u>
Bonds	102,364,731	81,990,071
Common stock – unaffiliated	9,942,675	9,131,302
Common stock – affiliates		
The Gray Casualty Co.	11,423,013	10,738,361
Mortgages	9,828,182	8,918,312
Real estate – home office	2,505,597	2,456,204
Cash and certificates of deposit	7,516,734	7,548,674

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 2002 over 2001. Increases in the U.S. Treasury portfolio are due to the increase in written premium. Cash inflows are outpacing claim payments and expenses. This continues the trend of recent periods.

The increase in real estate holdings results from minor improvements with the completion of renovations to the home office. Cash remained level with the previous year.

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. The Company receives interest and principle on the mortgage. During 2002, the parent paid \$504,434 in principle payments reducing the balance due to \$5,912,182.

During 2001, mortgages on oil & gas royalty properties owned by The Gray Oil & Gas Company in the amount of \$2,500,000 were written by the Company. During 2002, additional royalty properties were mortgaged for \$750,000 raising the total to \$3,250,000 of mortgaged properties. An additional mortgage for \$666,000 was placed with The Gray Exploration Company on oil properties placed into production in 2002.

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

Operations

As indicated above, the hard market continued in 2002. Continued growth and the costs associated with additional business again placed pressure on operations of the Company. However, economies and improved underwriting reduced the combined ratio to 98.3 from the 103.3 of the previous year. The Company maintained loss reserves above actuary's best estimate. Experience from prior years continues to have favorable development.

	<u>2002</u>	<u>2001</u>
Written Premium	57,149,606	38,572,052
Earned Premium	47,423,913	32,256,562
Losses & LAE Incurred	31,230,692	22,499,610
Other underwriting expenses	15,383,566	10,830,876
Policyholders Surplus	53,485,380	44,047,817

The Gray Insurance Company
Management's Discussion and Analysis
For the Year Ended December 31, 2002
Page 3

For 2002 over 2001, written premium rose by 50% fueled by the traffic created by the reduced writings of others in the market. This again allowed the Company to adjust insureds with poor performance and the opportunity to write new business.

The increase to Policyholders Surplus resulted from the capital gains taken to shorten the duration of the portfolio and a return to underwriting profit. Unrealized gains were again posted in 2002. The dividend to its parent was reduced to \$1,000,000 in 2002 versus \$1,750,000 in 2001.

	<u>2002</u>	<u>2001</u>
Net underwriting income	809,655	(1,073,924)
Investment income	5,665,083	5,271,150
Capital gains	4,923,798	1,273,000
Unrealized gain/(loss)	1,496,025	2,808,437
Federal income tax	(4,069,000)	(2,095,000)
Dividends to parent	<u>(1,000,000)</u>	<u>(1,750,000)</u>
Change in policyholders surplus	9,437,561	3,578,663

Capital gains were realized on the sale of U.S. Treasury bonds and notes to position the portfolio with a shorter duration as the bias toward interest rates has moved more toward the upside. At year-end 2002, the deferred tax liability on gains in bonds was realized causing an increase in the deferred tax asset resulting from the federal tax requirement of discounting of loss reserves. The increases in loss reserves and recognition of the gains on the sale of the stock resulted in a recognition of a deferred tax asset of \$1,612,000 for 2002.

Fueled by the above items, policyholder's surplus grew by over 21% taking it to \$53,485,378 for 2002 from \$44,047,817 for 2001.

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>2002</u>	<u>2001</u>
Policyholder's Surplus	53,485,378	44,047,817
RBC Authorization Level	11,336,258	5,466,069
Percent		
Policyholder's Surplus/RBCAL	472%	806%

The Company had unusual values on three IRIS ratios. For Ratio 3, "Change in Net Writings", the Company had 50 versus the indicated value limit of 33. This was consistent with the growth in earned premium previously discussed.

For IRIS Ratio 6, "Investment Yield", the Company experienced a value of 4.3, two-tenths of a percent below the limit of 4.5. This resulted from the increase in collections for new business that had to be invested at current depressed returns. The Company's investment guidelines prohibit chasing riskier investments for the higher returns. The Company will stay with US Treasurys with shorter durations in anticipation of increased returns in the future.

For IRIS ratio 12, "Estimated Current Reserve Deficiency to Policyholders Surplus", the Company scored a 96 versus the limit 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 this.

During 2002, the Company's book reserves rose above the actuary's best estimates to 101.0% from 100.1% for 2002 and 2001, respectively. The Company has increased loss and loss expenses in response to the new business written.

Year	<u>2002</u>	<u>2001</u>
GIC Book Reserve	97,224,138	83,126,185
Actuary's Best Estimate	96,274,836	83,040,639
Percent	101.0%	100.1%

As the Company enters its 26th 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 90% renewal rate this year.



Michael T. Gray, President
March 31, 2003