

# THE GRAY INSURANCE COMPANY

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METAIRIE, LOUISIANA 70002

## Management's Discussion and Analysis for the Year Ended December 31, 2003

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 2003 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 2003, the Company's insureds grew from 162 to 189. After growth outside Louisiana moderated in 2002, the business outside of Louisiana grew to account for 41.5% of the business written in 2003, over the 39.1% in 2002. No additional states were added to the list of certificates of authority in 2003. The Company is admitted to a total of forty-three states.

The hard market that was signaled by the exit of Reliance sponsored markets from workers' compensation in 2000, continued into 2003. While reinsurance markets were more organized for the 2003 anniversary, prices again remain high. The level of increased submissions received by the Company continued into 2003. As a result both the number of insureds has increased as has the written premium. The year 2003, saw an increase of 28.9% in net written premium to \$66,927,244.

	<u>2003</u>	<u>2002</u>
Insureds	189	162
Net Written Premium	\$66,927,244	\$51,917,299

In 2003, the Company expanded its surety business into construction bonds. The Company added Mr. Edmund Pixberg to the project who has over 40 years of experience as a surety underwriter. Additionally, the Company teamed with XL Reinsurance America Inc. on a 50% quota share reinsurance contract to limit exposure to the new venture and bring additional expertise. The Company initially wrote the business, but is in the process of transferring the operations to its subsidiary, The Gray Casualty & Surety Company. Combined premiums written totaled \$120,903 for 2003. Projected premium for 2004 is \$750,000.

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## Financial Position

### Assets:

	<u>2003</u>	<u>2002</u>
Bonds	104,466,344	102,364,731
Common stock – unaffiliated	11,639,398	9,942,675
Common stock – affiliates		
The Gray Casualty & Surety Co.	11,844,886	11,423,013
Mortgages	9,293,503	9,828,182
Real estate – mortgages	1,580,750	0
Real estate – home office	2,459,152	2,505,597
Cash and certificates of deposit	20,404,854	7,516,734

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 2003 over 2002. 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.

Cash grew as a result of increased business. The Company retained the cash in short term investments while researching appropriate longer term investments.

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 2003, the parent paid \$534,679 in principle payments reducing the balance due to \$5,377,503.

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 2003, 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. No additions were made to these investments in 2003.

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

## Operations

As indicated above, the hard market again continued into 2003. 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 94.7 from the 98.3 of the previous year. The Company maintained loss reserves at actuary's best estimate. Experience from prior years continues to have favorable development.

	<u>2003</u>	<u>2002</u>
Gross Written Premium	79,789,726	57,149,606
Earned Premium	63,839,020	47,423,913
Losses & LAE Incurred	39,577,400	31,230,692
Other underwriting expenses	20,387,058	15,383,566
Policyholders Surplus	58,630,129	53,485,380

For 2003, over 2002, gross written premium rose by 39.6% 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 2003. The dividend to its parent was increased to \$2,250,000 in 2003 versus \$1,000,000 in 2002.

	<u>2003</u>	<u>2002</u>
Net underwriting income	3,371,462	809,655
Investment income	3,066,579	5,665,083
Capital gains	2,147,114	4,923,798
Unrealized gain/(loss)	2,118,596	1,496,025
Federal income tax	(3,647,000)	(4,069,000)
Dividends to parent	<u>(2,250,000)</u>	<u>(1,000,000)</u>
Change in policyholders surplus	5,144,751	9,437,561

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 2003, 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 \$338,000 for 2003.

Fueled by the above items, policyholder's surplus grew by almost 10% taking it to \$58,630,129 for 2003 from \$53,485,378 for 2002.

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>2003</u>	<u>2002</u>
Policyholder's Surplus	58,630,130	53,485,378
RBC Authorization Level	15,328,263	11,336,258
Percent		
Policyholder's Surplus/RBCAL	382%	472%


The Company had unusual values on two IRIS ratios. For IRIS Ratio 6, "Investment Yield", the Company experienced a value of 2.0%, below the indicated value 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 U.S. 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 59 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 2003, the Company's book reserves held at the actuary's point estimate. The Company has increased loss and loss expenses in response to the new business written.

Year	<u>2003</u>	<u>2002</u>
GIC Book Reserve	112,537,216	97,224,138

As the Company enters its 27<sup>th</sup> year in business, the Company will continue focus on underwriting, expanding outside our base region and managing 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 29, 2004