

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, 2006

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 2006 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. In Texas and other jurisdictions where required, the Company writes large deductible programs.

During 2006, effects of the softening market in commercial coverages resulted in the number of insureds dropping to 176 from the 183 of the previous year. Growth of payrolls of insureds resulted in an overall increase in premiums written. The surety portion of the business contributed approximately \$2 million of the growth. Wage inflation appeared to be the major contributor to payroll increase.

Business outside of Louisiana as a percent of total business rose to 43.5% over the 41.0% of the previous year. Hawaii was added to the list of certificates of authority in 2006. The Company is admitted to a total of forty-five states.

The soft market was delayed in the mid-gulf region due to effects of Hurricane Katrina. Many of the Company's insureds are involved in the clean-up and rebuilding in the region. While reinsurance markets were more organized for the 2006 anniversary, reinsurance prices again remained high. The volume of submissions received by the Company remained level for 2006. Growth in payroll experienced by insureds from wage inflation drove increased written premium. The year 2006, saw an increase of 17.2% in net written premiums.

	<u>2006</u>	<u>2005</u>
Insureds	176	190
Net Written Premium	\$112,320,022	\$95,827,567

In 2003, the Company expanded its surety business into construction bonds. The Company added Mr. Edmund Pixberg to the Company. Mr. Pixberg has over 40 years of experience as a surety underwriter. Additionally in 2003, the Company teamed with XL Reinsurance America Inc., later the business was transferred to Endurance Reinsurance Corporation of America, on a 50% quota share reinsurance contract, to limit exposure and bring additional expertise to the new venture. This contract was amended in 2004, lowering the Endurance Re participation to 40%. 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 have risen to \$5,184,753. Refer to the table below for the progress over the past four years.

	<u>2006</u>	<u>2005</u>	<u>2004</u>	<u>2003</u>
TGIC surety business	\$3,233,637	\$1,414,216	\$565,137	\$ 74,094
TGCSC surety business	<u>1,951,116</u>	<u>718,020</u>	<u>376,410</u>	<u>46,809</u>
Total surety business	\$5,184,753	\$2,132,236	\$939,645	\$120,903

Financial Position

Assets:

	<u>2006</u>	<u>2005</u>
UST Bonds	\$140,106,950	\$160,862,368
CMO's US agency	18,131,888	0
Common stock – unaffiliated	14,510,932	12,205,854
Common stock – affiliates		
The Gray Casualty & Surety Co.	12,533,358	12,040,688
Collateral loans	9,135,601	9,765,962
Real estate – mortgages	1,496,927	1,526,132
Real estate – home office	2,360,276	2,399,678
Cash and short term investments	75,728,129	28,962,777

The Company has historically invested in U.S. Treasury bonds and notes. The Company has identified solid local companies for acquisition of stock. In 2006, the Company added United States agency bonds to improve returns. At year-end this amounted to less than 6% of admitted assets.

Cash and short term investments grew as a result of increased business. The Company retained the cash in short term investments while researching appropriate longer term investments. Cash inflows continue to outpace claim payments and expenses. This continues the trend of recent periods.

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 principal on the mortgage. During 2006, the parent paid \$630,360 in principal payments reducing the balance due to \$3,585,601.

Mortgages on oil & gas royalty properties owned by The Gray Oil & Gas Company in the amount of \$3,250,000 and similar mortgages with The Gray Exploration Company for \$2,300,000 placed in 2004 were still outstanding in 2006.

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

Liabilities

Loss reserves grew by 23.5% as a result of the growth in written premiums cited above. Loss reserves continue to be above actuary's best estimate and have been for the past 13 years. The Company added \$3.5 million in reserves to accident year 2003. The increase in land exposures led to above average commercial automobile experience. Reductions in limits offered to insureds with too much exposure or exposure to jurisdictions historically problematic have led to better experience in subsequent years.

The Company has no finite reinsurance and no off-balance sheet arrangements. All reinsurance programs are excess of loss or quota-share with no collars or other limits.

Changes to other liabilities were minor in the aggregate.

Capital and Surplus Accounts

In 2004, the Company sought and received approval to issue a Surplus Note for \$10,000,000 to its parent. The note was issued to increase surplus in support of the level of premiums developed over the previous four years. The surplus note was in place at year-end 2006.

Operations

As indicated above, effects of the softening market began to take hold in 2006. Underwriting remained strong as ratio was 92.4, down slightly from the previous year's 90.1. The Company maintained loss reserves above actuary's best estimate.

	<u>2006</u>	<u>2005</u>
Gross Written Premium	\$116,933,418	\$99,534,323
Earned Premium	111,158,003	95,344,300
Losses & LAE Incurred	73,090,947	57,838,483
Other underwriting expenses	29,645,808	27,131,947
Policyholders Surplus	96,544,612	83,091,092

Gross written premium rose by 17.5% for 2006. This growth was principally fueled by growth of payrolls experienced by insureds due to wage inflation and the return of workers to Louisiana. This enhanced the ability of the Company to retain insureds with better performance and allow those with poorer performance to seek other insurance companies seeking market.

The increase to Policyholders' Surplus resulted from the investment income and an underwriting profit. Unrealized gains on bonds reversed the prior year's losses as interest rates stabilized. The Company is positioned to maneuver to better long term yields as the market provides. The dividend to its parent was decreased to \$1,250,000 in 2006, versus \$1,780,000 in 2005.

	<u>2006</u>	<u>2005</u>
Net underwriting income	\$8,421,249	\$10,373,870
Investment income	8,596,064	6,040,519
Capital gains/(loss)	198,491	2
Unrealized gain/(loss)	2,797,749	(1,078,300)
Federal income tax	(4,899,143)	(6,330,943)
Dividends to parent	<u>(1,250,000)</u>	<u>(1,780,000)</u>
Change to policyholders' surplus	13,386,991	8,488,148

The dropping of the large growth percentage of 2003 from the Risk Based Capital calculation resulted in a decrease to the Risk Based Capital Authorized Control Level. The table below outlines the change. Policyholders' Surplus remains well above the Authorized Control Level.

	<u>2006</u>	<u>2005</u>
Policyholders' Surplus	\$96,544,612	\$83,091,092
RBC Authorized Control Level	14,548,318	15,103,210
Percent Policyholders' Surplus/RBCAL	664%	550%

The Company had no IRIS ratios fall outside the accepted range for 2006. Improvements in investment performance resulted in passing Ratio 6, "Investment Yield," as the Company experienced a value of 3.5%, above the required limit of 3.0%.

During 2006, the Company's book reserves remained above the actuary's best estimate

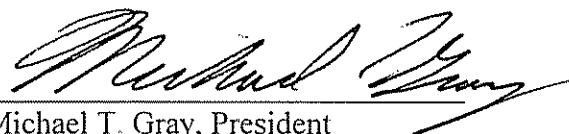
	<u>2006</u>	<u>2005</u>
Loss & LAE Reserves	196,063,614	158,727,285

Hurricane Katrina

While the effects of Hurricane Katrina have had a major impact to the area, effects to the Company have been minimal. The home office was not flooded but sustained minor damage to vents on the roof. The day after the storm, the Company issued checks to claimants out of its branch offices in Texas, Oklahoma and Louisiana. Within a week, the Company had established full operations in Baton Rouge in a sister company's office and the branch office in Mobile, Alabama opened. A little over two weeks after the storm, the claims department returned to the main office in Metairie, Louisiana. The remaining departments returned the next week. The Company retained 99% of its employees. To accommodate those without housing, 16 FEMA trailers were obtained and located on Company property.

The Company does not write property coverages except for some physical damage on fleet vehicles under the excess commercial automobile cover. To date, claims from this total about \$500,000. Several of the Company's customers are involved in heavy construction. They make up the force cleaning up the area and rebuilding the infrastructure. Expected growth was experienced by the Company in 2006. However, as the market softens, this effect will fade. This is similar to experience from Hurricane Andrew.

As the Company enters its 30th year in business, we will continue to focus on underwriting, and managing the current market. Growth outside Louisiana will continue to result from the Company's 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 renewal rate above 90 percent.



Michael T. Gray, President
March 30, 2007