

THE GRAY INSURANCE COMPANY

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Management's Discussion and Analysis for the Year Ended December 31, 2010

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 2010 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. The Company also writes a small amount of primarily construction surety.

During 2010, effects of the soft market in commercial coverages continued and resulted in the number of our insureds dropping to 127 from the 143 of the previous year. Premium volume continued to drop as a result of the soft market. The surety portion of the business remained even at \$2.3 million from \$2.2 million of the previous year. The market is the tail of the insurance cycle and it is the third such cycle experienced by the Company and its management.

Business outside of Louisiana as a percent of total business slipped to 27 percent from the 31 percent of the previous year driven by the Company's contraction to its core insureds. The Company is admitted to a total of 47 states and the District of Columbia.

Initial effects of the BP well blowout were an increase in payrolls for those insureds servicing the cleanup efforts. This amounted to approximately a 5 percent increase in payrolls. This was followed, later in 2010, by a decrease in activity of about 5 percent due to the drilling moratorium and delays in permitting.

Reinsurance markets remained stable for the 2010 anniversary and reinsurance prices were slightly down. The Company experienced a decrease of 22.7 percent in net written premium.

	<u>2010</u>	<u>2009</u>
Insureds	127	143
Net Written Premium	\$54,413,773	\$70,399,147

In 2003, the Company expanded its surety business into construction bonds bringing in underwriters with substantial experience in surety underwriting. To support this line, the Company teamed with XL Reinsurance America Inc. Later, XL Reinsurance America, Inc. transferred its surety business to Endurance Reinsurance Corporation of America. The relationship began with 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%. In 2008, the quota share reinsurance was replaced with excess of loss coverage, with a \$1 million retention and \$5 million of coverage. This program was renewed in June of 2010, but only placed for 75% such that the retention is now \$1.75 million with \$4.25 in coverage above that.

The Company initially wrote the business, but is in the process of transferring the operations to its subsidiary, The Gray Casualty & Surety Company. In 2010, the Company brought on Mr. David A. Castillo as President of The Gray Surety & Casualty Company and as a Vice President of The Gray Insurance Company. Mr. Castillo brings over 30 years of experience and is putting the growth plans back in action, after a break resulting from the passing of Mr. Pixberg in 2008. Combined premiums have dropped to \$4,857,157 from the \$5,293,379 of the previous year. The Company is taking a cautious approach to the growth of this new line. Refer to the table below for the progress over the past four years.

	<u>2010</u>	<u>2009</u>	<u>2008</u>	<u>2007</u>
TGIC surety business	\$2,294,299	\$2,233,321	\$3,382,429	\$3,053,065
TGCSC surety business	<u>2,562,858</u>	<u>3,060,058</u>	<u>2,970,688</u>	<u>2,686,791</u>
Total surety business	\$4,857,157	\$5,293,379	\$6,353,117	\$5,739,856

Financial Position

Assets:

	<u>2010</u>	<u>2009</u>
UST Bonds	\$132,000,472	\$101,601,223
CMO's US agency	44,775,425	43,535,260
Common stock – unaffiliated	46,222,759	34,294,613
Common stock – affiliates		
The Gray Casualty & Surety Co.	14,756,984	14,666,477
The Gray Oil & Gas Co.	15,716,987	16,750,000
The Gray Exploration Co.	5,294,126	2,300,000
Real estate – mortgages	1,366,059	1,401,012
Real estate – home office	6,622,972	6,677,620
Cash and other short term	24,107,728	78,385,814

The Company has historically invested in U.S. Treasury bonds and notes and bonds guaranteed by the Federal Government. The Company has identified solid local companies for acquisition of stock to take advantage of premium tax reductions for qualifying investments. In 2008, the Company added additional investments in Whitney Holding Corporation, parent of Whitney National Bank. As this bank had not participated directly in

sub-prime lending, the Company believed this positioned Whitney to ride through the economic turmoil of late 2008. However in 2009; it became evident that Whitney's expansion into the Florida market came at a price. Write-offs with this business led to a substantial drop in the share price. This caused pressure on the surplus of the Company requiring an injection of \$15 million to surplus to maintain ratios and the rating. The Whitney has digested much of this. In 2010 it was announced that Whitney would be acquired in a stock swap by Hancock Holding Company, owner of Hancock Bank of Mississippi. With this the investment has almost recovered its value to original cost. The Company has held the investment through this cycle.

In 2010, the Company invested amounts previously retained in cash, due to the security of non-interest bearing deposits having an unlimited Federal guarantee, in several issues of US Treasury bonds as interest rates firmed to improve investment returns.

The Company maintained its diversity of investments with \$25 million under management of Faye Sarofim & Company. Mr. Faye Sarofim has an excellent track record in the investment area. He manages a Dreyfus fund and portfolios of other insurance companies. The investments are with some 54 companies with small to no debt profiles and a strong record of earnings and dividends. While the Company entered the investment after the financial meltdown was believed to have run its course, the meltdown did affect the portfolio. The investments are in the fabric of the economy and have experienced a return as the current problems subside. The market has made a substantial recovery and the portfolio returned to the black in 2010.

Cash and short term investments decreased as discussed above. The effect of reduced premium has reversed the cash flows such that with the pace of claim settlements cash outflows outpace premium and investment income. This is expected and does not present a current or future problem.

In 1998, the Company created a new subsidiary, The Gray Oil & Gas Company, to own oil and gas royalty interests. 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 indicated that it would grow to levels that would exceed statutory limits.

In 2009, the Company repurchased The Gray Oil & Gas Company from its parent, Gray & Company, Inc. Additionally, it purchased The Gray Exploration Company. These companies are now mature and growth stabilized. Intercompany transactions had become cumbersome and this simplified the balance sheets. The basic effect was to exchange debt for equity, in that the mortgages on oil & gas royalty properties owned by The Gray Oil & Gas Company in the amount of \$6,450,000 and similar mortgages with The Gray Exploration Company for \$2,300,000 placed in 2004 were retired. All independent valuations more than adequately support the purchase values.

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

Liabilities

Loss reserve growth reversed in 2009 as the effects of decreased premium volumes took hold. The decrease in loss reserves continued into 2010. Loss reserves hold at just above actuary's best estimate. In late 2006, the Company replaced the Vice President of Claims. In 2007, an imaging system was installed that eliminated over 4 million paper documents in favor of electronic documents with improved claim administration. It has been so well received that implementation to other departments continues. In 2009, the Company took in-house the development of a claims management system. The initial phase of the system was released in the second quarter of 2010 and was well received. Additional functions are being added on a regular basis.

The increase in Workers' Compensation land exposure written in the early part of the decade, led to above average commercial automobile experience. Beginning in 2003, 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 pace of settlements in the face of decreased premiums written has resulted in a decrease of outstanding reserves. This trend is expected to continue until the soft market reverses.

	<u>2010</u>	<u>2009</u>
Loss & LAE Reserves	\$193,141,686	\$212,813,458
Actuary's Best Estimate	192,474,887	212,555,000

The Company has no finite reinsurance or 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 commensurate with the decrease in written premiums.

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 2009.

In 2009, the Company sought and received approval to issue a Surplus Note for \$15,000,000 to its parent. The note was issued to increase surplus to offset losses in the equity market as discussed above. The surplus note was in place at year end 2009.

In 2010, as equity markets recovered and as income was booked, the Company used these funds to pay down \$15,000,000 of surplus notes. This was accomplished while maintaining the Policyholders Surplus at above the \$100 million level.

Operations

As indicated above, effects of the soft market continued into 2010. Underwriting remained strong as the combined ratio was 96.6, well ahead of the industry's estimated 103.3. The Company maintained loss reserves above actuary's best estimate.

	<u>2010</u>	<u>2009</u>
Gross Written Premium	\$ 56,320,063	\$ 72,864,259
Net Earned Premium	56,283,269	72,971,068
Losses & LAE Incurred	31,611,067	42,783,721
Other underwriting expenses	22,741,667	25,002,088
Policyholders Surplus	107,975,078	113,618,152

Gross written premium declined by 22.7 percent in 2010. In this phase of the cycle, the Company can be competitive with insureds with better performance and allow those with poorer performance to team with other insurance companies seeking market share. This results in a shrinking of premium and holding of loss ratios. Expense ratios do tend to rise as the Company maintains staff and contracts to its core customers.

The decrease to Policyholders' Surplus resulted from deleveraging by reducing reliance on surplus notes. This totaled \$15 million in 2010. Income and recoveries in the investments provided funds for this. The dividend to its parent was reduced to \$4,000,000 from the \$5,000,000 of the previous year. The reduction in premium written and outstanding loss reserves has taken pressure off of Policyholders' Surplus.

	<u>2010</u>	<u>2009</u>
Net underwriting income	\$ 1,930,535	\$ 5,185,259
Investment income	8,883,691	10,892,447
Capital gains/(loss)	129,455	36,576
Unrealized gain/(loss)	8,186,503	(1,806,571)
Federal income tax	(2,703,695)	(5,448,785)
Surplus Note	(15,000,000)	15,000,000
Dividends to parent	(4,000,000)	(5,000,000)
Change to policyholders' surplus	(5,643,074)	16,658,392

Policyholders' Surplus remains well above the Authorized Control Level.

	<u>2010</u>	<u>2009</u>
Policyholders' Surplus	\$107,975,078	\$113,618,152
RBC Authorized Control Level	16,611,352	17,058,999
Percent Policyholders' Surplus/RBCAL	650%	666%

The Company had one IRIS ratios fall outside the accepted range for 2010. This was for investment yield and it was equal to the low return of 3 percent.


Current Economic Environment

While there are no direct effects from the meltdown of the financial markets, the Company expects that the slowdown in the construction market will impact its surety business in the number and size of future bonds. Investment opportunities show poorer return. The Company has taken a conservative approach to investments, with an eye to preservation of capital. Management has experienced this in the past and has made adjustments such that we can weather a prolonged slowdown. We will experience higher operating expenses to maintain the seasoned staff.

Subsequent events:

The Company opened a surety office in Phoenix, Arizona. An underwriter with 25 years of experience was brought in to anchor the operations.

As the Company completes its 33rd year in business, we will continue to focus on underwriting, and managing the current market. Casualty 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. Surety growth is back in our plans with the new head of surety. Superior loss control services, claims management and financial stability are at the heart of our customer loyalty.


Michael T. Gray, President
March 31, 2011