

National Interstate CORP  
Form 10-Q  
November 04, 2009

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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549**

**Form 10-Q**

**Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the quarterly period ended September 30, 2009**

**OR**

**Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_.**

**Commission File Number 000-51130**

**National Interstate Corporation**

*(Exact name of registrant as specified in its charter)*

**Ohio**

*(State or other jurisdiction of  
incorporation or organization)*

**34-1607394**

*(I.R.S. Employer  
Identification No.)*

**3250 Interstate Drive  
Richfield, Ohio 44286-9000  
(330) 659-8900**

*(Address and telephone number of principal executive offices)*

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.  Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (Section 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).  Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definition of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check One):

Large Accelerated Filer  Accelerated Filer  Non-Accelerated Filer  Smaller Reporting Company   
(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).  Yes  No

The number of shares outstanding of the registrant's sole class of common shares as of November 2, 2009 was 19,393,261.

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**Table of Contents****PART I FINANCIAL INFORMATION****ITEM 1. Financial Statements**

**National Interstate Corporation and Subsidiaries**  
**Consolidated Balance Sheets**  
(In thousands, except per share data)

|   | <b>September<br/>30,<br/>2009<br/>(Unaudited)</b> | <b>December<br/>31,<br/>2008</b> |
|---|---|----------------------------------|
| <b>ASSETS</b>   |   |                                  |
| Investments:  |   |                                  |
| Fixed maturities available-for-sale, at fair value (amortized cost \$521,089 and \$462,562, respectively) | \$ 523,742  | \$ 459,237                       |
| Equity securities available-for-sale, at fair value (cost \$25,363 and \$30,143, respectively)            | 28,013  | 27,233                           |
| Short-term investments, at cost which approximates fair value   | 86  | 85                               |
| <br>  |   |                                  |
| Total investments   | 551,841   | 486,555                          |
| Cash and cash equivalents   | 57,750  | 77,159                           |
| Securities lending collateral (cost \$0 and \$94,655, respectively)                                       |   | 84,670                           |
| Accrued investment income   | 4,837   | 5,161                            |
| Premiums receivable, net of allowance for doubtful accounts of \$769 and \$587, respectively              | 118,274   | 95,610                           |
| Reinsurance recoverables on paid and unpaid losses  | 151,739   | 150,791                          |
| Prepaid reinsurance premiums  | 32,730  | 28,404                           |
| Deferred policy acquisition costs   | 20,124  | 19,245                           |
| Deferred federal income taxes   | 12,733  | 18,324                           |
| Property and equipment, net   | 21,693  | 20,406                           |
| Funds held by reinsurer   | 3,346   | 3,073                            |
| Prepaid expenses and other assets   | 2,321   | 1,414                            |
| <br>  |   |                                  |
| Total assets  | \$ 977,388  | \$ 990,812                       |
| <b>LIABILITIES AND SHAREHOLDERS EQUITY</b>  |   |                                  |
| Liabilities:  |   |                                  |
| Unpaid losses and loss adjustment expenses  | \$ 417,786  | \$ 400,001                       |
| Unearned premiums and service fees  | 170,995   | 156,598                          |
| Long-term debt  | 15,000  | 15,000                           |
| Amounts withheld or retained for account of others  | 53,013  | 48,357                           |
| Reinsurance balances payable  | 15,877  | 10,267                           |
| Securities lending obligation   |   | 95,828                           |
| Accounts payable and other liabilities  | 31,679  | 35,813                           |
| Commissions payable   | 9,088   | 9,274                            |
| Assessments and fees payable  | 4,040   | 3,600                            |
| <br>  |   |                                  |
| Total liabilities   | 717,478   | 774,738                          |
| Shareholders' equity:   |   |                                  |
| Preferred shares - no par value   |   |                                  |

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|   |  |            |            |
|---|--|------------|------------|
| Authorized                                    | 10,000 shares  |            |            |
| Issued  | 0 shares   |            |            |
| Common shares                                 | \$0.01 par value   |            |            |
| Authorized                                    | 50,000 shares  |            |            |
| Issued  | 23,350 shares, including 4,049 and 4,055 shares, respectively, in treasury | 234        | 234        |
| Additional paid-in capital                    |  | 48,942     | 48,004     |
| Retained earnings                             |  | 213,017    | 184,187    |
| Accumulated other comprehensive income (loss) |  | 3,447      | (10,613)   |
| Treasury shares                               |  | (5,730)    | (5,738)    |
| Total shareholders' equity                    |  | 259,910    | 216,074    |
| Total liabilities and shareholders' equity    |  | \$ 977,388 | \$ 990,812 |

See notes to consolidated financial statements.

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**National Interstate Corporation and Subsidiaries**  
**Consolidated Statements of Operations**  
**(Unaudited)**  
**(In thousands, except per share data)**

|   | <b>Three Months Ended</b> |                   | <b>Nine Months Ended</b> |                 |
|---|---------------------------|-------------------|--------------------------|-----------------|
|   | <b>September 30,</b>      |                   | <b>September</b>         |                 |
|   | <b>2009</b>               | <b>2008</b>       | <b>2009</b>              | <b>2008</b>     |
| <b>Revenues:</b>                                      |                           |                   |                          |                 |
| Premiums earned                                       | \$ 70,825                 | \$ 75,058         | \$ 209,927               | \$ 214,521      |
| Net investment income                                 | 4,501                     | 5,498             | 14,430                   | 16,793          |
| Net realized gains (losses) on investments (*)        | 760                       | (8,457)           | 1,831                    | (10,768)        |
| Other   | 879                       | 605               | 2,627                    | 2,199           |
| <b>Total revenues</b>                                 | <b>76,965</b>             | <b>72,704</b>     | <b>228,815</b>           | <b>222,745</b>  |
| <b>Expenses:</b>                                      |                           |                   |                          |                 |
| Losses and loss adjustment expenses                   | 48,286                    | 51,995            | 127,052                  | 144,097         |
| Commissions and other underwriting expenses           | 15,189                    | 18,529            | 43,565                   | 46,685          |
| Other operating and general expenses                  | 3,085                     | 3,241             | 9,580                    | 9,786           |
| Expense on amounts withheld                           | 811                       | 1,001             | 2,578                    | 3,261           |
| Interest expense                                      | 71                        | 133               | 403                      | 704             |
| <b>Total expenses</b>                                 | <b>67,442</b>             | <b>74,899</b>     | <b>183,178</b>           | <b>204,533</b>  |
| Income (loss) before federal income taxes             | 9,523                     | (2,195)           | 45,637                   | 18,212          |
| Provision for federal income taxes                    | 1,367                     | 2,033             | 12,726                   | 8,499           |
| <b>Net income (loss)</b>                              | <b>\$ 8,156</b>           | <b>\$ (4,228)</b> | <b>\$ 32,911</b>         | <b>\$ 9,713</b> |
| <br>  |                           |                   |                          |                 |
| Net income (loss) per common share basic              | \$ 0.42                   | \$ (0.22)         | \$ 1.71                  | \$ 0.50         |
| Net income (loss) per common share diluted            | \$ 0.42                   | \$ (0.22)         | \$ 1.70                  | \$ 0.50         |
| <br>  |                           |                   |                          |                 |
| Weighted average of common shares outstanding basic   | 19,301                    | 19,293            | 19,301                   | 19,281          |
| Weighted average of common shares outstanding diluted | 19,384                    | 19,293            | 19,360                   | 19,375          |
| <br>  |                           |                   |                          |                 |
| Cash dividends per common share                       | \$ 0.07                   | \$ 0.06           | \$ 0.21                  | \$ 0.18         |

(\*) Consists of the following:

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|  |          |          |          |          |
|--|----------|----------|----------|----------|
| Realized gains (losses) before impairment losses | \$ 2,035 | \$ (498) | \$ 4,339 | \$ (252) |
|--|----------|----------|----------|----------|

See notes to consolidated financial statements.

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**National Interstate Corporation and Subsidiaries**  
**Consolidated Statements of Shareholders Equity**  
**(Unaudited)**  
**(Dollars in thousands)**

|   | <b>Common</b> | <b>Additional<br/>Paid-In</b> | <b>Retained</b> | <b>Accumulated<br/>Other<br/>Comprehensive<br/>Income</b> | <b>Treasury</b> | <b>Total</b> |
|---|---------------|-------------------------------|-----------------|---|-----------------|--------------|
|   | <b>Stock</b>  | <b>Capital</b>                | <b>Earnings</b> | <b>(Loss)</b>   | <b>Stock</b>    |              |
| Balance at January 1, 2009  | \$ 234        | \$ 48,004                     | \$ 184,187      | \$ (10,613)   | \$ (5,738)      | \$ 216,074   |
| Net income  |               |                               | 32,911          |   |                 | 32,911       |
| Unrealized appreciation of investment securities, net of tax expense of \$7.5 million                       |               |                               |                 | 14,060  |                 | 14,060       |
| Comprehensive income  |               |                               |                 |   |                 | 46,971       |
| Dividends on common stock   |               |                               | (4,081)         |   |                 | (4,081)      |
| Issuance of 6,089 treasury shares from restricted stock issued, net of forfeitures                          |               | (56)                          |                 |   | 8               | (48)         |
| Stock compensation expense  |               | 994                           |                 |   |                 | 994          |
| Balance at September 30, 2009   | \$ 234        | \$ 48,942                     | \$ 213,017      | \$ 3,447  | \$ (5,730)      | \$ 259,910   |
| Balance at January 1, 2008  | \$ 234        | \$ 45,566                     | \$ 178,190      | \$ (5,321)  | \$ (5,863)      | \$ 212,806   |
| Net income  |               |                               | 9,713           |   |                 | 9,713        |
| Unrealized depreciation of investment securities, net of tax benefit of \$4.4 million                       |               |                               |                 | (16,444)  |                 | (16,444)     |
| Comprehensive loss  |               |                               |                 |   |                 | (6,731)      |
| Dividends on common stock   |               |                               | (3,497)         |   |                 | (3,497)      |
| Issuance of 89,723 treasury shares upon exercise of options and restricted stock issued, net of forfeitures |               | 706                           |                 |   | 125             | 831          |
| Tax benefit realized from exercise of stock options   |               | 396                           |                 |   |                 | 396          |
| Stock compensation expense  |               | 1,012                         |                 |   |                 | 1,012        |
| Balance at September 30, 2008   | \$ 234        | \$ 47,680                     | \$ 184,406      | \$ (21,765)   | \$ (5,738)      | \$ 204,817   |

See notes to consolidated financial statements.

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**National Interstate Corporation and Subsidiaries**  
**Consolidated Statements of Cash Flows**  
**(Unaudited)**  
**(Dollars in thousands)**

|   | <b>Nine Months Ended September</b> |              |
|---|------------------------------------|--------------|
|   | <b>30,</b>                         |              |
|   | <b>2009</b>                        | <b>2008</b>  |
| <b>Operating activities</b>   |                                    |              |
| Net income  | \$ 32,911                          | \$ 9,713     |
| Adjustments to reconcile net income to net cash provided by operating activities:                           |                                    |              |
| Net amortization of bond premiums and discounts   | 1,940                              | 1,251        |
| Provision for depreciation and amortization   | 1,350                              | 1,017        |
| Net realized (gains) losses on investment securities  | (1,831)                            | 10,768       |
| Deferred federal income taxes   | (1,871)                            | (2,877)      |
| Stock compensation expense  | 994                                | 1,012        |
| Increase in deferred policy acquisition costs, net  | (879)                              | (4,488)      |
| Increase in reserves for losses and loss adjustment expenses  | 17,785                             | 86,627       |
| Increase in premiums receivable   | (22,664)                           | (34,046)     |
| Increase in unearned premiums and service fees  | 14,397                             | 40,281       |
| Increase in interest receivable and other assets  | (856)                              | (80)         |
| Increase in prepaid reinsurance premiums  | (4,326)                            | (15,260)     |
| (Decrease) increase in accounts payable, commissions and other liabilities and assessments and fees payable | (3,880)                            | 8,283        |
| Increase in amounts withheld or retained for account of others  | 4,656                              | 9,674        |
| Increase in reinsurance recoverable   | (948)                              | (40,425)     |
| Increase in reinsurance balances payable  | 5,610                              | 9,845        |
| Other   | (45)                               | (3)          |
| <br>Net cash provided by operating activities   | <br>42,343                         | <br>81,292   |
| <b>Investing activities</b>   |                                    |              |
| Purchases of fixed maturities   | (271,708)                          | (342,290)    |
| Purchases of equity securities  | (4,756)                            | (3,387)      |
| Proceeds from sale of fixed maturities  | 39,467                             | 1,148        |
| Proceeds from sale of equity securities   | 12,135                             | 10,115       |
| Proceeds from maturities and redemptions of investments   | 216,345                            | 278,896      |
| Capital expenditures  | (2,592)                            | (1,359)      |
| <br>Net cash used in investing activities   | <br>(11,109)                       | <br>(56,877) |
| <b>Financing activities</b>   |                                    |              |
| Decrease in securities lending collateral   | 49,314                             | 54,416       |
| Decrease in securities lending obligation   | (95,828)                           | (54,416)     |
| Additional long-term borrowings   |                                    | 15,000       |
| Reductions of long-term debt  |                                    | (15,464)     |
| Tax benefit realized from exercise of stock options   |                                    | 396          |
|   | (48)                               | 831          |

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|  |           |           |
|--|-----------|-----------|
| Issuance of common shares from treasury upon exercise of stock options or stock award grants |           |           |
| Cash dividends paid on common shares   | (4,081)   | (3,497)   |
| Net cash used in financing activities  | (50,643)  | (2,734)   |
| Net (decrease) increase in cash and cash equivalents   | (19,409)  | 21,681    |
| Cash and cash equivalents at beginning of period   | 77,159    | 43,069    |
| Cash and cash equivalents at end of period   | \$ 57,750 | \$ 64,750 |

See notes to consolidated financial statements.

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**NATIONAL INTERSTATE CORPORATION AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)**

**1. Basis of Presentation**

The accompanying unaudited consolidated financial statements of National Interstate Corporation (the Company) and its subsidiaries have been prepared in accordance with the instructions to Form 10-Q, which differ in some respects from statutory accounting principles permitted by state regulatory agencies.

The consolidated financial statements include the accounts of the Company and its subsidiaries, National Interstate Insurance Company ( NIIC ), Hudson Indemnity, Ltd. ( HIL ), National Interstate Insurance Company of Hawaii, Inc. ( NIIC-HI ), Triumpher Casualty Company ( TCC ), National Interstate Insurance Agency, Inc. ( NIIA ), Hudson Management Group, Ltd. ( HMG ), American Highways Insurance Agency, Inc., Safety, Claims and Litigation Services, Inc., Explorer RV Insurance Agency, Inc. and Safety, Claims and Litigation Services, LLC. Significant intercompany transactions have been eliminated.

These interim consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2008. The interim financial statements reflect all adjustments which are, in the opinion of management, necessary for the fair presentation of the results for the periods presented. Such adjustments are of a normal recurring nature.

Operating results for the three and nine month period ended September 30, 2009 are not necessarily indicative of the results that may be expected for the year ending December 31, 2009.

The preparation of the financial statements requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Changes in circumstances could cause actual results to differ materially from those estimates. Certain reclassifications have been made to financial information presented for prior years to conform to the current year's presentation.

**2. Securities Lending Program**

Prior to June 2009, the Company participated in a securities lending program whereby certain fixed maturity and equity securities from the Company's investment portfolio were loaned to other institutions for short periods of time. The Company required collateral equal to 102% of the market value of the loaned securities plus accrued interest. The collateral was invested by the lending agent generating investment income, net of applicable fees. The Company was not permitted to sell or re-pledge the collateral on the securities lending program. The Company accounted for this program as a secured borrowing and recorded the collateral held and corresponding liability to return the collateral on the Company's Consolidated Balance Sheets at fair value. The securities loaned remained a recorded asset of the Company. Prior to 2008, collateral could be invested in investments with maturities beyond the loan term, including asset backed securities and corporate obligations. However, in light of the market turmoil, beginning in 2008, new cash collateral was only invested in overnight investments.

In June 2009, the Company terminated its securities lending program. During 2009, and prior to the program's termination, approximately \$22.1 million of investments within the Company's securities lending collateral matured and were used to pay down a corresponding amount of the Company's securities lending obligation. Upon the program's termination, the Company used cash on hand and securities lending collateral to pay the \$73.7 million securities lending obligation. Securities lending collateral that had a fair value of \$35.8 million and an unrealized loss of \$9.1 million at the termination date were retained by the Company and are included in the Company's fixed maturities portfolio. Other-than-temporary impairments of \$1.6 million had previously been taken on these fixed maturities.

During its participation in the program, the Company examined the securities lending collateral held for possible other-than-temporary declines in value. During 2009, and prior to termination of the program, the Company recorded a \$0.4 million other-than-temporary impairment on one fixed maturity investment within the Company's securities lending collateral portfolio, compared to \$1.1 million recorded during the nine months ended September 30, 2008.

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|   | <b>September 30,<br/>2009</b>     | <b>December 31,<br/>2008</b>      |
|---|-----------------------------------|-----------------------------------|
|   | <b>(Dollars in<br/>thousands)</b> | <b>(Dollars in<br/>thousands)</b> |
| Collateral obligation                                   | \$                                | \$ 95,828                         |
| Pretax unrealized loss on fair value of collateral held |                                   | (9,985)                           |
| Cumulative other-than-temporary impairment charges      |                                   | (1,173)                           |
| Fair value of collateral held                           |                                   | 84,670                            |
| Fair value of securities lent plus accrued interest     |                                   | 94,265                            |

**3. Fair Value Measurements**

Under fair value accounting, the Company must determine the appropriate level in the fair value hierarchy for each applicable measurement. The fair value hierarchy prioritizes the inputs, which refer broadly to assumptions market participants would use in pricing an asset or liability, into three levels. It gives the highest priority to quoted prices (unadjusted) in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. The level in the fair value hierarchy within which a fair value measurement in its entirety falls is determined based on the lowest level input that is significant to the fair value measurement in its entirety. Fair values for the Company's investment portfolio are reviewed by company personnel using data from nationally recognized pricing services as well as non-binding broker quotes.

The pricing services use a variety of observable inputs to estimate the fair value of fixed maturities that do not trade on a daily basis. These inputs include, but are not limited to, recent reported trades, benchmark yields, issuer spreads, bids or offers, reference data and measures of volatility. Included in the pricing of mortgage-backed securities are estimates of the rate of future prepayments and defaults of principal over the remaining life of the underlying collateral. Valuation techniques utilized by pricing services and prices obtained from independent financial institutions are reviewed by company personnel who are familiar with the securities being priced and the markets in which they trade to ensure that the fair value determination is representative of an exit price, as defined by fair value accounting.

Effective April 1, 2009, the Company adopted revised accounting guidance on estimating the fair value of an asset or liability when there is no active market and on identifying transactions that are not orderly. This did not change the objective of fair value measurements. Adoption of this change in the accounting guidance did not have a material impact on the Company's consolidated financial position or results of operations.

Level 1 inputs are quoted prices (unadjusted) in active markets for identical securities that the reporting entity has the ability to access at the measurement date. Level 2 inputs are inputs other than quoted prices within Level 1 that are observable for the security, either directly or indirectly. Level 2 inputs include quoted prices for similar securities in active markets, quoted prices for identical or similar securities that are not active and observable inputs other than quoted prices, such as interest rate and yield curves. Level 3 inputs are unobservable inputs for the asset or liability. Level 1 consists of publicly traded equity securities whose fair value is based on quoted prices that are readily and regularly available in an active market. Level 2 primarily consists of financial instruments whose fair value is based on quoted prices in markets that are not active and include U.S. government and government agency securities, fixed maturity investments, perpetual preferred stock and certain publicly traded common stocks that are not actively traded. Included in Level 2 are \$6.0 million of securities, which are valued based upon a non-binding broker quote and validated by management by observable market data. Level 3 consists of financial instruments that are not traded in an active market, whose fair value is estimated by management based on inputs from independent financial institutions, which include non-binding broker quotes, for which the Company believes reflects fair value, but are unable to verify inputs to the valuation methodology. The Company obtained one quote or price per instrument from its brokers and pricing services and did not adjust any quotes or prices that it obtained. Management reviews these broker quotes using information such as the market prices of similar investments.

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The following table presents the Company's investment portfolio, categorized by the level within the fair value hierarchy in which the fair value measurements fall at September 30, 2009:

|   | Level 1   | September 30, 2009            |           | Total      |
|---|-----------|-------------------------------|-----------|------------|
|   |           | Level 2                       | Level 3   |            |
|   |           | <b>(Dollars in thousands)</b> |           |            |
| <b>Fixed maturities:</b>                          |           |                               |           |            |
| U.S. government and government agency obligations | \$        | \$ 177,159                    | \$        | \$ 177,159 |
| State and local government obligations            |           | 162,887                       | 6,373     | 169,260    |
| Residential mortgage-backed securities            |           | 120,217                       | 2,494     | 122,711    |
| Commercial mortgage-backed securities             |           | 3,751                         |           | 3,751      |
| Corporate obligations                             |           | 33,756                        | 5,878     | 39,634     |
| Redeemable preferred stocks                       | 8,231     | 650                           | 2,346     | 11,227     |
| Total fixed maturities                            | 8,231     | 498,420                       | 17,091    | 523,742    |
| <b>Equity securities:</b>                         |           |                               |           |            |
| Perpetual preferred stock                         | 848       | 246                           | 396       | 1,490      |
| Common stock                                      | 14,551    | 11,972                        |           | 26,523     |
| Total equity securities                           | 15,399    | 12,218                        | 396       | 28,013     |
| Short-term investments                            |           | 86                            |           | 86         |
| Total investments                                 | 23,630    | 510,724                       | 17,487    | 551,841    |
| Cash and cash equivalents                         | 57,750    |                               |           | 57,750     |
| Total investments and cash and cash equivalents   | \$ 81,380 | \$ 510,724                    | \$ 17,487 | \$ 609,591 |

The following table presents a reconciliation of the beginning and ending balances for all investments measured at fair value on a recurring basis using Level 3 inputs for the three months ended September 30, 2009:

|  | Three Months Ended September 30, 2009 |  |  |                            |                           |
|--|---------------------------------------|--|--|----------------------------|---------------------------|
|  | Corporate obligations                 | State and local government obligations | Residential mortgage-backed securities | Redeemable preferred stock | Perpetual preferred stock |
|  |                                       |  | <b>(Dollars in thousands)</b>          |                            |                           |
| Beginning balance at July 1, 2009          | \$ 5,825                              | \$ 6,338                               | \$ 2,705                               | \$ 2,299                   | \$ 396                    |
| Total gains or (losses):                   |                                       |  |  |                            |                           |
| Included in earnings                       | 65                                    |  |  |                            |                           |
| Included in other comprehensive income     | 65                                    | 35                                     | 16                                     | 47                         |                           |
| Purchases and (settlements) <sup>(1)</sup> | (77)                                  |  | (227)                                  |                            |                           |
| Transfers in and/or (out) of Level 3       |                                       |  |  |                            |                           |
| Ending balance at September 30, 2009       | \$ 5,878                              | \$ 6,373                               | \$ 2,494                               | \$ 2,346                   | \$ 396                    |

The amount of total gains or  
(losses) for the period included in  
earnings attributable to the change  
in unrealized gains or  
(losses) relating to assets still held  
at the reporting date

\$ 65 \$ \$ \$ \$

(1) These amounts  
are attributable  
to either  
purchases of  
securities or  
principal pay  
downs,  
conversions or  
maturities  
during the three  
months ended  
September 30,  
2009.

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The following table presents a reconciliation of the beginning and ending balances for all investments measured at fair value on a recurring basis using Level 3 inputs for the nine months ended September 30, 2009:

|  | <b>Nine Months Ended September 30, 2009</b> |   |  |   |  |  |  |
|--|---|---|--|---|--|--|--|
|  | <b>Corporate</b>                            | <b>State and<br/>local<br/>government</b> | <b>Residential<br/>mortgage-backed</b> | <b>Redeemable<br/>preferred<br/>stock</b> | <b>Perpetual<br/>preferred<br/>stock</b> | <b>Securities<br/>lending<br/>collateral</b> |  |
|  | <b>obligations</b>                          | <b>obligations</b>                        | <b>securities</b>                      | <b>stock</b>                              | <b>stock</b>                             | <b>collateral</b>                            |  |
|  | <b>(Dollars in thousands)</b>               |   |  |   |  |  |  |
| Beginning balance at January 1, 2009   | \$ 4,295                                    | \$ 6,118                                  | \$                                     | \$ 2,406                                  | \$ 3,265                                 | \$ 5,046                                     |  |
| Total gains or (losses):   |   |   |  |   |  |  |  |
| Included in earnings   | 65  |   | (497)                                  |   | (170)                                    | (421)  |  |
| Included in other comprehensive income   | (45)  | 255                                       | 716                                    | (60)                                      | 1,551                                    | 546  |  |
| Purchases and (settlements) <sup>(1)</sup>   | (577)                                       |   | (269)                                  |   | (4,250)                                  | (487)  |  |
| Transfers in and/or (out) of Level 3 <sup>(2)</sup>  | 2,140                                       |   | 2,544                                  |   |  | (4,684)                                      |  |
| Ending balance at September 30, 2009   | \$ 5,878                                    | \$ 6,373                                  | \$ 2,494                               | \$ 2,346                                  | \$ 396                                   | \$   |  |
| The amount of total gains or (losses) for the period included in earnings attributable to the change in unrealized gains or (losses) relating to assets still held at the reporting date | \$ 65                                       | \$  | \$ (497)                               | \$  | \$ (170)                                 | \$ (421)                                     |  |

(1) These amounts are attributable to either purchases of securities or principal pay downs, conversions or maturities during the nine months ended September 30, 2009.

- (2) Transfers in and/or (out) of Level 3 relate to the termination of the securities lending program and moving longer-term assets into the investment portfolio during the nine months ended September 30, 2009.

**4. Investments**

Effective April 1, 2009, the Company adopted revised accounting guidance regarding the recognition and presentation of other-than-temporary impairments. This revision to the guidance is intended to be more operational, amends previously issued other-than-temporary impairment guidance for debt securities and improves the presentation and disclosure of other-than-temporary impairments on debt and equity securities in the consolidated financial statements. This guidance did not amend existing recognition and measurement guidance related to other-than-temporary impairments of equity securities. The adoption of this change in the accounting guidance did not have a material impact on the Company's consolidated financial position or results of operations or require a cumulative effect adjustment.

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The cost or amortized cost and fair value of investments in fixed maturities, equity securities and securities lending collateral are as follows:

|   | <b>Cost or<br/>Amortized<br/><br/>Cost</b> | <b>Gross<br/>Unrealized<br/><br/>Gains<br/>(Dollars in thousands)</b> | <b>Gross<br/>Unrealized<br/><br/>Losses</b> | <b>Fair<br/>Value</b> |
|---|--|---|---|-----------------------|
| <b>September 30, 2009 <sup>(1)</sup> :</b>        |  |   |   |                       |
| <b>Fixed maturities:</b>                          |  |   |   |                       |
| U.S. Government and government agency obligations | \$ 174,694                                 | \$ 2,486  | \$ (21)                                     | \$ 177,159            |
| State and local government obligations            | 162,628                                    | 8,129   | (1,497)                                     | 169,260               |
| Residential mortgage-backed securities            | 126,134                                    | 3,010   | (6,433)                                     | 122,711               |
| Commercial mortgage-backed securities             | 4,566                                      |   | (815)                                       | 3,751                 |
| Corporate obligations                             | 40,641                                     | 1,195   | (2,202)                                     | 39,634                |
| Redeemable preferred stock                        | 12,426                                     | 83  | (1,282)                                     | 11,227                |
| <b>Total fixed maturities</b>                     | <b>521,089</b>                             | <b>14,903</b>   | <b>(12,250)</b>                             | <b>523,742</b>        |
| <b>Equity securities:</b>                         |  |   |   |                       |
| Perpetual preferred stocks                        | 1,320                                      | 182   | (12)  | 1,490                 |
| Common stocks                                     | 24,043                                     | 2,485   | (5)   | 26,523                |
| <b>Total equity securities</b>                    | <b>25,363</b>                              | <b>2,667</b>  | <b>(17)</b>                                 | <b>28,013</b>         |
| Short-term investments                            | 86   |   |   | 86                    |
| <b>Total investments</b>                          | <b>\$ 546,538</b>                          | <b>\$ 17,570</b>  | <b>\$ (12,267)</b>                          | <b>\$ 551,841</b>     |
| <b>December 31, 2008:</b>                         |  |   |   |                       |
| <b>Fixed maturities:</b>                          |  |   |   |                       |
| U.S. Government and government agency obligations | \$ 199,207                                 | \$ 3,120  | \$ (50)                                     | \$ 202,277            |
| State and local government obligations            | 125,312                                    | 2,172   | (2,405)                                     | 125,079               |
| Residential mortgage-backed securities            | 77,170                                     | 1,425   | (27)  | 78,568                |
| Corporate obligations                             | 46,942                                     | 188   | (5,116)                                     | 42,014                |
| Redeemable preferred stock                        | 13,931                                     | 49  | (2,681)                                     | 11,299                |
| <b>Total fixed maturities</b>                     | <b>462,562</b>                             | <b>6,954</b>  | <b>(10,279)</b>                             | <b>459,237</b>        |
| <b>Equity securities:</b>                         |  |   |   |                       |
| Perpetual preferred stocks                        | 8,650                                      | 2   | (2,912)                                     | 5,740                 |
| Common stocks                                     | 21,493                                     |   |   | 21,493                |
| <b>Total equity securities</b>                    | <b>30,143</b>                              | <b>2</b>  | <b>(2,912)</b>                              | <b>27,233</b>         |
| Short-term investments                            | 85   |   |   | 85                    |
| <b>Total investments</b>                          | <b>\$ 492,790</b>                          | <b>\$ 6,956</b>   | <b>\$ (13,191)</b>                          | <b>\$ 486,555</b>     |

**Securities lending:**

|  |           |      |            |           |
|--|-----------|------|------------|-----------|
| Cash and cash equivalents              | \$ 42,359 | \$   | \$         | \$ 42,359 |
| Residential mortgage-backed securities | 23,108    |      | (8,038)    | 15,070    |
| Commercial mortgage-backed securities  | 4,695     |      | (1,164)    | 3,531     |
| Corporate obligations                  | 24,493    | 3    | (786)      | 23,710    |
| Total securities lending               | \$ 94,655 | \$ 3 | \$ (9,988) | \$ 84,670 |

(1) As of September 30, 2009, the Company held no securities lending collateral, therefore no breakout is included.

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The amortized cost and fair value of fixed maturities at September 30, 2009, by contractual maturity, are shown below. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. The average life of mortgage-backed securities is 3.1 years in the Company's investment portfolio.

Amortized cost and fair value of the fixed maturities in the Company's investment portfolio were as follows:

|  | <b>Fixed Maturities</b>       |                   |
|--|-------------------------------|-------------------|
|  | <b>Amortized</b>              |                   |
|  | <b>Cost</b>                   | <b>Fair Value</b> |
|  | <b>(Dollars in thousands)</b> |                   |
| Due in one year or less                | \$ 25,886                     | \$ 26,140         |
| Due after one year through five years  | 155,517                       | 157,368           |
| Due after five years through ten years | 157,064                       | 163,149           |
| Due after ten years                    | 51,922                        | 50,623            |
|  | 390,389                       | 397,280           |
| Mortgage-backed securities             | 130,700                       | 126,462           |
| Total                                  | \$ 521,089                    | \$ 523,742        |

Gains and losses on the sale of investments, including other-than-temporary impairments charges, were as follows:

|  | <b>Three Months Ended</b>     |             | <b>Nine Months Ended</b>      |             |
|--|-------------------------------|-------------|-------------------------------|-------------|
|  | <b>September 30,</b>          |             | <b>September 30,</b>          |             |
|  | <b>2009</b>                   | <b>2008</b> | <b>2009</b>                   | <b>2008</b> |
|  | <b>(Dollars in thousands)</b> |             | <b>(Dollars in thousands)</b> |             |
| Fixed maturity gains                       | \$ 266                        | \$ 13       | \$ 1,828                      | \$ 423      |
| Fixed maturity losses                      | (1,392)                       | (3,197)     | (2,424)                       | (3,734)     |
| Equity security gains                      | 1,886                         |             | 4,766                         | 148         |
| Equity security losses                     |                               | (4,777)     | (1,916)                       | (6,463)     |
| Securities lending fixed maturity losses   |                               | (496)       | (423)                         | (1,142)     |
| Net realized gains (losses) on investments | \$ 760                        | \$ (8,457)  | \$ 1,831                      | \$ (10,768) |

Net realized gains were \$0.8 million and \$1.8 million for the three and nine months ended September 30, 2009, respectively. The net realized gains for both the three and nine month period ended September 30, 2009 were primarily generated from gains on an equity partnership of \$1.0 million and \$3.6 million, respectively, realized gains from the sales of equity securities of \$0.9 million for the three and nine months ended September 30, 2009 and realized gains from the sales or calls of fixed maturity securities of \$0.3 and \$1.8 million, respectively, for the three and nine months ended September 30, 2009. The gains on equity and fixed maturity securities were primarily due to favorable market conditions that increased the value of the securities over book value and the Company sold these securities to realize these gains.

These gains were offset by other-than-temporary impairment charges of \$1.3 million and \$2.5 million for the three and nine months ended September 30, 2009, respectively, and equity security losses of \$1.3 million primarily related to a conversion of a perpetual preferred stock to common stock on a financial institution holding and losses on an equity partnership of \$0.5 million for the nine months ended September 30, 2009. The other-than-temporary impairment charge of \$1.3 million during the three months and nine months ended September 30, 2009 relates to one corporate note that experienced credit issues and, due to the potential of selling this security in the near future, the entire impairment charge loss was recognized in earnings. Included in the remaining other-than-temporary impairment

charge for the nine months ended September 30, 2009 are several securities totaling \$0.7 million, including one fixed maturity investment previously held within the securities lending collateral portfolio, which experienced credit issues that, in the Company's estimation, made full recovery of the cost of these investments unlikely and credit only impairments of \$0.5 million on two mortgage-backed securities which were written down to the present value of the expected cash flows. A non-credit charge of \$3.0 million relating to these two mortgage-backed securities is included in other comprehensive income for the nine months ended September 30, 2009.

Net realized losses were \$8.5 million and \$10.8 million for the three and nine months ended September 30, 2008, respectively. The net realized losses for both the three and nine month period ended September 30, 2008 were primarily caused by an other-than-temporary impairment charge of \$8.0 million, which consisted of a \$5.8 million charge related to securities issued by Fannie Mae, Freddie Mac and Lehman Brothers Holdings Inc., \$1.6 million related to securities in the financial and real estate sector and

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\$0.6 million, primarily from an asset-backed security. The net realized losses for the nine months ended September 30, 2008 also includes other-than-temporary impairment charges of \$2.5 million consisting of \$1.6 million on several perpetual preferred stock holdings, \$0.6 million on one fixed maturity holding and \$0.3 million on two redeemable preferred stock holdings. These charges were due to credit issues that, in the Company's estimation, made full recovery of the cost of these investments unlikely.

The following table summarizes the Company's gross unrealized losses on fixed maturities, equity securities and securities lending collateral and the length of time that individual securities have been in a continuous unrealized loss position:

|   | Less than Twelve Months |                   |                         |                    | Twelve Months or More |                   |                         |                    |
|---|-------------------------|-------------------|-------------------------|--------------------|-----------------------|-------------------|-------------------------|--------------------|
|   | Fair Value              | Unrealized Losses | Fair Value as % of Cost | Number of Holdings | Fair Value            | Unrealized Losses | Fair Value as % of Cost | Number of Holdings |
| <b>September 30, 2009 <sup>(1)</sup>:</b>           |                         |                   |                         |                    |                       |                   |                         |                    |
| Fixed maturities:                                   |                         |                   |                         |                    |                       |                   |                         |                    |
| U.S. Government and government agency obligations   |                         |                   |                         |                    |                       |                   |                         |                    |
|   | \$ 11,241               | \$ (21)           | 99.8%                   | 7                  | \$                    | \$                |                         |                    |
| State and local government obligations              |                         |                   |                         |                    |                       |                   |                         |                    |
|   | 2,430                   | (15)              | 99.4%                   | 2                  | 6,734                 | (1,482)           | 82.0%                   | 6                  |
| Residential mortgage-backed securities              |                         |                   |                         |                    |                       |                   |                         |                    |
|   | 10,106                  | (35)              | 99.7%                   | 6                  | 8,520                 | (6,398)           | 57.1%                   | 7                  |
| Commercial mortgage-backed securities               |                         |                   |                         |                    |                       |                   |                         |                    |
|   |                         |                   |                         |                    | 3,751                 | (815)             | 82.2%                   | 2                  |
| Corporate obligations                               |                         |                   |                         |                    |                       |                   |                         |                    |
|   | 5,780                   | (272)             | 95.5%                   | 5                  | 11,816                | (1,930)           | 86.0%                   | 9                  |
| Redeemable preferred stocks                         |                         |                   |                         |                    |                       |                   |                         |                    |
|   | 1,962                   | (38)              | 98.1%                   | 1                  | 7,184                 | (1,244)           | 85.2%                   | 21                 |
| <b>Total fixed maturities</b>                       |                         |                   |                         |                    |                       |                   |                         |                    |
|   | 31,519                  | (381)             | 98.8%                   | 21                 | 38,005                | (11,869)          | 76.2%                   | 45                 |
| Equity securities:                                  |                         |                   |                         |                    |                       |                   |                         |                    |
| Perpetual preferred stocks                          |                         |                   |                         |                    |                       |                   |                         |                    |
|   |                         |                   |                         |                    | 220                   | (12)              | 94.8%                   | 2                  |
| Common stocks                                       |                         |                   |                         |                    |                       |                   |                         |                    |
|   | 162                     | (5)               | 97.0%                   | 2                  |                       |                   |                         |                    |
| <b>Total equity securities</b>                      |                         |                   |                         |                    |                       |                   |                         |                    |
|   | 162                     | (5)               | 97.0%                   | 2                  | 220                   | (12)              | 94.8%                   | 2                  |
| <b>Total fixed maturities and equity securities</b> |                         |                   |                         |                    |                       |                   |                         |                    |
|   | \$ 31,681               | \$ (386)          | 98.8%                   | 23                 | \$ 38,225             | \$ (11,881)       | 76.3%                   | 47                 |
| <b>December 31, 2008:</b>                           |                         |                   |                         |                    |                       |                   |                         |                    |
| Fixed maturities:                                   |                         |                   |                         |                    |                       |                   |                         |                    |
| U.S. Government and government agency obligations   |                         |                   |                         |                    |                       |                   |                         |                    |
|   | \$ 4,305                | \$ (36)           | 99.2%                   | 5                  | \$ 2,985              | \$ (14)           | 99.5%                   | 1                  |

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|  |           |            |       |    |           |            |       |    |
|--|-----------|------------|-------|----|-----------|------------|-------|----|
| State and local government obligations       | 24,990    | (2,109)    | 92.2% | 28 | 7,947     | (296)      | 96.4% | 7  |
| Residential mortgage-backed securities       | 2,424     | (16)       | 99.3% | 2  | 680       | (11)       | 98.4% | 1  |
| Corporate obligations                        | 14,746    | (513)      | 96.6% | 21 | 16,124    | (4,603)    | 77.8% | 20 |
| Redeemable preferred stocks                  | 2,113     | (12)       | 99.4% | 2  | 8,170     | (2,669)    | 75.4% | 27 |
| Total fixed maturities                       | 48,578    | (2,686)    | 94.8% | 58 | 35,906    | (7,593)    | 82.5% | 56 |
| Equity securities:                           |           |            |       |    |           |            |       |    |
| Perpetual preferred stocks                   | 3,368     | (2,625)    | 56.2% | 4  | 1,485     | (287)      | 83.8% | 9  |
| Common stocks                                |           |            |       |    |           |            |       |    |
| Total equity securities                      | 3,368     | (2,625)    | 56.2% | 4  | 1,485     | (287)      | 83.8% | 9  |
| Total fixed maturities and equity securities | \$ 51,946 | \$ (5,311) | 90.7% | 62 | \$ 37,391 | \$ (7,880) | 82.6% | 65 |
| Securities Lending:                          |           |            |       |    |           |            |       |    |
| Residential mortgage-backed securities       | \$        | \$         |       |    | \$ 15,070 | \$ (8,038) | 65.2% | 7  |
| Commercial mortgage-backed securities        |           |            |       |    | 3,531     | (1,164)    | 75.2% | 2  |
| Corporate obligations                        |           |            |       |    | 16,213    | (786)      | 95.4% | 5  |
| Total securities lending                     | \$        | \$         |       |    | \$ 34,814 | \$ (9,988) | 77.7% | 14 |

(1) As of September 30, 2009, the Company held no securities lending collateral, therefore no breakout is included.

The gross unrealized losses on the Company's fixed maturities, equity securities and securities lending portfolios decreased from \$23.2 million at December 31, 2008 to \$12.3 million at September 30, 2009. The improvement in gross unrealized losses was primarily driven by the partial recovery from December 31, 2008 of the Company's corporate obligations, redeemable preferred stocks and perpetual preferred stock holdings as investment markets recovered during the second and third quarter of 2009. The \$12.3 million in gross unrealized losses at September 30, 2009 was primarily on residential mortgage-backed securities and corporate obligations that were transferred into the Company's fixed maturities portfolio from the terminated securities lending portfolio and fixed maturity holdings in state and local governments and redeemable preferred stocks. The gross unrealized losses on common stocks and perpetual preferred stocks are minimal and are considered to be temporary. In the fourth quarter of 2008, the Company began treating its perpetual preferred stocks similar to a debt security for assessing other-than-temporary impairments.

The Company analyzes its perpetual preferred securities by examining credit ratings, contractual payments on these specific issues and other issues of the issuer, company specific data of the issuer and the outlook for industry sectors to ensure that it is appropriate to treat these securities similar to debt securities. Investment grade securities (as determined by nationally recognized rating agencies) represented 77.3% of all fixed maturity securities with unrealized losses and 100% of all perpetual preferred stock securities with unrealized losses.

At September 30, 2009, gross unrealized losses on residential and commercial mortgage-backed securities were \$7.2 million and represented 59.2% of the total gross unrealized loss on fixed maturities. There were nine securities with gross unrealized losses of \$7.2 million that were in an unrealized loss position for 12 months or more. Three of these securities were rated investment grade and comprised \$0.8 million of the gross unrealized losses. The remaining six securities were in an unrealized loss position of \$6.4 million, including two securities, which previously had an other-than-temporary impairment credit charge and were in a gross

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unrealized loss position of \$3.3 million. Based on historical payment data and analysis of expected future cash flows of the underlying collateral, independent credit ratings and other facts and analysis, including management's current intent and ability to hold these securities for a period of time sufficient to allow for anticipated recovery, management believes that the Company will recover its cost basis in all these securities and no additional charges for other-than-temporary impairments will be required.

At September 30, 2009, gross unrealized losses on all other fixed maturity securities primarily consisted of state and local government obligations, corporate obligations and redeemable preferred stock. The state and local government obligations, with gross unrealized losses of \$1.5 million, had six holdings that were in an unrealized loss position for more than 12 months. Investment grade securities represented 88.4% of all state and local government obligations with unrealized losses greater than 12 months. The corporate obligations, which are primarily in financial institutions, had gross unrealized losses totaling \$2.2 million at September 30, 2009. The gross unrealized losses on corporate obligations consisted of five holdings that were in an unrealized loss position of \$0.3 million for less than 12 months and nine holdings with gross unrealized losses of \$1.9 million that were in an unrealized loss position for more than 12 months. Investment grade securities represented 78.3% of all corporate obligations with unrealized losses greater than 12 months. The redeemable preferred stocks, which are primarily in financial institutions, had gross unrealized losses totaling \$1.3 million, with 21 holdings that were in an unrealized loss position of \$1.2 million for more than 12 months. Investment grade securities represented 66.3% of all redeemable preferred stocks with unrealized losses greater than 12 months.

Management concluded that no additional charges for other-than-temporary impairment were required on the fixed maturity holdings based on many factors, including the Company's ability and current intent to hold these investments for a period of time sufficient to allow for anticipated recovery of its amortized cost, the length of time and the extent to which fair value has been below cost, analysis of company-specific financial data and the outlook for industry sectors and credit ratings. The Company believes these unrealized losses are primarily due to temporary market and sector-related factors and does not consider these securities to be other-than-temporarily impaired. If the Company's strategy was to change or these securities were determined to be other-than-temporarily impaired, the Company would recognize a write-down in accordance with its stated policy. The following table is a progression of the amount related to credit losses on fixed maturity securities for which a portion of an other-than-temporary impairment has been recognized in other comprehensive income.

|                                      | <b>Three Months<br/>Ended<br/>September 30,<br/>2009<br/>(Dollars in<br/>thousands)</b> | <b>Nine Months<br/>Ended<br/>September 30,<br/>2009<br/>(Dollars in<br/>thousands)</b> |
|--------------------------------------|---|--|
| Beginning balance                    | \$ 534  | \$   |
| Additional credit impairment on:     |   |  |
| Previously impaired securities       |   |  |
| Securities without prior impairments |   | 534  |
| Reductions                           |   |  |
| Ending balance                       | \$ 534  | \$ 534   |

**5. Income Taxes**

A reconciliation of the provision for federal income taxes for financial reporting purposes and the provision for federal income taxes calculated at the prevailing federal income tax rate of 35% is as follows:

| <b>Three Months Ended<br/>September 30,</b> | <b>Nine Months Ended<br/>September 30,</b> |
|---|--|
|---|--|

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|  | <b>2009</b>                   | <b>2008</b>     | <b>2009</b>                   | <b>2008</b>     |
|--|-------------------------------|-----------------|-------------------------------|-----------------|
|  | <b>(Dollars in thousands)</b> |                 | <b>(Dollars in thousands)</b> |                 |
| Expected federal income tax expense<br>(benefit) at statutory rate | \$ 3,333                      | \$ (768)        | \$ 15,973                     | \$ 6,374        |
| Tax effect of tax exempt investment income                         | (420)                         | (339)           | (1,287)                       | (1,006)         |
| Change in valuation allowance on net<br>capital losses             | (1,792)                       | 3,191           | (2,397)                       | 3,191           |
| Other items, net   | 246                           | (51)            | 437                           | (60)            |
|  | <b>\$ 1,367</b>               | <b>\$ 2,033</b> | <b>\$ 12,726</b>              | <b>\$ 8,499</b> |

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The tax effects of temporary differences that give rise to significant portions of the net deferred tax assets and liabilities in the Consolidated Balance Sheets were as follows:

|   | <b>September 30,<br/>2009<br/>(Dollars in<br/>thousands)</b> | <b>December 31,<br/>2008<br/>(Dollars in<br/>thousands)</b> |
|---|--|---|
| <b>Deferred Tax Assets:</b>                           |  |   |
| Unearned premiums                                     | \$ 9,735   | \$ 9,035  |
| Unpaid losses and loss adjustment expenses            | 8,672  | 8,233   |
| Assignments and assessments                           | 1,099  | 945   |
| Unrealized losses on investments                      | 360  | 5,677   |
| Realized losses on investments, primarily impairments | 5,966  | 7,936   |
| Other, net  | 1,806  | 873   |
|   | 27,638   | 32,699  |
| Valuation allowance                                   | (5,149)  | (7,616)   |
|   | 22,489   | 25,083  |
| <b>Deferred Tax Liabilities:</b>                      |  |   |
| Deferred policy acquisition costs                     | (7,043)  | (6,736)   |
| Other, net  | (2,713)  | (23)  |
| Total deferred tax liabilities                        | (9,756)  | (6,759)   |
| Net deferred income tax assets                        | \$ 12,733  | \$ 18,324   |

Management has reviewed the recoverability of the deferred tax asset and believes that, with the exception of realized losses on investments, the amount will be recoverable against future earnings. The gross deferred tax assets have been reduced by a valuation allowance related to unrealized losses on equity investments for the year ended December 31, 2008 of \$0.1 million. There was no such valuation allowance related to unrealized losses on equity investments for the nine months ended September 30, 2009. Additionally, gross deferred tax assets have been reduced by a valuation allowance related to net realized losses on investments of \$5.1 million and \$7.5 million for the nine months ended September 30, 2009 and year ended December 31, 2008, respectively, both primarily related to impairment charges.

**6. Shareholders Equity and Stock-Based Compensation**

The Company grants options and other stock awards to officers of the Company under the Long Term Incentive Plan ( LTIP ). At September 30, 2009, there were 825,567 of the Company s common shares reserved for issuance under the LTIP and options for 647,050 shares were outstanding. Treasury shares are used to fulfill the options exercised and other awards granted. Options and restricted shares vest pursuant to the terms of a written grant agreement. Options must be exercised no later than the tenth anniversary of the date of grant. As set forth in the LTIP, the Compensation Committee of the Board of Directors may accelerate vesting and exercisability of options.

For both the three months ended September 30, 2009 and 2008, the Company recognized stock-based compensation expense of \$0.3 million. Related income tax benefits were approximately \$0.1 million for both the three months ended September 30, 2009 and 2008. For both the nine months ended September 30, 2009 and 2008, the Company recognized stock-based compensation expense of \$1.0 million with related income tax benefits of \$0.2 million, respectively.

**7. Comprehensive Income**

Comprehensive income or loss includes the Company's net income or loss plus the changes in the unrealized gains or losses (net of income taxes) on the Company's available-for-sale securities. There was total comprehensive income for the third quarter of 2009 of \$17.4 million and a comprehensive loss of \$11.6 million for the third quarter of 2008.

**Table of Contents****8. Earnings Per Common Share**

The following table sets forth the computation of basic and diluted net income (loss) per share:

|   | Three Months Ended<br>September 30,      |            | Nine Months Ended<br>September 30,       |          |
|---|--|------------|--|----------|
|   | 2009                                     | 2008       | 2009                                     | 2008     |
|   | (In thousands, except per<br>share data) |            | (In thousands, except per<br>share data) |          |
| Net income (loss)   | \$ 8,156                                 | \$ (4,228) | \$ 32,911                                | \$ 9,713 |
| Weighted average shares outstanding<br>during period  | 19,301                                   | 19,293     | 19,301                                   | 19,281   |
| Additional shares issuable under employee<br>common stock option plans using treasury<br>stock method | 83                                       |            | 59                                       | 94       |
| Weighted average shares outstanding<br>assuming exercise of stock options <sup>(1)</sup>              | 19,384                                   | 19,293     | 19,360                                   | 19,375   |
| Net income (loss) per share:  |  |            |  |          |
| Basic   | \$ 0.42                                  | \$ (0.22)  | \$ 1.71                                  | \$ 0.50  |
| Diluted   | \$ 0.42                                  | \$ (0.22)  | \$ 1.70                                  | \$ 0.50  |

(1) Since the Company reported a net loss for the third quarter 2008, the calculated diluted earnings per share was anti-dilutive; therefore, basic earnings (loss) per share was used.

For the three months ended September 30, 2009 and 2008, there were 498,050 and 691,050 respectively, outstanding options and restricted shares excluded from diluted earnings (loss) per share because they were anti-dilutive. For the nine months ended September 30, 2009 and 2008, there were 498,050 and 348,113, respectively, outstanding options and restricted shares excluded from diluted earnings (loss) per share because they were anti-dilutive.

**9. Transactions with Related Parties**

The Company's principal insurance subsidiary, NIIC, is involved in both the cession and assumption of reinsurance. NIIC is a party to a reinsurance agreement, and NIIA, a wholly-owned subsidiary of the Company, is a party to an underwriting management agreement with Great American Insurance Company (Great American). As of September 30, 2009, Great American owned 52.6% of the outstanding shares of the Company. The reinsurance agreement calls for the assumption by NIIC of all of the risk on Great American's net premiums written for public transportation and recreational vehicle risks underwritten pursuant to the reinsurance agreement. NIIA provides

administrative services to Great American in connection with Great American's underwriting of these risks. The Company also cedes premium through reinsurance agreements with Great American to reduce exposure in certain of its property-casualty insurance programs.

The table below summarizes the reinsurance balance and activity with Great American:

|   | <b>Three Months Ended</b>     |             | <b>Nine Months Ended</b>      |             |
|---|-------------------------------|-------------|-------------------------------|-------------|
|   | <b>September 30,</b>          |             | <b>September 30,</b>          |             |
|   | <b>2009</b>                   | <b>2008</b> | <b>2009</b>                   | <b>2008</b> |
|   | <b>(Dollars in thousands)</b> |             | <b>(Dollars in thousands)</b> |             |
| Assumed premiums written                            | \$ 588                        | \$ 821      | \$ 2,624                      | \$ 4,779    |
| Assumed premiums earned                             | 835                           | 1,617       | 3,042                         | 4,818       |
| Assumed losses and loss adjustment expense incurred | 931                           | 1,347       | 3,215                         | 3,763       |
| Ceded premiums written                              | 610                           | 576         | 2,789                         | 3,026       |
| Ceded premiums earned                               | 827                           | 880         | 2,422                         | 2,707       |
| Ceded losses and loss adjustment expense recoveries | 783                           | 452         | 2,454                         | 849         |
| Payable to Great American as of period end          | 531                           | 526         | 531                           | 526         |

Great American or its parent, American Financial Group, Inc., perform certain services for the Company without charge including, without limitation, actuarial services and on a consultative basis, as needed, internal audit, legal, accounting and other support services. If Great American no longer controlled a majority of the Company's common shares, it is possible that many of these services would cease or, alternatively, be provided at an increased cost to the Company. This could impact the Company's personnel resources, require the Company to hire additional professional staff and generally increase the Company's operating expenses. Management believes, based on discussions with Great American, that these services will continue to be provided by the affiliated entity in future periods and the relative impact on operating results is not material.

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In 2008, Great American filed an Undertaking on Appeal as surety with the Superior Court of the State of California for the County of Los Angeles in the amount of \$17.9 million on behalf of NIIC. This surety was purchased from Great American to secure a judgment amount associated with the Company's pending appellate case as noted in Note 11 Commitments and Contingencies and was renewed in January 2009.

**10. Reinsurance**

Premiums and reinsurance activity consisted of the following:

|             | Three Months Ended September 30, |           |           |           | Nine Months Ended September 30, |            |            |            |
|-------------|----------------------------------|-----------|-----------|-----------|---------------------------------|------------|------------|------------|
|             | 2009                             |           | 2008      |           | 2009                            |            | 2008       |            |
|             | Written                          | Earned    | Written   | Earned    | Written                         | Earned     | Written    | Earned     |
|             | (Dollars in thousands)           |           |           |           |                                 |            |            |            |
| Direct      | \$ 67,423                        | \$ 87,158 | \$ 75,487 | \$ 93,386 | \$ 274,044                      | \$ 259,372 | \$ 304,508 | \$ 264,561 |
| Assumed     | 2,145                            | 2,191     | 1,964     | 2,748     | 5,702                           | 6,103      | 7,739      | 7,934      |
| Ceded       | (10,584)                         | (18,524)  | (15,036)  | (21,076)  | (59,875)                        | (55,548)   | (72,674)   | (57,974)   |
| Net Premium | \$ 58,984                        | \$ 70,825 | \$ 62,415 | \$ 75,058 | \$ 219,871                      | \$ 209,927 | \$ 239,573 | \$ 214,521 |

The Company cedes premiums through reinsurance agreements with reinsurers to reduce exposure in certain of its property-casualty insurance programs. Ceded losses and loss adjustment expense recoveries recorded for the three months ended September 30, 2009 and 2008 were \$11.3 million and \$8.9 million, respectively, and were \$37.5 million and \$22.3 million for the nine months ended September 30, 2009 and 2008, respectively. The Company remains primarily liable as the direct insurer on all risks reinsured and a contingent liability exists to the extent that the reinsurance companies are unable to meet their obligations for losses assumed. To minimize its exposure to significant losses from reinsurer insolvencies, the Company seeks to do business with only reinsurers rated Excellent or better by A.M. Best Company and regularly evaluates the financial condition of its reinsurers.

**11. Commitments and Contingencies**

The Company and its subsidiaries are subject at times to various claims, lawsuits and legal proceedings arising in the ordinary course of business. All legal actions relating to claims made under insurance policies are considered in the establishment of the Company's loss and loss adjustment expense reserves. In addition, regulatory bodies, such as state insurance departments, the Securities and Exchange Commission, the Department of Labor and other regulatory bodies may make inquiries and conduct examinations or investigations concerning the Company's compliance with insurance laws, securities laws, labor laws and the Employee Retirement Income Security Act of 1974, as amended. The Company's subsidiaries also have lawsuits pending in which the plaintiff seeks extra-contractual damages from the Company in addition to damages claimed or in excess of the available limits under an insurance policy. These lawsuits, which are in various stages of development, generally mirror similar lawsuits filed against other carriers in the industry. Although the Company is vigorously defending these lawsuits, the outcomes of these cases cannot be determined at this time. The Company has established loss and loss adjustment expense reserves for lawsuits as to which the Company has determined that a loss is both probable and estimable. In addition to these case reserves, the Company also establishes reserves for claims incurred but not reported to cover unknown exposures and adverse development on known exposures. Based on currently available information, the Company believes that reserves for these lawsuits are reasonable and that the amounts reserved did not have a material effect on the Company's financial condition or results of operations. However, if any one or more of these cases results in a judgment against or settlement by the Company for an amount that is significantly greater than the amount so reserved, the resulting liability could have a material effect on the Company's financial condition, cash flows and results of operations. On August 3, 2007, the Company was informed that the jury in a case pending in the Superior Court of the State of California for the County of Los Angeles (the Court), had issued, on August 2, 2007, a special verdict adverse to the Company's interests in a pending lawsuit against one of the Company's insurance companies. The Court entered a formal judgment on October 25, 2007 and the Company received notice of that formal judgment on November 5, 2007. The current net exposure to the Company for this judgment approximates \$7.2 million and, as required by the

Court, the Company secured the judgment amount with a surety bond. However, the Company believes that it has a strong appellate case and strategy and is vigorously pursuing the appellate process. Additionally, during April 2009, the Association of California Insurance Companies, the California affiliate of the Property Casualty Insurers Association of America, filed an amicus curiae brief in support of the Company's legal position. The Company believes the matter will be resolved in a manner that will not have a material adverse effect on the Company's consolidated financial position, results of operations or cash flows. As of September 30, 2009, the Company had not established a case reserve for this claim but has and will continue to closely monitor this case with counsel. The Company has consistently established litigation expense reserves to account for the cost associated with the defense of the Company's position, which it will continue to reserve for throughout the appeal process.

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As a direct writer of insurance, the Company receives assessments by state funds to cover losses to policyholders of insolvent or rehabilitated companies and other authorized fees. These mandatory assessments may be partially recovered through a reduction in future premium taxes in some states over several years. At September 30, 2009 and December 31, 2008, the liability for such assessments was \$4.0 million and \$3.6 million, respectively, and will be paid over several years as assessed by the various state funds.

**12. Segment Information**

The Company operates its business as one segment, property and casualty insurance. The Company manages this segment through a product management structure. The following table shows revenues summarized by the broader business component description, which were determined based primarily on similar economic characteristics, products and services:

|  | Three Months Ended<br>September 30, |           | Nine Months Ended<br>September 30, |            |
|--|-------------------------------------|-----------|------------------------------------|------------|
|  | 2009                                | 2008      | 2009                               | 2008       |
|  | (Dollars in thousands)              |           | (Dollars in thousands)             |            |
| <b>Revenue:</b>                            |                                     |           |                                    |            |
| Premiums earned:                           |                                     |           |                                    |            |
| Alternative Risk Transfer                  | \$ 36,695                           | \$ 35,814 | \$ 105,680                         | \$ 99,212  |
| Transportation                             | 14,300                              | 19,162    | 46,074                             | 56,882     |
| Specialty Personal Lines                   | 14,262                              | 14,046    | 42,127                             | 40,797     |
| Hawaii and Alaska                          | 3,837                               | 4,467     | 11,671                             | 13,393     |
| Other                                      | 1,731                               | 1,569     | 4,375                              | 4,237      |
| Total premiums earned                      | 70,825                              | 75,058    | 209,927                            | 214,521    |
| Net investment income                      | 4,501                               | 5,498     | 14,430                             | 16,793     |
| Net realized gains (losses) on investments | 760                                 | (8,457)   | 1,831                              | (10,768)   |
| Other                                      | 879                                 | 605       | 2,627                              | 2,199      |
| Total revenues                             | \$ 76,965                           | \$ 72,704 | \$ 228,815                         | \$ 222,745 |

**13. Subsequent Events**

In preparing these financial statements, the Company evaluated subsequent events through the time the financial statements were issued on November 4, 2009. Financial statements are considered issued when they are widely distributed to all shareholders and other financial statement users, or filed with the Securities and Exchange Commission. In conjunction with applicable accounting standards, all material subsequent events have either been recognized in the financial statements or disclosed in the notes to the financial statements.

**ITEM 2. Management's Discussion and Analysis of Financial Condition and Results of Operations****Forward-Looking Statements**

This document, including information incorporated by reference, contains forward-looking statements (within the meaning of the Private Securities Litigation Reform Act of 1995). All statements, trend analyses and other information contained in this Form 10-Q relative to markets for our products and trends in our operations or financial results, as well as other statements including words such as may, target, anticipate, believe, plan, estimate, intend, project, and other similar expressions, constitute forward-looking statements. We made these statements based on our plans and current analyses of our business and the insurance industry as a whole. We caution that these statements may and often do vary from actual results and the differences between these statements and actual results can be material. Factors that could contribute to these differences include, among other things:

general economic conditions, any weaknesses in the financial markets and other factors, including prevailing interest rate levels and stock and credit market performance, which may affect or continue to affect (among other things) our ability to sell our products and to collect amounts due to us, our ability to access capital

resources and the costs associated with such access to capital and the market value of our investments;

customer response to new products and marketing initiatives;

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tax law changes;

increasing competition in the sale of our insurance products and services and the retention of existing customers;

changes in legal environment;

regulatory changes or actions, including those relating to regulation of the sale, underwriting and pricing of insurance products and services and capital requirements;

levels of natural catastrophes, terrorist events, incidents of war and other major losses;

adequacy of insurance reserves; and

availability of reinsurance and ability of reinsurers to pay their obligations.

The forward-looking statements herein are made only as of the date of this report. We assume no obligation to publicly update any forward-looking statements.

**General**

We underwrite and sell traditional and alternative risk transfer property and casualty insurance products to the passenger transportation industry and the trucking industry, general commercial insurance to small businesses in Hawaii and Alaska and personal insurance to owners of recreational vehicles and commercial vehicles throughout the United States.

We have four property and casualty insurance subsidiaries: National Interstate Insurance Company ( NIIC ), National Interstate Insurance Company of Hawaii, Inc. ( NIIC-HI ), Triumpe Casualty Company ( TCC ), Hudson Indemnity, Ltd. ( HIL ) and six other agency and service subsidiaries. We write our insurance policies on a direct basis through NIIC, NIIC-HI and TCC. NIIC is licensed in all 50 states and the District of Columbia. NIIC-HI is licensed in Ohio, Hawaii, Michigan and New Jersey. TCC, a Pennsylvania domiciled company, holds licenses for multiple lines of authority, including auto-related lines, in 26 states and the District of Columbia. HIL is domiciled in the Cayman Islands and provides reinsurance for NIIC, NIIC-HI and TCC primarily for the alternative risk transfer product. Insurance products are marketed through multiple distribution channels, including independent agents and brokers, affiliated agencies and agent internet initiatives. We use our six agency and service subsidiaries to sell and service our insurance business.

As of September 30, 2009, Great American Insurance Company ( Great American ) owned 52.6% of our outstanding common shares. Great American is a wholly-owned subsidiary of American Financial Group, Inc.

**Results of Operations**

***Overview***

Through the operations of our subsidiaries, we are engaged in property and casualty insurance operations. We generate underwriting profits by providing specialized insurance products, services and programs not generally available in the marketplace. We focus on niche insurance markets where we offer insurance products designed to meet the unique needs of targeted insurance buyers that we believe are underserved by the insurance industry. We derive our revenues primarily from premiums generated by our insurance policies and income from our investment portfolio. Our expenses consist primarily of losses and loss adjustment expenses ( LAE ), commissions and other underwriting expenses and other operating and general expenses.

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Our September 30, 2009 and 2008 net income from operations, after-tax net realized gains (losses) from investments and net income (loss) were as follows:

|  | Three Months Ended September 30,<br>2009      |              | 2008       |              |
|--|---|--------------|------------|--------------|
|  | Amount  | Per<br>Share | Amount     | Per<br>Share |
|  | (Dollars in thousands, except per share data) |              |            |              |
| Net income from operations                             | \$ 5,869                                      | \$ 0.30      | \$ 4,460   | \$ 0.23      |
| After-tax net realized gains (losses) from investments | 2,287   | 0.12         | (8,688)    | (0.45)       |
| Net income (loss)                                      | \$ 8,156                                      | \$ 0.42      | \$ (4,228) | \$ (0.22)    |

|  | Nine Months Ended September 30,<br>2009       |              | 2008      |              |
|--|---|--------------|-----------|--------------|
|  | Amount  | Per<br>Share | Amount    | Per<br>Share |
|  | (Dollars in thousands, except per share data) |              |           |              |
| Net income from operations                             | \$ 29,324                                     | \$ 1.51      | \$ 19,903 | \$ 1.03      |
| After-tax net realized gains (losses) from investments | 3,587   | 0.19         | (10,190)  | (0.53)       |
| Net income   | \$ 32,911                                     | \$ 1.70      | \$ 9,713  | \$ 0.50      |

Our net income from operations for the three and nine months ended September 30, 2009 was \$5.9 million (\$0.30 per share diluted) and \$29.3 million (\$1.51 per share diluted), respectively, compared to \$4.5 million (\$0.23 per share diluted) and \$19.9 million (\$1.03 per share diluted) reported in the same periods in 2008. During the first nine months of 2008, we experienced an unusual number of large claims whereas in the first nine months of 2009, we experienced favorable large claims activity levels compared to 2008, thus contributing to the year to date increase in earnings from operations over the same period in 2008. The large claims in the first nine months of 2008 resulted in a 5.9% increase to the loss and LAE ratio, or an approximate \$8.2 million decrease to net income from operations. A lower expense ratio of 24.6% for the three months ended September 30, 2009 as compared to 28.2% for the same period in 2008 was the primary factor relating to the \$1.4 million increase in net income from operations for the quarter ended September 30, 2009. The decrease in the expense ratio relates to a decrease in net commission expense due to a change in our overall mix of business, as well as a one-time state guaranty fund charge recorded in the third quarter of 2008 which increased the expense ratio during that period by 1.7 percentage points.

We had after-tax net realized gains from investments of \$2.3 million (\$0.12 per share diluted) and \$3.6 million (\$0.19 per share diluted) for the third quarter and first nine months of 2009, respectively, compared to after-tax net realized losses from investments of \$8.7 million (\$0.45 per share diluted) and \$10.2 million (\$0.53 per share diluted) reported in the same periods in 2008. Included in the 2009 after-tax net realized gains for the third quarter and first nine months of 2009 are other-than-temporary impairment adjustments of \$1.3 million and \$2.5 million, respectively, compared to other-than-temporary impairment adjustments of \$8.0 million and \$10.5 million in the same periods in 2008. Despite recording these realized losses in accordance with other-than-temporary impairment accounting guidelines, we intend to maximize future potential recoveries related to these investments. The investment losses incurred in 2008 were a reflection of the unprecedented financial crisis that occurred compared to more typical investment markets being experienced in 2009.

**Table of Contents****Gross Premiums Written**

We operate our business as one segment, property and casualty insurance. We manage this segment through a product management structure. The following table sets forth an analysis of gross premiums written by business component during the periods indicated:

|                           | Three Months Ended September 30,<br>2009 |         | 2008      |         |
|---------------------------|--|---------|-----------|---------|
|                           | Amount                                   | Percent | Amount    | Percent |
|                           | (Dollars in thousands)                   |         |           |         |
| Alternative Risk Transfer | \$ 27,839                                | 40.0%   | \$ 33,808 | 43.7%   |
| Transportation            | 18,837                                   | 27.1%   | 20,972    | 27.1%   |
| Specialty Personal Lines  | 14,692                                   | 21.1%   | 14,120    | 18.2%   |
| Hawaii and Alaska         | 6,319                                    | 9.1%    | 6,996     | 9.0%    |
| Other                     | 1,881                                    | 2.7%    | 1,555     | 2.0%    |
| Gross premiums written    | \$ 69,568                                | 100.0%  | \$ 77,451 | 100.0%  |

|                           | Nine Months Ended September 30,<br>2009 |         | 2008       |         |
|---------------------------|---|---------|------------|---------|
|                           | Amount                                  | Percent | Amount     | Percent |
|                           | (Dollars in thousands)                  |         |            |         |
| Alternative Risk Transfer | \$ 161,188                              | 57.6%   | \$ 172,024 | 55.1%   |
| Transportation            | 51,147                                  | 18.3%   | 71,735     | 23.0%   |
| Specialty Personal Lines  | 48,210                                  | 17.2%   | 46,800     | 15.0%   |
| Hawaii and Alaska         | 14,958                                  | 5.4%    | 17,727     | 5.7%    |
| Other                     | 4,243                                   | 1.5%    | 3,961      | 1.2%    |
| Gross premiums written    | \$ 279,746                              | 100.0%  | \$ 312,247 | 100.0%  |

Gross premiums written include both direct premium and assumed premium. During the third quarter of 2009, our gross premiums written decreased \$7.9 million, or 10.2%, compared to the same period in 2008. This decrease is primarily attributable to our alternative risk transfer and transportation components which decreased by \$6.0 million, or 17.7%, and \$2.1 million, or 10.2%, respectively. The decline in gross premiums written in the alternative risk component was driven by lower renewal premium per policy due to fewer insured vehicles reflecting the current economic conditions, management's decision to reduce lines of coverage written in one of our existing captive programs, as well as other risk selection decisions made during the first half of 2009. This decrease was partially offset by the addition of one new truck captive program during the third quarter of 2009. The decrease in our transportation component is a reflection of the current economic environment, characterized through decreased vehicle count and mileage-based exposures, as well as the continued competitive insurance market. We continue to maintain our disciplined underwriting approach, which is to price our products to achieve an underwriting profit even if we forgo volume in the short term as a result. While our gross premiums written may continue to be impacted by the reduction in these lines of coverage throughout 2009, management believes that such risk selection decisions will provide a benefit to our underwriting results.

For the first nine months of 2009, our gross premiums written decreased \$32.5 million, or 10.4%, compared to the same period in 2008. This decrease is primarily attributable to our transportation, alternative risk transfer and Hawaii and Alaska components, which decreased by \$20.6 million, \$10.8 million and \$2.8 million, respectively. The overall decrease in gross premiums written is primarily attributed to several factors including the effect that the current economic environment has had on our commercial customers, particularly through reductions in vehicle counts and

mileage-based exposures, the effects of risk selection and pricing adequacy initiatives specific to a few of our products that we put in place in 2008 and the continued overly aggressive pricing from competition in the insurance marketplace. In spite of the obstacles posed by the current economic environment, we have maintained our disciplined underwriting approach and have continued to generate new business leads and add new programs and accounts to our existing book of business. This was demonstrated in our alternative risk transfer component, where we added five new captive programs during the first nine months of 2009, contributing approximately \$16.8 million in gross premiums written. These gains in the alternative risk transfer component were offset by decreased exposures in two of our existing truck captives and one of our existing passenger transportation captives, despite nearly a 100% member retention at the common renewal dates, as well as the reduction in our lines of coverage relative to another existing captive product.

The group captive programs, which focus on specialty or niche businesses, provide various services and coverages tailored to meet specific requirements of defined client groups and their members. These services include risk management consulting, claims administration and handling, loss control and prevention and reinsurance placement, along with providing various types of property and casualty insurance coverage. Insurance coverage is provided primarily to companies with similar risk profiles and to specified classes of business of our agent partners.

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As part of our captive programs, we have analyzed, on a quarterly basis, captive members' loss performance on a policy year basis to determine if there would be a premium assessment to participants, or if there would be a return of premium to members as a result of better-than-expected losses. We record assessment premium and return of premium as adjustments to written premium (assessments increase written premium; returns of premium reduce written premium). For the third quarter of 2009 and 2008, we recorded a return of premium of \$1.7 million and \$2.8 million, respectively. For the first nine months of 2009 and 2008, we recorded a return of premium of \$3.2 million and \$5.3 million, respectively.

Our specialty personal lines component increased \$1.4 million, or 3.0%, during the first nine months of 2009 compared to the same period in 2008 primarily due to additional policies in force in our commercial vehicle product from expanded marketing initiatives and product enhancements. The growth in our commercial vehicle product was offset by a decrease in our recreational vehicle product, as the economic downturn has created a decline in the demand for recreational vehicles.

**Premiums Earned**

Three months ended September 30, 2009 compared to September 30, 2008. The following table shows net premiums earned summarized by the broader business component description, which were determined based primarily on similar economic characteristics, products and services:

|                           | <b>Three Months Ended</b>     |             | <b>Change</b>                 |                |
|---------------------------|-------------------------------|-------------|-------------------------------|----------------|
|                           | <b>September 30,<br/>2009</b> | <b>2008</b> | <b>Amount</b>                 | <b>Percent</b> |
|                           |                               |             | <b>(Dollars in thousands)</b> |                |
| Premiums earned:          |                               |             |                               |                |
| Alternative Risk Transfer | \$ 36,695                     | \$ 35,814   | \$ 881                        | 2.5%           |
| Transportation            | 14,300                        | 19,162      | (4,862)                       | (25.4%)        |
| Specialty Personal Lines  | 14,262                        | 14,046      | 216                           | 1.5%           |
| Hawaii and Alaska         | 3,837                         | 4,467       | (630)                         | (14.1%)        |
| Other                     | 1,731                         | 1,569       | 162                           | 10.3%          |
| Net premiums earned       | \$ 70,825                     | \$ 75,058   | \$ (4,233)                    | (5.6%)         |

Our net premiums earned decreased \$4.2 million, or 5.6%, to \$70.8 million during the three months ended September 30, 2009 compared to \$75.0 million for the same period in 2008. This decrease is primarily attributable to the transportation and Hawaii and Alaska components which, compared to 2008, decreased \$4.9 million and \$0.6 million, respectively. Such decreases are primarily attributed to reductions in gross premiums written in these components during the fourth quarter of 2008 and the first nine months of 2009, which is directly related to the effect that the current economic environment has had on our customers and the effects of risk selection and pricing adequacy initiatives. The decreases in the transportation and Hawaii and Alaska components were partially offset by increases in our alternative risk transfer and specialty personal lines components. The alternative risk transfer component increased \$0.9 million, or 2.5%, mainly due to new captive programs introduced in 2008 and throughout 2009, as well as new participants in our existing captive programs. This was partially offset by a decrease attributable to management's decision in 2009 to reduce lines of coverage written in one of our existing captive programs. Our specialty personal lines component increased \$0.2 million, or 1.5%, primarily due to an increase in our commercial vehicle product.

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*Nine months ended September 30, 2009 compared to September 30, 2008.* The following table shows net premiums earned summarized by the broader business component description, which were determined based primarily on similar economic characteristics, products and services:

|                           | <b>Nine Months Ended</b>      |                               | <b>Change</b> |                |
|---------------------------|-------------------------------|-------------------------------|---------------|----------------|
|                           | <b>September 30,<br/>2009</b> | <b>September 30,<br/>2008</b> | <b>Amount</b> | <b>Percent</b> |
|                           | <b>(Dollars in thousands)</b> |                               |               |                |
| Premiums earned:          |                               |                               |               |                |
| Alternative Risk Transfer | \$ 105,680                    | \$ 99,212                     | \$ 6,468      | 6.5%           |
| Transportation            | 46,074                        | 56,882                        | (10,808)      | (19.0%)        |
| Specialty Personal Lines  | 42,127                        | 40,797                        | 1,330         | 3.3%           |
| Hawaii and Alaska         | 11,671                        | 13,393                        | (1,722)       | (12.9%)        |
| Other                     | 4,375                         | 4,237                         | 138           | 3.3%           |
| Net premiums earned       | \$ 209,927                    | \$ 214,521                    | \$ (4,594)    | (2.1%)         |

Our net premiums earned decreased \$4.6 million, or 2.1%, to \$209.9 million during the nine months ended September 30, 2009 compared to \$214.5 million for the same period in 2008. This decrease is primarily attributable to the transportation and Hawaii and Alaska components, which decreased \$10.8 million and \$1.7 million, respectively, compared to 2008, due to reductions in gross premiums written in these components during the fourth quarter of 2008 and the first nine months of 2009. These reductions related to the effect that the current economic environment has had on our customers and the effects of risk selection and pricing adequacy initiatives undertaken in 2008. Partially offsetting these decreases were increases in our alternative risk transfer and specialty personal lines components. Our alternative risk transfer component increased \$6.5 million, or 6.5%, mainly due to new captive programs introduced throughout 2009 and new participants in existing captive programs during 2008 and 2009. Our specialty personal lines component increased \$1.3 million, or 3.3%, due to continued gross premiums written growth in our commercial vehicle product.

***Underwriting and Loss Ratio Analysis***

Underwriting profitability, as opposed to overall profitability or net earnings, is measured by the combined ratio. The combined ratio is the sum of the losses and LAE ratio and the underwriting expense ratio. A combined ratio under 100% is indicative of an underwriting profit. Our underwriting approach is to price our products to achieve an underwriting profit even if we forgo volume as a result. For the three and nine months ended September 30, 2009, we experienced a modest single digit decrease in rate levels on our renewal business due to the continued soft market. The table below presents our net premiums earned and combined ratios for the periods indicated:

|   | <b>Three Months Ended</b>     |                               | <b>Nine Months Ended</b>      |                               |
|---|-------------------------------|-------------------------------|-------------------------------|-------------------------------|
|   | <b>September 30,<br/>2009</b> | <b>September 30,<br/>2008</b> | <b>September 30,<br/>2009</b> | <b>September 30,<br/>2008</b> |
|   | <b>(Dollars in thousands)</b> |                               | <b>(Dollars in thousands)</b> |                               |
| Gross premiums written                    | \$ 69,568                     | \$ 77,451                     | \$ 279,746                    | \$ 312,247                    |
| Ceded reinsurance                         | (10,584)                      | (15,036)                      | (59,875)                      | (72,674)                      |
| Net premiums written                      | 58,984                        | 62,415                        | 219,871                       | 239,573                       |
| Change in unearned premiums, net of ceded | 11,841                        | 12,643                        | (9,944)                       | (25,052)                      |
| Net premiums earned                       | \$ 70,825                     | \$ 75,058                     | \$ 209,927                    | \$ 214,521                    |

|   |       |       |       |       |
|---|-------|-------|-------|-------|
| Combined Ratios:                          |       |       |       |       |
| Loss and LAE ratio <sup>(1)</sup>         | 68.2% | 69.3% | 60.5% | 67.2% |
| Underwriting expense ratio <sup>(2)</sup> | 24.6% | 28.2% | 24.1% | 25.3% |
| Combined ratio                            | 92.8% | 97.5% | 84.6% | 92.5% |

(1) The ratio of losses and LAE to premiums earned.

(2) The ratio of the sum of commissions and other underwriting expenses, other operating expenses less other income to premiums earned.

*Three months ended September 30, 2009 compared to September 30, 2008.* Losses and LAE are a function of the amount and type of insurance contracts we write and of the loss experience of the underlying risks. We seek to establish case reserves at the maximum probable exposure based on our historical claims experience. Our ability to accurately estimate losses and LAE at the

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time of pricing our contracts is a critical factor in determining our profitability. The amount reported under losses and LAE in any period includes payments in the period net of the change in reserves for unpaid losses and LAE between the beginning and the end of the period. The loss and LAE ratio for the third quarter of 2009 decreased 1.1 percentage points to 68.2% compared to 69.3% in the same period in 2008 primarily associated with greater large loss severity in 2008, which was partially offset by higher claims frequency in 2009. During the third quarter of 2008, we experienced large claims concentrated in our charter passenger transportation products which contributed approximately 4 percentage points to the loss ratio during that period, whereas we experienced no large claims in the third quarter of 2009. Offsetting this decrease was an increase in claim frequency related to higher vehicle usage particularly within our recreational vehicle and transportation products. We do not consider elevated severity and/or frequency in the third quarter of any year unusual based on the seasonality associated with the risks we insure. The loss and LAE ratio for the third quarter of 2009 includes a \$0.3 million, or 0.5 percentage points, increase for unfavorable development of losses from prior years compared to favorable development of \$0.3 million, or 0.4 percentage points, in the third quarter of 2008.

Our underwriting expense ratio includes commissions and other underwriting expenses and other operating and general expenses, offset by other income. Commissions and other underwriting expenses consist principally of brokerage and agent commissions reduced by ceding commissions received from assuming reinsurers, and vary depending upon the amount and types of contracts written and, to a lesser extent, premium taxes. The underwriting expense ratio for the third quarter of 2009 decreased 3.6 percentage points to 24.6% compared to 28.2% for the same period in 2008. This decrease is attributable to a one-time state guaranty fund charge which contributed 1.7 percentage points to our third quarter 2008 expense ratio and decreased commission expenses due to a change in our overall mix of business.

*Nine months ended September 30, 2009 compared to September 30, 2008.* The loss and LAE ratio for the nine months ended September 30, 2009 decreased 6.7 percentage points to 60.5% compared to 67.2% in the same period in 2008 primarily due to underwriting improvements that began in the last half of 2008 and have continued during 2009. In addition, we have experienced favorable large claims activity throughout the first nine months of 2009, in part attributable to lower vehicle use by our customers. This is in sharp contrast to the first nine months of 2008 when the results were adversely impacted by an unusual number of severe claims concentrated in our charter passenger transportation product which negatively impacted the loss ratio by approximately 5 percentage points. The loss and LAE ratio for the nine months ended September 30, 2009 includes a \$0.2 million, or 0.1 percentage points, decrease for favorable development of losses from prior years compared to an increase for unfavorable development of losses of \$0.8 million, or 0.4 percentage points, in the first nine months of 2008.

The underwriting expense ratio for the nine months ended September 30, 2009 decreased 1.2 percentage points to 24.1% compared to 25.3% for the same period in 2008. The decrease in our year-to-date 2009 expense ratio is primarily due to a change in our overall mix of business, as many of the new captive programs written in 2009 have lower commission rates compared to the programs where we had high premium growth in 2008.

***Net Investment Income***

*2009 compared to 2008.* For the three and nine month periods ended September 30, 2009, net investment income was \$4.5 million and \$14.4 million, respectively, compared to \$5.5 million and \$16.8 million in the same periods in 2008, reflecting lower yields on our cash, short-term and fixed income portfolios as well as a high allocation to tax exempt state and local government investments. Yields declined throughout 2008 and remained at those levels during the first nine months of 2009 for most investment categories in which we are active.

***Net Realized Gains (Losses) on Investments***

*2009 compared to 2008.* Net realized gains were \$0.8 million for the third quarter of 2009 compared to net realized losses of \$8.5 million for the third quarter of 2008. For the nine months ended September 30, 2009, net realized gains were \$1.8 million compared to net realized losses of \$10.8 million for the nine months ended September 30, 2008. The net realized gains for the third quarter of 2009 were primarily generated from net gains associated with an equity partnership investment of \$1.0 million and \$1.1 million of net realized gains associated with the sales of securities. Offsetting these gains was an other-than-temporary impairment charge of \$1.3 million taken during the third quarter of 2009 related to a corporate note. For the nine months ended September 30, 2009, the net realized gains were

primarily driven by the equity partnership investment which generated net gains of \$3.1 million and net gains due to sales of securities of \$2.2 million. These gains were offset by a \$1.0 million realized loss on the conversion of a perpetual preferred stock to common stock on a financial institution holding, in addition to year-to-date other-than-temporary impairment charges of \$2.5 million. The \$2.5 million charge related to three corporate notes and two mortgage backed securities. In 2008, turmoil in the investment markets resulted in market declines in our portfolio, particularly in our financial and real estate related holdings. This had an adverse impact on our investment portfolio, as we recognized other-than-temporary impairment charges of \$8.0 million and \$10.5 million for the third quarter and first nine months of 2008, respectively.

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These impairment charges related to several perpetual and redeemable preferred stock holdings, one fixed maturity investment with market values that were significantly below cost and securities issued by Fannie Mae, Freddie Mac and Lehman Brothers Holdings Inc.

***Commissions and Other Underwriting Expenses***

*2009 compared to 2008.* During the third quarter of 2009, commissions and other underwriting expenses of \$15.2 million decreased \$3.3 million, or 18.0%, from \$18.5 million in the comparable period in 2008. For the first nine months of 2009 and 2008, commissions and other underwriting expenses were \$43.6 million and \$46.7 million, respectively, decreasing \$3.1 million, or 6.7%. Both the quarter and year-to-date decreases relate to a decrease in net commission expense due to a change in our overall mix of business. Additionally, in the third quarter of 2008 we recorded an approximate \$1.3 million charge for a one-time state guaranty fund which also contributed to the overall decrease in our current year commissions and other underwriting expenses.

***Expense on Amounts Withheld***

*2009 compared to 2008.* We invest funds in the participant loss layer for several of the alternative risk transfer programs. We receive investment income and incur an equal expense on the amounts owed to alternative risk transfer participants. Expense on amounts withheld decreased \$0.2 million, or 19.0%, to \$0.8 million from \$1.0 million for the three months ended September 30, 2009 and 2008, respectively. For the nine months ended September 30, 2009, expense on amounts withheld decreased \$0.7 million, or 20.9%, to \$2.6 million from \$3.3 million in the comparable period in 2008. Both the quarter and year to date decreases are primarily attributable to lower interest rate yields experienced during the first nine months of 2009 compared to 2008.

***Income Taxes***

*2009 compared to 2008.* The effective tax rate was 14.4% and (92.6%) for the three month period ended September 30, 2009 and 2008, respectively. The 2009 year-to-date effective tax rate decreased 18.8 percentage points to 27.9% compared to a 46.7% rate for the same period in 2008. The decrease in our 2009 effective tax rate was favorably impacted, primarily, from a decrease in our valuation allowance associated with capital losses. In the third quarter of 2008, the tax benefit relating to the pre-tax loss was decreased by the recording of a \$3.2 million valuation allowance related to our realized losses, primarily impairment charges, which also increased the year-to-date 2008 effective tax rate by 17.5 percentage points. In the third quarter of 2009 available tax strategies, primarily associated with realized and unrealized gain positions in our investment portfolio, provided for a reduction to the valuation allowance thereby decreasing both our quarter and year-to-date effective tax rates by 18.8 percentage points and 5.3 percentage points, respectively.

***Financial Condition******Investments and Securities Lending Collateral***

During the second quarter of 2009, we terminated our securities lending program and transferred fixed maturities with a fair market value of \$35.8 million, primarily residential mortgage-backed securities and corporate obligations, into our fixed maturities portfolio.

At September 30, 2009, our investment portfolio contained \$523.7 million in fixed maturity securities and \$28.0 million in equity securities, all carried at fair value with unrealized gains and losses reported as a separate component of shareholders' equity on an after-tax basis. At September 30, 2009, we had pre-tax net unrealized gains of \$2.7 million on fixed maturities and pre-tax net unrealized gains of \$2.7 million on equity securities.

At September 30, 2009, 96.1% of the fixed maturities in our portfolio were rated investment grade (credit rating of AAA to BBB-) by nationally recognized rating agencies. Investment grade securities generally bear lower yields and lower degrees of risk than those that are unrated or non-investment grade.

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Summary information for securities with unrealized gains or losses at September 30, 2009 is shown in the following table. Approximately \$2.9 million of fixed maturities and \$12.3 million of equity securities had no unrealized gains or losses at September 30, 2009.

|   | <b>Securities<br/>with<br/>Unrealized<br/>Gains<br/>(Dollars in thousands)</b> | <b>Securities<br/>with<br/>Unrealized<br/>Losses</b> |
|---|--|--|
| <b>Fixed Maturities:</b>                                |  |  |
| Fair value of securities                                | \$451,295  | \$ 69,524  |
| Amortized cost of securities                            | 436,392  | 81,774   |
| Gross unrealized gain or (loss)                         | \$ 14,903  | \$ (12,250)  |
| Fair value as a % of amortized cost                     | 103.4%   | 85.0%  |
| Number of security positions held                       | 357  | 66   |
| Number individually exceeding \$50,000 gain or (loss)   | 117  | 29   |
| Concentration of gains or (losses) by type or industry: |  |  |
| US government and government agencies                   | \$ 2,486   | \$ (21)  |
| State, municipalities and political subdivisions        | 8,129  | (1,497)  |
| Residential mortgage-backed securities                  | 3,010  | (6,433)  |
| Commercial mortgage-backed securities                   |  | (815)  |
| Banks, insurance and brokers                            | 877  | (2,925)  |
| Industrial and other                                    | 401  | (559)  |
| Percentage rated investment grade <sup>(1)</sup>        | 99.4%  | 77.3%  |
| <b>Equity Securities:</b>                               |  |  |
| Fair value of securities                                | \$ 15,282  | \$ 382   |
| Cost of securities                                      | 12,615   | 399  |
| Gross unrealized gain or (loss)                         | \$ 2,667   | \$ (17)  |
| Fair value as a % of cost                               | 121.1%   | 95.7%  |
| Number individually exceeding \$50,000 gain or (loss)   | 8  |  |

(1) Investment grade of AAA to BBB- by nationally recognized rating agencies.

The table below sets forth the scheduled maturities of available for sale fixed maturity securities at September 30, 2009, based on their fair values. Actual maturities may differ from contractual maturities because certain securities may be called or prepaid by the issuers.

|                                       | <b>Fixed Maturities Portfolio<br/>Securities<br/>with<br/>Unrealized<br/>Gains</b> | <b>Securities<br/>with<br/>Unrealized<br/>Losses</b> |
|---------------------------------------|--|--|
| <b>Maturity:</b>                      |  |  |
| Due one year or less                  | 4.1%   | 9.8%   |
| Due after one year through five years | 30.9%  | 25.4%  |

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|  |        |        |
|--|--------|--------|
| Due after five years through ten years | 34.3%  | 9.4%   |
| Due after ten years                    | 7.6%   | 23.2%  |
|  | 76.9%  | 67.8%  |
| Mortgage-backed securities             | 23.1%  | 32.2%  |
|  | 100.0% | 100.0% |

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The table below summarizes the unrealized gains and losses on fixed maturities and equity securities by dollar amount:

|   | <b>At September 30, 2009</b>        |   |  |
|---|-------------------------------------|---|--|
|   | <b>Aggregate<br/>Fair<br/>Value</b> | <b>Aggregate<br/>Unrealized<br/>Gain<br/>(Loss)</b> | <b>Fair<br/>Value<br/>as % of<br/>Cost Basis</b> |
|   | <b>(Dollars in thousands)</b>       |   |  |
| <b>Fixed Maturities:</b>                  |                                     |   |  |
| <b>Securities with unrealized gains:</b>  |                                     |   |  |
| Exceeding \$50,000 and for:               |                                     |   |  |
| Less than one year (113 issues)           | \$ 168,744                          | \$ 9,354  | 105.9%   |
| More than one year (4 issues)             | 6,153                               | 375   | 106.5%   |
| Less than \$50,000 (240 issues)           | 276,398                             | 5,174   | 101.9%   |
|   | \$ 451,295                          | \$ 14,903   |  |
| <b>Securities with unrealized losses:</b> |                                     |   |  |
| Exceeding \$50,000 and for:               |                                     |   |  |
| Less than one year (3 issues)             | \$ 2,135                            | \$ (501)  | 81.0%  |
| More than one year (26 issues)            | 28,385                              | (11,324)  | 71.5%  |
| Less than \$50,000 (37 issues)            | 39,004                              | (425)   | 98.9%  |
|   | \$ 69,524                           | \$ (12,250)   |  |
| <b>Equity Securities:</b>                 |                                     |   |  |
| <b>Securities with unrealized gains:</b>  |                                     |   |  |
| Exceeding \$50,000 and for:               |                                     |   |  |
| Less than one year (8 issues)             | \$ 13,648                           | \$ 2,396  | 121.3%   |
| More than one year (0 issues)             |                                     |   | 0.0%   |
| Less than \$50,000 (18 issues)            | 1,634                               | 271   | 119.9%   |
|   | \$ 15,282                           | \$ 2,667  |  |
| <b>Securities with unrealized losses:</b> |                                     |   |  |
| Exceeding \$50,000 and for:               |                                     |   |  |
| Less than one year (0 issues)             | \$                                  | \$  | 0.0%   |
| More than one year (0 issue)              |                                     |   | 0.0%   |
| Less than \$50,000 (4 issues)             | 382                                 | (17)  | 95.7%  |
|   | \$ 382                              | \$ (17)   |  |

When a decline in the value of a specific investment is considered to be other-than-temporary, a provision for impairment is charged to earnings (accounted for as a realized loss) and the cost basis of that investment is reduced. The determination of whether unrealized losses are other-than-temporary requires judgment based on subjective as well as objective factors. Factors considered and resources used by management include those discussed in Management's Discussion and Analysis of Financial Condition and Results of Operations Critical Accounting Policies

Other-Than-Temporary Impairment.

***Premiums and Reinsurance***

In the alternative risk transfer component, under most group captive programs, all members of the group share a common renewal date. These common renewal dates are scheduled throughout the year. However, we have several large captives that renew during the first six months of a given fiscal year. The captive renewals in the first six months result in a large increase in premiums receivable, unearned premiums, prepaid reinsurance premiums and reinsurance balances payable during the first half of a given fiscal year. These increases continually decrease through the year. Premiums receivable increased \$22.7 million, or 23.7%, and unearned premiums increased \$14.4 million, or 9.2%, from December 31, 2008 to September 30, 2009. The increase in premiums receivable and unearned premiums is primarily due to an increase in direct premiums written in the first six months of 2009 as compared to the last six months of 2008.

Prepaid reinsurance premiums increased \$4.3 million, or 15.2%, and reinsurance balances payable increased \$5.6 million, or 54.6%, from December 31, 2008 to September 30, 2009. The increase in prepaid reinsurance premiums and reinsurance balances payable is primarily due to an increase in ceded premium for the first six months of 2009 as compared to the last six months of 2008.

**Liquidity and Capital Resources**

The liquidity requirements of our insurance subsidiaries relate primarily to the liabilities associated with their products as well as operating costs and payments of dividends and taxes to us from insurance subsidiaries. Historically and during the first nine months of 2009, cash flows from premiums and investment income have provided more than sufficient funds to meet these requirements, without requiring the sale of investments. If our cash flows change dramatically from historical patterns, for example as a result of a decrease in premiums or an increase in claims paid or operating expenses, we may be required to sell securities

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before their maturity and possibly at a loss. Our insurance subsidiaries generally hold a significant amount of highly liquid, short-term investments or cash and cash equivalents to meet their liquidity needs. Our historic pattern of using receipts from current premium writings for the payment of liabilities incurred in prior periods has enabled us to extend slightly the maturities of our investment portfolio beyond the estimated settlement date of our loss reserves. Funds received in excess of cash requirements are generally invested in additional marketable securities.

We believe that our insurance subsidiaries maintain sufficient liquidity to pay claims and operating expenses, as well as meet commitments in the event of unforeseen events such as reserve deficiencies, inadequate premium rates or reinsurer insolvencies. Our principal sources of liquidity are our existing cash, cash equivalents and short-term investments. Cash, cash equivalents and short-term investments decreased \$19.4 million from \$77.2 million at December 31, 2008 to \$57.8 million at September 30, 2009. Net cash provided by operating activities was \$42.3 million during the nine month period ended September 30, 2009, compared to \$81.3 million during the comparable period in 2008. This decrease of \$39.0 million is primarily attributable to a large amount of claims payments being made during the first nine months of 2009 and a reduction in our premiums written in the first nine months of 2009 compared to the same period in 2008.

Net cash used in investing activities was \$11.1 million for the nine months ended September 30, 2009, as compared to \$56.9 million during the same period in 2008. This \$45.8 million decrease in cash used in investing activities was primarily related to a \$70.6 million decrease in the purchase of fixed maturity investments in 2009, which was offset by a \$62.6 million decrease in the proceeds from maturities and redemptions of investments and an increase of \$38.3 million in the proceeds from the sale of fixed maturity securities. The decrease in both purchases and redemptions of fixed maturity investments in 2009, compared to the prior period was primarily due to a shift in asset allocation from callable U.S. government agency bonds into longer duration state and local government bonds and residential collateralized mortgage-backed securities. The increase in proceeds from the sale of fixed maturity securities was the result of taking advantage of improving market conditions to realize gains on portions of our fixed maturity portfolio.

We utilized net cash of \$50.6 million and \$2.7 million from financing activities for the nine months ended September 30, 2009 and 2008, respectively. The \$47.9 million increase in net cash used in financing activities was primarily driven by the termination of our securities lending program in June 2009. During 2009 and prior to the program's termination, approximately \$22.1 million of investments within our securities lending collateral matured and were used to pay down a corresponding amount of our securities lending obligation. Upon the program's termination, cash on hand and securities lending collateral were used to pay off the remaining \$73.7 million securities lending obligation. Securities lending collateral that had an original cost of \$46.5 million at the termination date were retained by us and are included in our fixed maturities portfolio through a non-cash transaction.

We will have continuing cash needs for administrative expenses, the payment of principal and interest on borrowings, shareholder dividends and taxes. Funds to meet these obligations will come primarily from parent company cash, dividends and other payments from our insurance company subsidiaries and from our line of credit.

We have a \$50 million unsecured Credit Agreement (the "Credit Agreement") that terminates in December 2012, which includes a sublimit of \$10 million for letters of credit. We have the ability to increase the line of credit to \$75 million subject to the Credit Agreement's accordion feature. Amounts borrowed bear interest at either (1) a rate per annum equal to the greater of the administrative agent's prime rate or 0.5% in excess of the federal funds effective rate or (2) rates ranging from 0.45% to 0.90% over LIBOR based on our A.M. Best insurance group rating, or 0.65% at September 30, 2009. Commitment fees on the average daily unused portion of the Credit Agreement also vary with our A.M. Best insurance group rating and range from 0.090% to 0.175%, or 0.125% at September 30, 2009.

The Credit Agreement requires us to maintain specified financial covenants measured on a quarterly basis, including consolidated net worth, fixed charge coverage ratio and debt-to-capital ratio. In addition, the Credit Agreement contains certain affirmative and negative covenants, including negative covenants that limit or restrict our ability to, among other things, incur additional indebtedness, effect mergers or consolidations, make investments, enter into asset sales, create liens, enter into transactions with affiliates and other restrictions customarily contained in such agreements. As of September 30, 2009, we were in compliance with all financial covenants.

On May 23, 2008, we drew \$15 million from our Credit Agreement to redeem in full our outstanding junior subordinated debentures, replacing higher variable rate debt of LIBOR plus 420 basis points with lower variable rate debt. As of September 30, 2009, the interest rate on this debt is equal to the six-month LIBOR (1.2% at May 26, 2009) plus 65 basis points, with interest payments due quarterly.

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We believe that funds generated from operations, including dividends from insurance subsidiaries, parent company cash and funds available under our Credit Agreement will provide sufficient resources to meet our liquidity requirements for at least the next 12 months. However, if these funds are insufficient to meet fixed charges in any period, we would be required to generate cash through additional borrowings, sale of assets, sale of portfolio securities or similar transactions. If we were required to sell portfolio securities early for liquidity purposes rather than holding them to maturity, we would recognize gains or losses on those securities earlier than anticipated. Our ongoing corporate initiatives include actively evaluating potential acquisitions. At such time that we would execute an agreement to enter into an acquisition, such a transaction, depending upon the structure and size, could have an impact on our liquidity. If we were forced to borrow additional funds in order to meet liquidity needs, we would incur additional interest expense, which could have a negative impact on our earnings. Since our ability to meet our obligations in the long term (beyond a 12-month period) is dependent upon factors such as market changes, insurance regulatory changes and economic conditions, no assurance can be given that the available net cash flow will be sufficient to meet our operating needs.

**Critical Accounting Policies**

The preparation of financial statements in conformity with U.S. generally accepted accounting principles ( GAAP ) requires management to make estimates and assumptions that affect amounts reported in the financial statements. As more information becomes known, these estimates and assumptions could change and thus impact amounts reported in the future. Management believes that the establishment of losses and LAE reserves and the determination of other-than-temporary impairment on investments are the two areas where the degree of judgment required in determining amounts recorded in the financial statements make the accounting policies critical. For a more detailed discussion of these policies, see Management's Discussion and Analysis of Financial Condition and Results of Operations Critical Accounting Policies in our Annual Report on Form 10-K for the year ended December 31, 2008.

**Losses and LAE Reserves**

Significant periods of time can elapse between the occurrence of an insured loss, the reporting of that loss to us and our final payment of that loss, and its related LAE. To recognize liabilities for unpaid losses, we establish reserves as balance sheet liabilities. At September 30, 2009 and December 31, 2008, we had \$417.8 million and \$400.0 million, respectively, of gross loss and LAE reserves, representing management's best estimate of the ultimate loss. Management records, on a monthly and quarterly basis, its best estimate of loss reserves. For purposes of computing the recorded reserves, management utilizes various data inputs, including analysis that is derived from a review of prior quarter results performed by actuaries employed by Great American. On an annual basis, actuaries from Great American, utilizing current period data, review the recorded reserves for NIIC, NIIC-HI and TCC. The actuaries provide a Statement of Actuarial Opinion, required annually in accordance with state insurance regulations, on the statutory reserves recorded by these U.S. insurance subsidiaries. The actuarial analysis of NIIC's, NIIC-HI's and TCC's net reserves for the year ending December 31, 2008 reflected point estimates that were within 2% of management's recorded net reserves as of such date. Using this actuarial data along with its other data inputs, management concluded that the recorded reserves appropriately reflect management's best estimates of the liability as of September 30, 2009 and December 31, 2008.

The quarterly reviews of unpaid loss and LAE reserves by Great American actuaries are prepared using standard actuarial techniques. These may include (but may not be limited to):

the Case Incurred Development Method;

the Paid Development Method;

the Bornhuetter-Ferguson Method; and

the Incremental Paid LAE to Paid Loss Methods.

The period of time from the occurrence of a loss through the settlement of the liability is referred to as the tail. Generally, the same actuarial methods are considered for both short-tail and long-tail lines of business because most of them work properly for both. The methods are designed to incorporate the effects of the differing length of time to

settle particular claims. For short-tail lines, management tends to give more weight to the Case Incurred and Paid Development Methods, although the various methods tend to produce similar results. For long-tail lines, more judgment is involved, and more weight may be given to the Bornhuetter-Ferguson Method. Liability claims for long-tail lines are more susceptible to litigation and can be significantly affected by changing contract interpretation and the legal environment. Therefore, the estimation of loss reserves for these classes is more complex and subject to a higher degree of variability.

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Supplementary statistical information is reviewed to determine which methods are most appropriate and whether adjustments are needed to particular methods. This information includes:

open and closed claim counts;

average case reserves and average incurred on open claims;

closure rates and statistics related to closed and open claim percentages;

average closed claim severity;

ultimate claim severity;

reported loss ratios;

projected ultimate loss ratios; and

loss payment patterns.

***Other-Than-Temporary Impairment***

Our investments are exposed to at least one of three primary sources of investment risk: credit, interest rate and market valuation risks. The financial statement risks are those associated with the recognition of impairments and income, as well as the determination of fair values. We evaluate whether other-than-temporary impairments have occurred on a case-by-case basis. Management considers a wide range of factors about the security issuer and uses its best judgment in evaluating the cause and amount of decline in the estimated fair value of the security and in assessing the prospects for near-term recovery. Inherent in management's evaluation of the security are assumptions and estimates about the operations of the issuer and its future earnings potential. Considerations we use in the impairment evaluation process include, but are not limited to:

the length of time and the extent to which the market value has been below amortized cost;

whether the issuer is experiencing significant financial difficulties;

economic stability of an entire industry sector or subsection;

whether the issuer, series of issuers or industry has a catastrophic type of loss;

the extent to which the unrealized loss is credit-driven or a result of changes in market interest rates or conditions;

historical operating, balance sheet and cash flow data;

internally generated financial models and forecasts;

our ability and current intent to hold the investment for a period of time sufficient to allow for any anticipated recovery in market value; and

other subjective factors, including concentrations and information obtained from regulators and rating agencies.

We closely monitor each investment that has a market value that is below its amortized cost and make a determination each quarter for other-than-temporary impairment for each of those investments. During the three and nine months ended September 30, 2009, we recorded \$1.3 million and \$2.5 million, respectively, in other-than-temporary

impairments on investments that had all experienced credit issues. The \$1.3 million in other-than-temporary impairment charges taken during the third quarter of 2009 relate to one corporate note in the financial services sector. Due to deteriorating business prospects and credit ratings on this investment, as well as the possibility that we may sell this security in the near future, the entire unrealized loss of \$1.3 million is fully recognized as an impairment charge in earnings. In addition to the \$1.3 million charge, the nine months ended September 30, 2009 was also impacted by other-than-temporary impairment charges on several fixed maturity investments of \$0.7 million, which were fully recognized in earnings and on two non-agency mortgage backed securities. The other-than-temporary impairment charge on the two mortgage backed securities was separated into: a credit loss of \$0.5 million which is recognized in earnings and

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a non-credit loss of \$3.0 million, which is included in other comprehensive income. The credit loss of \$0.5 million was the result of management's analysis that indicated we may not receive the full principal amounts due to potential defaults on the mortgage loans underlying the mortgage-backed securities.

For the three and nine months ended September 30, 2008, we recorded other-than-temporary impairment charges of \$8.0 million and \$10.5 million, respectively, as these charges were directly related to adverse market conditions that began in the last half of 2007 and continued into the first nine months of 2008. Of the \$8.0 million other-than-temporary impairments taken during the third quarter of 2008, \$5.8 million related to securities issued by Fannie Mae, Freddie Mac and Lehman Brothers Holdings Inc., \$1.6 million related to securities in the financial and real estate sector and \$0.6 million related to an insurance sector and other corporate holding. Also impacting the nine months ended September 30, 2008 were \$1.9 million in preferred stock securities in the financial sector and a fixed maturity holding of \$0.6 million as these securities experienced credit issues that in our estimation made recovery of the cost of our investments unlikely. In all instances of calculating an other-than-temporary impairment loss we adjusted the cost or amortized cost of the investment down to its fair market value or expected discounted cash flows, where applicable. Due to inherent uncertainty in the market, it is not possible to accurately predict if or when a specific security will become impaired. As such, charges for other-than-temporary impairment could be material to net income in subsequent quarters. Management believes it is not likely that future impairment charges will have a significant effect on our liquidity. See Management's Discussions and Analysis of Financial Condition and Results of Operations Investments.

**Contractual Obligations/Off-Balance Sheet Arrangements**

During the first nine months of 2009, our contractual obligations did not change materially from those discussed in our Annual Report on Form 10-K for the year ended December 31, 2008 with the exception that we terminated our securities lending program during 2009 and therefore there is no longer an outstanding obligation related to such program.

We do not currently have any relationships with unconsolidated entities of financial partnerships, such as entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes.

**ITEM 3. Quantitative and Qualitative Disclosures About Market Risk**

As of September 30, 2009, there were no material changes to the information provided in our Annual Report on Form 10-K for the year ended December 31, 2008 under Item 7A Quantitative and Qualitative Disclosures About Market Risk.

**ITEM 4. Controls and Procedures**

Our management is responsible for establishing and maintaining effective disclosure controls and procedures, as defined under Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934. Our management, with participation of our Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of our disclosure controls and procedures (as defined in Rule 13a-15(e)) as of September 30, 2009. Based on that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of September 30, 2009, to ensure that information required to be disclosed by us in reports that we file or submit under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

There have been no significant changes in our internal controls over financial reporting or in other factors that have occurred during the quarter ended September 30, 2009 that have materially affected, or are reasonably likely to affect, our internal control over financial reporting.

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**PART II OTHER INFORMATION**

**ITEM 1. Legal Proceedings.**

There are no material changes from the legal proceedings previously reported in our Annual Report on Form 10-K for the year ended December 31, 2008. For more information regarding such legal matters please refer to Item 3 of our Annual Report on Form 10-K for the year ended December 31, 2008, Note 16 to the Consolidated Financial Statements included therein and Note 11 to the Consolidated Financial Statements contained in this quarterly report.

**ITEM 1A. Risk Factors.**

There are no material changes to the risk factors previously reported in our Annual Report on Form 10-K for the year ended December 31, 2008. For more information regarding such risk factors, please refer to Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2008.

**ITEM 2. Unregistered Sales of Equity Securities and Use of Proceeds.**

None.

**ITEM 3. Defaults Upon Senior Securities.**

None.

**ITEM 4. Submission of Matters to a Vote of Security Holders.**

None.

**ITEM 5. Other Information.**

None.

**ITEM 6. Exhibits.**

- 3.1 Amended and Restated Articles of Incorporation <sup>(1)</sup>
- 3.2 Amended and Restated Code of Regulations <sup>(1)</sup>
- 31.1 Certification of Chief Executive Officer pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 31.2 Certification of Chief Financial Officer pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 32.1 Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 32.2 Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

<sup>(1)</sup> These exhibits are incorporated by reference to our Registration Statement on Form S-1, as amended (Registration No. 333-119270) filed on November 12, 2004.



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**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

NATIONAL INTERSTATE CORPORATION

Date: November 4, 2009

/s/ David W. Michelson  
David W. Michelson  
President and Chief Executive Officer  
(Duly Authorized Officer and Principal Executive Officer)

Date: November 4, 2009

/s/ Julie A. McGraw  
Julie A. McGraw  
Vice President and Chief Financial Officer  
(Duly Authorized Officer and Principal Financial Officer)

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