Financial Statements – Statutory Basis and Supplementary Information

State National Insurance Company, Inc.
Years Ended December 31, 2011 and 2010
With Report of Independent Auditors

Ernst & Young LLP

Ernst & Young

State National Insurance Company, Inc.

Financial Statements – Statutory Basis
and Supplementary Information

Years Ended December 31, 2011 and 2010

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Report of Independent Auditors

The Board of Directors
State National Insurance Company, Inc.

We have audited the accompanying statutory-basis balance sheets of State National Insurance Company, Inc. as of December 31, 2011 and 2010, and the related statutory-basis statements of income, changes in capital and surplus, and cash flow for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We were not engaged to perform an audit of the Company's internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described in Note 1 to the financial statements, the Company presents its financial statements in conformity with accounting practices prescribed or permitted by the Texas Department of Insurance, which practices differ from U.S. generally accepted accounting principles. The variances between such practices and U.S. generally accepted accounting principles and the effects on the accompanying financial statements are described in Note 7.

In our opinion, because of the effects of the matter described in the preceding paragraph, the financial statements referred to above do not present fairly, in conformity with U.S. generally accepted accounting principles, the financial position of State National Insurance Company, Inc. at December 31, 2011 and 2010, or the results of its operations or its cash flows for the years then ended.

However, in our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of State National Insurance Company, Inc. at December 31, 2011 and 2010, and the results of its operations and its cash flows for the years then ended, in conformity with accounting practices prescribed or permitted by the Texas Department of Insurance.

Ernst & Young LLP

May 10, 2012

State National Insurance Company, Inc.

Balance Sheets – Statutory Basis

	December 31	
	2011	**2010**
Admitted assets		
Bonds	**$ 98,262,895**	$ 94,008,670
Preferred stocks	**1,123,115**	758,708
Common stocks	**18,162**	–
Common stocks of affiliates	**52,758,614**	49,453,492
Real estate, net	**16,517,746**	17,295,536
Cash, cash equivalents, and short-term investments	**14,233,494**	13,718,671
Total cash and invested assets	**182,914,026**	175,235,077
Agents' balances receivable	**10,627,563**	12,498,136
Reinsurance receivables	**4,079,785**	4,385,100
Equipment, net	**14,276**	26,367
Deferred taxes recoverable, net	**4,825,920**	4,406,665
Other assets	**1,915,753**	1,923,872
Total admitted assets	**$ 204,377,323**	$ 198,475,217
Liabilities and capital and surplus		
Liabilities:		
Unpaid losses and loss adjustment expenses	**$ 5,306,773**	$ 6,578,611
Unearned premiums	**21,475,812**	22,719,434
Ceded reinsurance premiums payable	**7,032,599**	7,272,826
Reinsurance payables	**3,977,177**	3,974,977
Agents' balances payable	**1,044,463**	1,411,863
Commissions payable	**5,995,940**	6,418,639
Taxes, licenses, and fees payable	**679,215**	1,235,449
Federal income taxes payable	**203,019**	37,487
Payable to affiliates	**2,498,387**	3,605,101
Deferred ceding fees	**9,014,717**	7,775,151
Guaranty fund payable	**15,218**	344,622
Other liabilities	**6,425,637**	5,743,266
Total liabilities	**63,668,957**	67,117,426
Capital and surplus:		
Common stock, $1 par value, 6,500,000 shares authorized; 3,500,000 shares issued and outstanding	**3,500,000**	3,500,000
Paid-in surplus	**32,998,230**	32,998,230
Unassigned surplus	**104,210,136**	94,859,561
Total capital and surplus	**140,708,366**	131,357,791
Total liabilities and capital and surplus	**$ 204,377,323**	$ 198,475,217

See accompanying notes.

State National Insurance Company, Inc.

Statements of Income – Statutory Basis

	Year Ended December 31 2011	2010
Underwriting income:		
Premiums written	**$ 51,925,610**	$ 59,936,220
Change in unearned premiums	**1,243,622**	(197,183)
Premiums earned	**53,169,232**	59,739,037
Losses and loss adjustment expenses	**20,994,611**	24,041,690
Commissions	**1,609,875**	6,266,225
Taxes, licenses, and fees	**9,527,614**	9,146,565
Management fees, affiliate	**12,835,510**	11,977,155
Other underwriting expenses	**3,923,120**	4,315,017
Net underwriting income	**4,278,502**	3,992,385
Investment income:		
Net investment income	**4,048,607**	4,233,563
Net realized investment gains, net of tax	**241,465**	614,027
Net investment income	**4,290,072**	4,847,590
Other income	**124,276**	14,536
Income before federal income taxes	**8,692,850**	8,854,511
Federal income tax expense	**3,001,256**	1,717,612
Net income	**$ 5,691,594**	$ 7,136,899

See accompanying notes.

State National Insurance Company, Inc.

Statements of Changes in Capital and Surplus – Statutory Basis

	Common Stock	Paid-In Surplus	Unassigned Surplus	Total
Balance at December 31, 2009	$ 3,500,000	$ 32,998,230	$ 84,873,793	$ 121,372,023
Net income	–	–	7,136,899	7,136,899
Change in net unrealized capital gains	–	–	3,491,042	3,491,042
Change in net deferred taxes	–	–	(1,071,769)	(1,071,769)
Change in nonadmitted assets	–	–	429,596	429,596
Balance at December 31, 2010	3,500,000	32,998,230	94,859,561	131,357,791
Net income	**–**	**–**	**5,691,594**	**5,691,594**
Change in net unrealized capital gains	**–**	**–**	**3,250,784**	**3,250,784**
Change in net deferred taxes	**–**	**–**	**390,886**	**390,886**
Change in nonadmitted assets	**–**	**–**	**17,311**	**17,311**
Balance at December 31, 2011	**$ 3,500,000**	**$ 32,998,230**	**$ 104,210,136**	**$ 140,708,366**

See accompanying notes.

State National Insurance Company, Inc.

Statements of Cash Flow – Statutory Basis

	Year Ended December 31	
	2011	**2010**
Operating activities		
Premiums collected, net of reinsurance	**$ 53,308,414**	$ 57,986,872
Net investment income received	**5,521,901**	4,783,549
Losses and loss adjustment expenses paid	**(22,266,449)**	(26,248,313)
Received from affiliates for reinsurance settlements	**469,094**	264,695
Commissions and expenses paid	**(28,682,489)**	(20,548,779)
Federal income taxes paid	**(3,074,426)**	(2,305,303)
Miscellaneous income	**124,274**	14,536
Net cash provided by operations	**5,400,319**	13,947,257
Investing activities		
Proceeds from sales and maturities of investments	**19,336,676**	25,632,820
Cost of investment securities acquired	**(24,219,560)**	(37,176,172)
Cost of real estate acquired	**(2,612)**	(411,605)
Net cash used in investing activities	**(4,885,496)**	(11,954,957)
Net change in cash, cash equivalents, and short-term investments	**514,823**	1,992,300
Cash, cash equivalents, and short-term investments:		
Cash, cash equivalents, and short-term investments at beginning of year	**13,718,671**	11,726,371
Cash, cash equivalents, and short-term investments at end of year	**$ 14,233,494**	$ 13,718,671

See accompanying notes.

State National Insurance Company, Inc.

Notes to Financial Statements – Statutory Basis

December 31, 2011

1. Summary of Significant Accounting Policies

Business

State National Insurance Company, Inc. (SNIC or the Company), a Texas corporation, is a wholly owned subsidiary of State National Intermediate Holdings, Inc. (SNIH). SNIH's ultimate parent is State National Companies, Inc. (SNC). The Company owns 100% of National Specialty Insurance Company (NSIC) and 100% of United Specialty Insurance Company (USIC), which are reflected in the balance sheets as common stocks of affiliates.

The Company writes Collateral Protection Insurance (CPI) and Guaranteed Auto Protection (GAP) through TBA Insurance Group, Ltd. (TBA), an affiliate. The Company also writes program business, which includes distinct books of personal and commercial lines of business produced by program managers. A majority of the risk associated with program business is ceded to unaffiliated, highly rated reinsurance companies.

SNIC entered into a pooling arrangement with NSIC in 2002 and with USIC in 2006, whereby NSIC and USIC cede 100% of their net business to SNIC, and SNIC retrocedes 10% and 25% of the companies' combined net business to NSIC and USIC, respectively (see Note 18 regarding changes to the pooling arrangement subsequent to December 31, 2011). The cessions to unaffiliated reinsurers are prior to the cession of the pooled business.

Basis of Presentation

The accompanying financial statements have been prepared in conformity with statutory accounting practices prescribed or permitted by the Texas Department of Insurance (the Department). Such practices vary from U.S. generally accepted accounting principles (GAAP). The National Association of Insurance Commissioners' (NAIC) *Accounting Practices and Procedures Manual* has been adopted as a component of prescribed practices by the State of Texas (NAIC SAP), subject to certain deviations permitted by the State of Texas Commissioner of Insurance. For the Company, there are no significant differences between Texas prescribed practices and the NAIC's *Accounting Practices and Procedures Manual*. The Company's permitted statutory accounting practices encompass all accounting practices prescribed by the Department. Such practices differ from state to state, may differ from company to company within a state, and may change in the future. A reconciliation of SNIC's shareholder's equity and net income from NAIC SAP to GAAP is presented in Note 7.

1. Summary of Significant Accounting Policies (continued)

The significant differences between statutory accounting practices prescribed by the Department and GAAP are as follows:

Investments: Investments in bonds are reported at amortized cost or fair value based on their NAIC rating; for GAAP, such bonds would be designated at purchase as held-to-maturity, trading, or available-for-sale. Held-to-maturity bonds would be reported at amortized cost. Those investments designated as trading would be reported at fair value with unrealized holding gains and losses reported in operations. For those investments designated as available-for-sale, unrealized gains and losses are reported as a separate component of other comprehensive income, net of the related deferred taxes.

Policy Acquisition Costs: The costs of acquiring and renewing business are charged to current operations as incurred. Under GAAP, those costs that vary with and are primarily related to the acquisition of new and renewal insurance contracts, to the extent recoverable, would be deferred and amortized over the effective period of the related insurance policies.

Nonadmitted Assets: Certain assets designated as “nonadmitted” are excluded from the accompanying balance sheets and are charged directly to unassigned surplus. Under GAAP, such assets are included in the balance sheet to the extent that those assets are not impaired.

Premiums and Unearned Premiums: Return premiums, corresponding unearned premiums, and commissions for certain lines of business of the pooled group are charged to current operations as incurred. Under GAAP, an allowance for policy cancellations is provided for the estimated amount of return premiums and policy fees, net of commission expense and premium taxes that will be incurred on expected future policy cancellations associated with the Company’s business. This allowance is based on the Company’s historical cancellation experience. Under NAIC SAP, unearned premiums are calculated on a pro rata basis over the policy terms for all policies in force. Under GAAP, unearned premiums are calculated on a pro rata basis after consideration of these expected future policy cancellations.

Reinsurance: Reserves for losses and loss adjustment expenses and unearned premiums ceded to reinsurers have been reported as reductions of the related reserves rather than as assets as would be required under GAAP.

1. Summary of Significant Accounting Policies (continued)

Deferred Taxes: Deferred tax assets (DTAs) are limited to (a) the amount of federal income taxes paid in prior years that can be recovered through loss carrybacks for existing temporary differences that reverse by the end of the subsequent calendar year, plus (b) the lesser of the remaining gross deferred tax assets expected to be realized within one year of the balance sheet date or 10% of capital and surplus excluding any net deferred tax assets, electronic data processing equipment and operating software, and any net positive goodwill, plus (c) the amount of remaining gross deferred tax assets that can be offset against existing gross deferred tax liabilities. The remaining deferred tax assets are nonadmitted. Deferred taxes do not include amounts for state income taxes. Under GAAP, state income taxes are included in the computation of deferred taxes, a deferred tax asset is recorded for the amount of gross deferred tax assets expected to be realized in all future years, and a valuation allowance is established for deferred tax assets that are not realizable.

Statements of Cash Flow: Cash, cash equivalents, and short-term investments represent cash balances and investments with initial maturities of one year or less. Under GAAP, the corresponding caption of cash and cash equivalents includes cash balances and investments with initial maturities of three months or less.

Permitted Practices

Through December 31, 2010, the Company received permission from the Department to record commercial trucking premiums written through program managers in a manner that differs from NAIC SAP. The Company records premiums on a monthly basis, based upon information provided by the insured (typically the number of miles driven). There was no material monetary effect on 2010 net income or statutory surplus from the use of this practice. This permitted practice was not effective for the year ended December 31, 2011.

The Company has received permission from the Department for recording fees receivable from general agents or program managers in a manner that differs from NAIC SAP. According to the permitted practice, fees not associated with premiums that are due from general agents and program managers are recorded as an aggregate write-in for other-than-invested assets. There is no monetary effect on 2011 or 2010 net income or statutory surplus from the use of this practice.

1. Summary of Significant Accounting Policies (continued)

Investments

Bonds are stated at amortized cost using the interest method or fair value, based on their NAIC rating. Preferred stocks are carried at cost or fair value, based on their NAIC rating. Single-class and multi-class mortgage-backed/asset-backed securities are valued at amortized cost using the interest method, including anticipated prepayments. Prepayment assumptions are obtained from broker-dealer surveys and are based on the current interest rate and economic environment. The prospective adjustment method is used to value all such securities. Realized gains and losses on sales of investments are determined on a specific identification basis. Unrealized gains and losses on preferred and common stocks, also determined on a specific identification basis, are recorded as changes in surplus.

Common stocks of affiliates reflect SNIC's investments in NSIC and USIC, which are carried at the underlying statutory equity of the subsidiaries.

Investments are evaluated quarterly to determine whether any declines in fair value, below the cost basis, are other-than-temporary. If a decline in fair value is deemed to be other-than-temporary, the cost basis of the individual investment is written down to fair value, which becomes the new cost basis. The amount of the write-down is included in the statement of income as a realized loss.

In 2011, all investment income due and accrued was less than 90 days past due. In 2010, the company excluded $20,653 due and accrued investment income from surplus for one security that was over 90 days past due.

Cash, cash equivalents, and short-term investments include securities with remaining maturities of one year or less at the time of acquisition and are stated at amortized cost. The carrying amount approximates fair value.

Real Estate, Equipment, and Depreciation

Land held for use is recorded at cost. Land held for sale is recorded at net realizable value. Building, building improvements, and equipment are recorded at depreciated cost. Depreciation on the building, building improvements, and equipment is computed using the straight-line method over estimated useful lives of two to twenty years.

1. Summary of Significant Accounting Policies (continued)

Unpaid Losses and Loss Adjustment Expenses

The liability for unpaid losses and loss adjustment expenses includes an estimate for claims reported and an additional liability for claims incurred but not reported, based on the Company's historical loss experience. Ceded unpaid losses and loss adjustment expenses (LAE) are reflected as reductions of direct loss and LAE reserves. While the Company's management (Management) believes the amounts included in the financial statements are adequate, such estimates may be more or less than the amounts ultimately paid when the claims are settled. These estimates are continually reviewed and adjusted as experience develops or new information becomes known and any necessary adjustments are included in current operations. The Company does not discount unpaid losses and LAE.

Program Business

In connection with writing program business, the Company enters into contractual agreements with both the producing program managers and reinsurers, whereby the program managers and reinsurers are obligated to each other for payment of insurance amounts, including premiums, commissions, and losses. These funds do not flow through the Company, but are settled directly between the program manager and the reinsurer; accordingly, no receivables or payables are recorded for these amounts. All obligations of SNIC owed to or on behalf of its policyholders are recorded by the Company, and, to the extent appropriate, offsetting reinsurance recoverables are recorded. Reinsurance receivables and payables and agents' balances receivable and payable recorded in the balance sheets are carried at cost, which approximates fair value.

Deferred Ceding Fees

Ceding fees are deferred and recognized on a pro rata basis over the terms of the underlying policies and are included as a contra-expense in commissions in the statements of income.

Premiums

Premium revenue is recognized on a pro rata basis over the terms of the policies, with the exception of GAP premium revenue, which is recognized using the rule of 78 method. Ceded premiums earned and unearned are reflected as reductions of direct and assumed premiums earned and unearned, respectively. Anticipated investment income is not utilized as a factor in the premium deficiency calculation.

1. Summary of Significant Accounting Policies (continued)

Reinsurance

Reinsurance premiums and unpaid losses and LAE are accounted for on bases consistent with those used in accounting for the original policies issued and the terms of the reinsurance contracts.

Commissions

The Company incurs a provisional commission on direct, assumed, and ceded premiums upon policy issuance. This commission expense is subject to retroactive adjustment based upon the claims experience of the policies produced and is recorded when incurred.

Other Liabilities

Other liabilities consist mainly of prepaid assessments collected from program managers and payables to service organizations.

Estimates

The preparation of financial statements in conformity with NAIC SAP requires Management to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the dates of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from these estimates.

2. Investments

The book/adjusted carrying value, unrealized gains and losses, and the fair value of the Company's bonds are summarized as follows:

	Book/Adjusted Carrying Value	Unrealized Gains	Unrealized Losses	Fair Value
December 31, 2011				
Bonds:				
Government	**$ 3,402,257**	**$ 289,997**	**$ –**	**$ 3,692,254**
Government agency	**537,172**	**37,894**	**–**	**575,066**
State and municipality	**22,973,759**	**1,358,722**	**–**	**24,332,481**
Industrial and miscellaneous	**25,549,630**	**1,767,113**	**(214,830)**	**27,101,913**
Residential mortgage-backed	**39,092,822**	**1,640,740**	**(228,319)**	**40,505,243**
Commercial mortgage-backed	**6,707,255**	**399,639**	**–**	**7,106,894**
Total bonds	**$ 98,262,895**	**$ 5,494,105**	**$ (443,149)**	**$ 103,313,851**
December 31, 2010				
Bonds:				
Government	$ 3,412,586	$ 255,664	$ –	$ 3,668,250
Government agency	542,789	32,616	–	575,405
State and municipality	23,352,968	776,959	(127,810)	24,002,117
Industrial and miscellaneous	23,304,541	1,616,313	(84,854)	24,836,000
Residential mortgage-backed	34,457,911	1,012,253	(446,939)	35,023,225
Commercial mortgage-backed	8,937,875	473,571	–	9,411,446
Total bonds	$ 94,008,670	$ 4,167,376	$ (659,603)	$ 97,516,443

Bonds that carry NAIC designations of 3 to 6 are reflected in the balance sheets at lower of amortized cost or fair value. As a result, the amortized cost of bonds at December 31, 2011 and 2010, has been reduced by $85,291 and $7,919, respectively.

2. Investments (continued)

The book/adjusted carrying value, unrealized gains and losses, and fair value on investments in preferred and common stocks are summarized as follows:

	Book/Adjusted Carrying Value	Unrealized Gains	Unrealized Losses	Fair Value
December 31, 2011				
Common stocks	**$ 18,162**	**$ –**	**$ –**	**$ 18,162**
Preferred stocks	**1,123,115**	**367,597**	**–**	**1,490,712**
Total stocks	**$ 1,141,277**	**$ 367,597**	**$ –**	**$ 1,508,874**
December 31, 2010				
Preferred stocks	$ 758,708	$ 474,701	$ –	$ 1,233,409
Total stocks	$ 758,708	$ 474,701	$ –	$ 1,233,409

Investment securities are exposed to various risks such as interest rate, market, and credit risk. Fair values of securities fluctuate based on the magnitude of changing market conditions; significant changes in market conditions could materially affect portfolio value in the near term.

The following tables show unrealized losses and fair values of bonds, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at December 31, 2011 and 2010:

	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
December 31, 2011						
Industrial and miscellaneous	**$ 4,211,265**	**$ (214,830)**	**$ –**	**$ –**	**$ 4,211,265**	**$ (214,830)**
Residential mortgage-backed	**2,730,344**	**(24,578)**	**1,214,426**	**(203,741)**	**3,944,770**	**(228,319)**
	$ 6,941,609	**$ (239,408)**	**$ 1,214,426**	**$ (203,741)**	**$ 8,156,035**	**$ ($443,149)**
December 31, 2010						
State and municipality	$ 5,646,022	$ (127,810)	$ –	$ –	$ 5,646,022	$ (127,810)
Industrial and miscellaneous	3,617,900	(84,367)	14,513	(487)	3,632,413	(84,854)
Residential mortgage-backed	8,398,643	(183,457)	2,701,119	(263,482)	11,099,762	(446,939)
	$ 17,662,565	$ (395,634)	$ 2,715,632	$ (263,969)	$ 20,378,197	$ (659,603)

2. Investments (continued)

Management believes that the temporary impairments for bonds are primarily the result of interest rate fluctuations, current conditions in capital markets, and the impact of those conditions on market liquidity and prices. In reviewing for other-than-temporary impairment, the Company evaluated information regarding creditworthiness, future outlook, and the extent to which each security was impaired.

There are 25 securities in an unrealized loss position at December 31, 2011. These securities are all considered investment-grade based on their NAIC rating at December 31, 2011. The Company does not have the intent to sell these bonds before recovery of the amortized cost and has the ability to hold these investments until maturity or until fair value recovers above amortized cost. Therefore, the Company does not consider these investments to be other-than-temporarily impaired at December 31, 2011.

There were no preferred stocks or common stocks of affiliates in an unrealized loss position at December 31, 2011 or 2010.

The following table presents the Company's gross realized gains (losses) on bonds and equity securities for the years ended December 31:

	2011	**2010**
Realized gains:		
Bonds	**$ 838,088**	$ 943,354
Equity securities	**78,489**	132,009
Gross realized gains	**916,577**	1,075,363
Realized losses:		
Bonds	**(148,724)**	(236,968)
Equity securities	–	(173)
Other-than-temporary impairment losses on bonds	**(287,686)**	(64,851)
Gross realized losses	**(436,410)**	(301,992)
Net realized investment gains	**480,167**	773,371
Capital gains tax	**(238,702)**	(159,344)
Net realized investment gains, net of tax	**$ 241,465**	$ 614,027

Proceeds from sales of investment securities during 2011 and 2010 were $10,478,145 and $12,181,006, respectively.

2. Investments (continued)

The following table shows the Company's current investment holdings, including loan-backed investments, for which an other-than-temporary impairment (OTTI) has been recognized, with the present value of the cash flows expected to be collected less than the amortized cost of the securities at impairment.

CUSIP	Description	Amortized Cost Basis Before OTTI	Recognized OTTI	Amortized Cost Basis After OTTI	Fair Value at Impairment	Period Impairment Reported
23242M-AD-3	CWL 2006-S3	$ 749,997	$ 352,497	$ 397,500	$ 397,500	2008
02149V-AG-4	CWALT INC 2007-3T1	209,245	24,052	185,193	185,193	2009
12544L-AA-9	CWHL 2007-11	249,033	20,245	228,788	228,788	2009
12493V-AC-4	CBO HOLDGS VII LTD	99,984	6,065	93,919	93,919	2009
126673-JE-3	CWL 2004-10	395,994	217,589	178,405	178,405	2009
12493V-AC-4	CBO HOLDGS VII LTD	94,940	12,968	81,972	81,972	2010
126673-JE-3	CWL 2004-10	181,063	51,883	129,180	129,180	2010
02149V-AG-4	CWALT INC 2007-3T1	114,593	28,023	86,570	86,570	2011
12544L-AA-9	CWHL 2007-11	155,578	15,613	139,965	139,965	2011
126673-JE-3	CWL 2004-10	132,142	22,216	109,926	109,926	2011
55277J-AA-6	MF GLOBAL HLDGS	104,845	41,845	63,000	63,000	2011
55277J-AA-6	MF GLOBAL HLDGS	134,054	57,679	76,375	76,375	2011
82934H-AD-3	SINO FOREST	162,610	122,310	40,300	40,300	2011

The following schedule details the maturities of the Company's bonds as of December 31, 2011. Actual maturities may differ from contractual maturities because certain borrowers have the right to call or prepay obligations, with or without call or prepayment penalties.

	Book/Adjusted Carrying Value	Fair Value
Due in one year or less	$ 5,413,569	$ 5,503,578
Due after one through five years	25,126,986	26,612,519
Due after five years through ten years	19,119,005	20,499,730
Due after ten years	2,803,258	3,085,888
Residential mortgage-backed securities	39,092,822	40,505,242
Commercial mortgage-backed securities	6,707,255	7,106,894
	$ 98,262,895	$ 103,313,851

2. Investments (continued)

The Company is required by various states in which it is licensed to maintain deposits for the benefit of policyholders. These deposits are comprised of bonds totaling $6,292,382 and $6,189,780 at December 31, 2011 and 2010, respectively.

The Company entered into an agreement with one of its CPI clients whereby the Company agreed to secure certain unearned premium liabilities arising from CPI business. These liabilities are secured by loan-backed securities and money market funds totaling $6,432,110 at December 31, 2011. The client has the right to withdraw the deposit only upon a determination of the Company's insolvency by the Department. The Company receives all benefits of the interest, dividends, or benefits generated by the deposited funds.

Net investment income for the years ended December 31, consists of the following:

	2011	2010
Interest on investments	**$ 7,043,386**	$ 7,116,790
Dividends	**83,383**	72,915
Gross investment income	**7,126,769**	7,189,705
Investment expenses	**(3,078,162)**	(2,956,142)
Net investment income	**$ 4,048,607**	$ 4,233,563

2. Investments (continued)

Summarized Financial Information of Affiliates

The summarized financial information of NSIC and USIC is presented below:

	December 31, 2011		December 31, 2010	
	NSIC	**USIC**	**NSIC**	**USIC**
Total cash and invested assets	**$ 26,199,439**	**$ 46,867,037**	$ 27,712,687	$ 45,775,110
Other assets	**8,546,904**	**7,836,188**	5,402,317	8,333,499
Total admitted assets	**$ 34,746,343**	**$ 54,703,225**	$ 33,115,004	$ 54,108,609
Total liabilities	**$ 15,685,806**	**$ 21,005,148**	$ 14,996,635	$ 22,773,486
Capital and surplus	**19,060,537**	**33,698,077**	18,118,369	31,335,123
Total liabilities and capital and surplus	**$ 34,746,343**	**$ 54,703,225**	$ 33,115,004	$ 54,108,609
Net underwriting income	**$ 658,231**	**$ 1,645,578**	$ 614,213	$ 1,535,531
Net investment income	**695,790**	**1,680,897**	770,297	1,895,748
Other income	**19,119**	**47,799**	2,236	5,591
Net income	**886,585**	**2,167,489**	974,097	2,359,772

Statutory carrying value and cost of the Company's subsidiaries, as reported in common stocks of affiliates, are as follows:

	Statutory Carrying Value	Cost	Unrealized Gains
December 31, 2011			
National Specialty Insurance Company	**$ 19,060,537**	**$ 11,750,000**	**$ 7,310,537**
United Specialty Insurance Company	**33,698,077**	**20,000,000**	**13,698,077**
	$ 52,758,614	**$ 31,750,000**	**$ 21,008,614**
December 31, 2010			
National Specialty Insurance Company	$ 18,118,369	$ 11,750,000	$ 6,368,369
United Specialty Insurance Company	31,335,123	20,000,000	11,335,123
	$ 49,453,492	$ 31,750,000	$ 17,703,492

3. Real Estate, Equipment, and Depreciation

The following is a summary of real estate, equipment, and depreciation balances:

	December 31	
	2011	**2010**
Land held for use	**$ 2,375,763**	$ 2,375,763
Land held for sale	**1,034,000**	1,034,000
Building	**15,126,799**	15,124,187
Computer equipment and software	**68,656**	66,874
	18,605,218	18,600,824
Accumulated depreciation	**(2,073,196)**	(1,278,921)
Real estate and equipment, net	**$ 16,532,022**	$ 17,321,903
Disclosed as:		
Real estate, net	**$ 16,517,746**	$ 17,295,536
Equipment, net	**14,276**	26,367
Real estate and equipment, net	**$ 16,532,022**	$ 17,321,903
Depreciation expense	**$ 794,276**	$ 805,949

On November 28, 2007, the Company purchased a tract of land with a plan to build a new home office building for its own use. During 2009, the Company classified this land as held for sale, since it had abandoned its plan to build a new home office and purchased an existing building for its own use. No losses were recognized on real estate and equipment in 2011 or 2010.

4. Unpaid Losses and Loss Adjustment Expenses

Activity in the liability for unpaid losses and LAE is as follows:

	Year Ended December 31	
	2011	**2010**
Unpaid losses and LAE, net of reinsurance receivables, at January 1	**$ 6,578,611**	$ 8,785,234
Incurred related to:		
Current year	**22,719,000**	26,355,000
Prior years	**(1,724,389)**	(2,313,310)
Total incurred	**20,994,611**	24,041,690
Paid related to:		
Current year	**19,176,070**	21,685,753
Prior years	**3,090,379**	4,562,560
Total paid	**22,266,449**	26,248,313
Unpaid losses and LAE, net of reinsurance receivables, at December 31	**$ 5,306,773**	$ 6,578,611

Reserves for incurred losses and LAE attributable to insured events of prior years decreased by $1,724,389 in 2011 and $2,313,310 in 2010, primarily as a result of re-estimation of unpaid losses and LAE, principally on commercial auto, commercial multi-peril, and credit lines of insurance in 2011 and on commercial auto and credit lines of insurance in 2010. The net change in reserves is the result of ongoing analysis of recent loss development trends. Original estimates are adjusted as additional information becomes known regarding individual claims.

5. Income Taxes

The Company files its federal income taxes on a consolidated basis with its parent company, SNIH, and its subsidiaries, NSIC and USIC. The method of allocation among companies is subject to a written agreement, approved by the Company's directors, whereby allocation is made primarily on a separate return basis, with a current credit for losses. Tax years ended December 31, 2008 through December 31, 2011, are open for examination by the Internal Revenue Service (IRS).

The components of the net deferred tax balances at December 31, are as follows:

	2011			**2010**		
	Ordinary	**Capital**	**Total**	**Ordinary**	**Capital**	**Total**
Gross deferred tax asset	**$ 4,756,711**	**$ 418,395**	**$ 5,175,106**	$ 4,519,601	$ 318,455	$ 4,838,056
Statutory valuation allowance	**–**	**–**	**–**	–	–	–
Adjusted gross deferred tax asset	**4,756,711**	**418,395**	**5,175,106**	4,519,601	318,455	4,838,056
Gross deferred tax liabilities	**(349,186)**	**–**	**(349,186)**	(431,391)	–	(431,391)
Net deferred tax asset	**4,407,525**	**418,395**	**4,825,920**	4,088,210	318,455	4,406,665
Nonadmitted deferred tax asset	**–**	**–**	**–**	–	–	–
Net deferred tax asset admitted	**$ 4,407,525**	**$ 418,395**	**$ 4,825,920**	$ 4,088,210	$ 318,455	$ 4,406,665
Change in deferred tax asset nonadmitted	**$ –**	**$ –**	**$ –**	$ (80,837)	$ (373,110)	$ (453,947)

Deferred taxes are recorded by the Company to reflect the tax consequences on future years of differences between the tax bases of assets and liabilities and their financial reporting amounts. The Company has not elected to admit deferred taxes pursuant to paragraph 10(e) of Statement of Statutory Accounting Principles (SSAP) 10R, *Income Taxes Revised – A Temporary Replacement of SSAP 10*, for the years ended December 31, 2011 and 2010.

5. Income Taxes (continued)

The Company's admitted deferred tax asset is computed as follows, pursuant to SSAP 10R:

	2011			2010		
	Ordinary	**Capital**	**Total**	**Ordinary**	**Capital**	**Total**
Federal tax paid in carryback years 10a	**$ 4,724,265**	**$ 418,395**	**$ 5,142,660**	$ 4,095,404	$ 247,454	$ 4,342,858
Lesser of:						
Deferred taxes expected to be realized within one year 10b(i)	**–**	**–**	**–**	360,310	71,001	431,311
Or						
10% of adjusted statutory surplus of previously filed statement 10b(ii)	**–**	**–**	**13,588,245**	–	–	12,695,113
Lesser of 10b(i) or 10b(ii)	**–**	**–**	**–**	360,310	71,001	431,311
Amount of gross deferred tax assets that can be offset against deferred tax liabilities 10c	**32,446**	**–**	**32,446**	63,887	–	63,887
Total of 10a, 10b, 10c	**$ 4,756,711**	**$ 418,395**	**$ 5,175,106**	$ 4,519,601	$ 318,455	$ 4,838,056
Gross admitted deferred tax assets	**$ 4,756,711**	**$ 418,395**	**$ 5,175,106**	$ 4,519,601	$ 318,455	$ 4,838,056
Gross deferred tax liabilities	**(349,186)**	**–**	**(349,186)**	(431,391)	–	(431,391)
Net admitted deferred tax assets	**$ 4,407,525**	**$ 418,395**	**$ 4,825,920**	$ 4,088,210	$ 318,455	$ 4,406,665

There are no deferred tax liabilities not recognized as of December 31, 2011 and 2010.

5. Income Taxes (continued)

The risk-based capital level for SSAP 10R, paragraphs 10(a)–10(c), is as follows for the years ended December 31:

	2011	2010
Gross admitted deferred tax assets	**$ 5,175,106**	$ 4,838,056
Admitted assets	**204,377,323**	198,475,217
Statutory surplus	**140,708,366**	131,357,791
Total adjusted capital in the risk-based capital calculation	**140,708,366**	131,357,791
Authorized control level of risk-based capital	**31,255,666**	31,296,964
Applicable % for application of SSAP 10R	**450.2%**	419.7%

5. Income Taxes (continued)

The tax effects of temporary differences that give rise to the deferred tax assets and deferred tax liabilities as of December 31, are summarized as follows:

	2011	2010
Deferred tax assets:		
Capital:		
Bonds	**$ 321,496**	$ 195,644
Stocks	**96,899**	122,811
Total gross capital deferred tax asset	**418,395**	318,455
Non-admitted capital deferred tax asset	**–**	–
Admitted capital deferred tax asset	**418,395**	318,455
Ordinary:		
Agents' balances receivable	**–**	803
Compensation and benefits	**55,694**	–
Unearned premiums	**1,473,241**	1,558,553
Unpaid losses and loss adjustment expenses	**129,783**	182,536
Deferred ceding fees	**3,092,048**	2,666,877
Charitable contribution carryforward	**–**	110,832
Other	**5,945**	–
Total gross ordinary deferred tax asset	**4,756,711**	4,519,601
Non-admitted ordinary deferred tax asset	**–**	–
Admitted ordinary deferred tax asset	**4,756,711**	4,519,601
Deferred tax liabilities:		
Ordinary:		
Bonds discount amortization	**(73,550)**	(77,219)
Real estate and equipment	**(274,009)**	(354,172)
Other	**(1,627)**	–
Total ordinary deferred tax liabilities	**(349,186)**	(431,391)
Total deferred tax liabilities	**(349,186)**	(431,391)
Net admitted deferred tax assets	**$ 4,825,920**	$ 4,406,665

5. Income Taxes (continued)

The change in net deferred taxes, exclusive of nonadmitted assets, is comprised of the following:

	December 31		
	2011	**2010**	**Change**
Gross deferred tax assets	**$ 5,175,106**	$ 4,838,056	$ 337,050
Gross deferred tax liabilities	**(349,186)**	(431,391)	82,205
Net deferred tax asset	**$ 4,825,920**	$ 4,406,665	419,255
Tax effect of unrealized gains			(28,369)
Change in net deferred taxes			$ 390,886

The Company computes its income tax provision using a 34.3% tax rate as its taxable income is within the graduated rates of 34% to 35%. The provision for federal income taxes incurred is different from that which would be obtained by applying the statutory federal income tax rate utilized to income before income taxes. The significant items causing this difference as of December 31, are as follows:

	Year Ended December 31, 2011		**Year Ended December 31, 2010**	
	Amount	**Effective Tax Rate**	**Amount**	**Effective Tax Rate**
Provisions computed at statutory rate	**$ 3,063,522**	**34.3%**	$ 3,091,752	34.3%
Interest income	**(197,133)**	**(2.2)**	(170,140)	(1.9)
Other	**(17,317)**	**(0.2)**	27,113	0.3
Total	**$ 2,849,072**	**31.9%**	$ 2,948,725	32.7%
Federal income taxes incurred	**$ 3,239,958**		$ 1,876,956	
Change in net deferred taxes	**(390,886)**		1,071,769	
Total statutory income taxes	**$ 2,849,072**		$ 2,948,725	

5. Income Taxes (continued)

The impact of tax planning strategies on the determination of adjusted gross deferred tax assets and the determination of net admitted deferred tax assets is as follows:

	2011			**2010**			**Change**		
	Ordinary	**Capital**	**Total**	**Ordinary**	**Capital**	**Total**	**Ordinary**	**Capital**	**Total**
Percent of total adjusted gross DTAs	**0.0%**	**8.1%**	**8.1%**	0.0%	6.6%	6.6%	0.0%	1.5%	1.5%
Percent of total net admitted gross DTAs	**0.0**	**8.1**	**8.1**	0.0	6.6	6.6	0.0	1.5	1.5

Current income taxes consist of the following major components for the years ended December 31:

	2011	**2010**
Current income tax expense	**$ 3,004,068**	$ 2,157,347
Tax on capital gains	**238,702**	159,344
Prior-year over accrual	**(2,812)**	(439,735)
Federal income taxes incurred	**$ 3,239,958**	$ 1,876,956

At December 31, 2011, the Company did not have any unused operating loss carryforwards or capital loss carryforwards available to offset future taxable income. At December 31, 2010, the Company had a charitable contribution carryforward of $111,124 that would have expired in 2013. The Company fully utilized this carryforward in 2011.

Federal income taxes incurred in current and prior years that are available for recoupment in the event of future net losses are as follows:

	Ordinary	**Capital**	**Total**
2011	**$ 3,004,068**	**$ 238,702**	**$ 3,242,770**
2010	2,121,207	192,672	2,313,879
	$ 5,125,275	$ 431,374	$ 5,556,649

5. Income Taxes (continued)

No deposits were admitted under Section 6603 of the Internal Revenue Code. The Company recognizes interest and penalties related to uncertain tax positions in general and administrative expenses. There were no penalties or interest recognized during 2011 and 2010.

6. Capital and Surplus

The payment of dividends by the Company is limited and can only be made from earned profits without the prior approval from the Department. The maximum dividend that may be paid without prior approval of the Commissioner of Insurance is limited to the greater of 10% of statutory surplus at the end of the preceding calendar year or the statutory net income of the preceding calendar year. Accordingly, SNIC has unrestricted net assets available for dividends to SNIH in 2011 of $14,070,837. The minimum required statutory capital and surplus was $2,000,000 at December 31, 2011. Unassigned surplus at December 31, 2011, contains net unrealized gains of $20,865,390 and nonadmitted assets of $17,334.

The Company is subject to certain Risk-Based Capital (RBC) requirements, as specified by the NAIC. Under the RBC standards, risk specific to the Company in such areas as asset risk, insurance risk, interest rate risk, and business risk are calculated and compared to the Company's capital and surplus. In its calculation of risk-based capital, the Company has deducted amounts for which it holds collateral (either trust funds in the name of the Company or irrevocable letters of credit) for amounts recoverable from reinsurance companies. The Company believes this practice to be appropriate because the credit risk for the related reinsurance balances is virtually eliminated due to the protection provided by the collateral. This practice differs from NAIC statutory annual statement instructions. There is no monetary effect on 2011 or 2010 net income or statutory surplus from the use of this practice. If the Company would have used the practice outlined in the NAIC's annual statement instructions, its risk-based capital calculation would not have resulted in a regulatory event in 2011 or 2010.

7. NAIC SAP to GAAP Reconciliation

A reconciliation of SNIC's shareholder's equity and net income from NAIC SAP to GAAP is as follows:

	Year Ended December 31	
	2011	**2010**
Shareholder's equity:		
Statutory-basis capital and surplus	**$ 140,708,366**	$ 131,357,791
Adjustments for:		
Commissions payable	**7,335,346**	7,329,694
Allowance for return commissions	**12,860,189**	13,196,763
Allowance for policy cancellations	**(12,665,299)**	(13,161,340)
Deferred acquisition costs	**7,416,519**	8,211,965
GAAP adjustment effects of pooling agreement	**540,326**	213,075
Management fees	**(4,924,629)**	(5,133,855)
Deferred income taxes	**(5,922,827)**	(5,636,622)
Unrealized gains on investments	**5,418,546**	3,981,899
Investment in subsidiaries	**5,014,159**	4,369,342
Nonadmitted assets	**17,334**	34,645
Other	**212,316**	143,434
Shareholder's equity in accordance with GAAP	**$ 156,010,346**	$ 144,906,791
Net income:		
Statutory-basis net income	**$ 5,691,594**	$ 7,136,899
Adjustments for:		
Contingent commissions	**5,652**	2,977,385
Allowance for return commissions	**(336,574)**	239,157
Allowance for policy cancellations	**496,041**	(1,091,744)
Deferred acquisition costs	**(795,446)**	(791,851)
GAAP adjustment effects of pooling agreement	**327,251**	(16,776)
Management fees	**209,226**	(1,010,260)
Deferred income taxes	**597,452**	(1,179,704)
Equity in earnings of subsidiaries	**3,273,629**	3,425,643
Other	**68,883**	16,719
Net income in accordance with GAAP	**$ 9,537,708**	$ 9,705,468

8. Program Managers

Through unaffiliated program managers, SNIC writes primarily commercial lines of business. This business is written pursuant to quota share and excess of loss reinsurance contracts and general agency agreements that are tripartite agreements executed by SNIC, the reinsurer, and the general agent. Substantially all of the risk associated with this business is retained by the reinsurer.

As compensation for writing this business, SNIC receives ceding commissions from the program managers and, accordingly, the related ceding commissions receivable are reflected as agents' balances receivable. If the program manager defaults on its obligation to pay these commissions (or any other amount due under the contract), the reinsurer is obligated to make the payment under the guarantee contained in the contracts.

For the years ended December 31, 2011 and 2010, direct premiums written by unaffiliated program managers or an affiliated agent are shown below:

	2011	**2010**
Appalachian Underwriters, Inc.	**$ 50,394,874**	$ 36,961,457
Cal-Regent Insurance Services Corp.	**15,480,891**	15,379,265
Climate Insurance Agency, LLC	**27,172,363**	93,902
Crump Insurance Services	**14,173,056**	6,764,263
Direct General Insurance Company	**17,726,124**	17,027,593
First Indemnity Insurance Agency	**16,173,067**	5,124,720
Knight Management Insurance Services	**13,053,923**	5,211,577
Personable General Insurance Agency	**12,372,903**	16,669,787
Restaurant Coverage Association, Inc.	**33,072,537**	28,218,275
Sure Products Insurance Agency	**10,383,549**	10,416,668
Torus US Intermediaries	**9,149,354**	1,529,137
T.B.A. Insurance Group, Ltd., affiliate	**93,545,212**	111,919,790
The Insurance Professionals	**16,696,479**	102,678,277
Venture Underwriters, Inc.	**14,750,597**	–
WFT, Inc.	**13,225,485**	21,199,335
Others	**47,770,693**	66,825,818
	$ 405,141,107	$ 446,019,864

All of the program managers in the preceding table have been granted underwriting, policy issuance, collections, and claim administration authority.

9. Reinsurance

The Company entered into a reinsurance agreement in 2009 to cede 50% of certain CPI policies to Cumis Insurance Society, Inc. (CUNA) and receives a ceding commission related to these policies (see Note 12).

The Company remains liable for unearned premiums and unpaid losses and LAE with respect to reinsurance ceded should the reinsurer be unable to meet its obligations. Management considers the possibility of a reinsurer becoming unable to meet its obligations as remote due to the reinsurers' financial stability, A.M. Best Company rating, size, security funds available, and other factors as appropriate. Following is a summary of these balances at December 31:

	2011	2010
Ceded unearned premium	**$ 162,766,976**	$ 174,364,906
Ceded unpaid losses and LAE	**535,951,196**	502,302,173
Total reinsurance recoverable	**698,718,172**	676,667,079
Less secured balances	**(412,152,231)**	(260,916,630)
Unsecured reinsurance recoverable	**$ 286,565,941**	$ 415,750,449

SNIC holds collateral securing $412,152,231 of ceded balances at December 31, 2011. The fair value of the collateral is approximately 133% of the related recoverables as of December 31, 2011.

The effects of reinsurance on premiums written and earned are as follows:

	2011		**2010**	
	Written	**Earned**	**Written**	**Earned**
Direct premiums	**$ 405,141,107**	**$ 418,312,325**	$ 446,019,864	$ 448,364,883
Assumed premiums:				
Affiliates	**6,157,686**	**5,918,255**	5,147,016	4,156,693
Nonaffiliates	**1,609,098**	**1,518,864**	(400,492)	13,812
Ceded premiums:				
Affiliates	**(27,959,944)**	**(28,629,588)**	(32,273,350)	(32,167,174)
Nonaffiliates	**(333,022,337)**	**(343,950,624)**	(358,556,818)	(360,629,177)
Net premiums	**$ 51,925,610**	**$ 53,169,232**	$ 59,936,220	$ 59,739,037

9. Reinsurance (continued)

At December 31, 2011, the Company has unsecured reinsurance recoverables that exceed 3% of surplus from the following reinsurers:

Technology Insurance Company	$ 73,112,088
State Automobile Mutual Insurance Co.	40,966,340
Tower Insurance Company of NY	37,146,154
Torus National Insurance Company	21,491,500
Hiscox Syndicate 33	18,395,100
North Carolina Reinsurance Facility	15,445,000
Harco National Insurance Company	12,880,986
Canal Insurance Company	10,953,000
California Capital Insurance Company	10,926,000
United Specialty Insurance Company (affiliate)	10,300,994
Cumis Insurance Society, Inc.	9,669,651
NGM Insurance Company	8,261,388
Odyssey American Reinsurance Corporation	6,121,763

The net amount of return commissions payable or recoverable at December 31, 2011, if all assumed and ceded reinsurance treaties were canceled, is summarized as follows:

	Assumed Reinsurance		**Ceded Reinsurance**		**Net**	
	Unearned Premium Reserve	**Commission Recoverable**	**Unearned Premium Reserve**	**Commission Recoverable**	**Unearned Premium Reserve**	**Commission Recoverable**
Affiliates	$2,357,708	$ 929,256	$ 11,563,899	$ 4,732,444	$ (9,206,191)	$ (3,803,188)
Nonaffiliates	182,234	–	151,203,077	44,416,326	(151,020,843)	(44,416,326)
Total	$2,539,942	$ 929,256	$ 162,766,976	$ 49,148,770	$ (160,227,034)	$ (48,219,514)

9. Reinsurance (continued)

Additional or return commissions or other equivalent amounts pursuant to contractual agreements of a profit-sharing nature are accrued based on the experience of the underlying business using case and statistical methods. Contingent commission amounts payable (receivable) at December 31, 2011 and 2010, are summarized as follows:

	2011	2010
Direct	**$ 8,869,285**	$ 9,647,761
Assumed	**355,238**	227,068
Ceded	**(3,228,583)**	(3,456,190)
Net	**$ 5,995,940**	$ 6,418,639

10. Fair Value Measurements

Assets and liabilities reported in the financial statements at fair value are required to be classified according to a fair value hierarchy that prioritizes the use of inputs used in valuation methodologies into three levels. The hierarchy gives the highest ranking to fair values determined using unadjusted quoted prices in active markets for identical assets and liabilities (Level 1) and the lowest ranking to fair values determined using methodologies and models with unobservable inputs (Level 3). An asset's or liability's classification is based on the lowest level input that is significant to its measurement. For example, a Level 3 fair value measurement may include inputs that are both observable (Level 1 and 2) and unobservable (Level 3). The levels of the fair value hierarchy are as follows:

- Level 1: Inputs are quoted prices for identical assets or liabilities in active markets that are accessible at the measurement date.

- Level 2: Inputs include quoted prices for similar assets or liabilities in active markets, quoted prices from those willing to trade in markets that are not active, or other inputs that are observable or can be corroborated by market data for the term of the instrument. These inputs include market interest rates and volatilities, spreads, and yield curves.

- Level 3: Inputs are unobservable. Unobservable inputs reflect the Company's own assumptions about the assumptions market participants would use in pricing the asset or liability based on the best information available in the circumstances.

10. Fair Value Measurements (continued)

A description of the Company's valuation techniques used to measure its assets at fair value is as follows:

- Bonds: Level 2 inputs are used to determine fair value of substantially all bonds. These inputs are obtained from either an independing pricing service using quoted prices or from its third party investment managers and are valued utilizing observable data that may include dealer quotes, market spreads, cash flows, yield curves, live trading levels, trade execution data, market consensus prepayment speeds, credit information, and the security's terms and conditions, among other information. The remaining bonds are reported at fair value utilizing Level 3 inputs. These securities are priced by the investment managers utilizing cash flow testing with unobservable inputs.

- Equity Securities: Level 2 inputs are used to determine fair value of equity securities. For these securities, the Company obtains fair value measurements from an independent pricing service using quoted prices.

Management has reviewed the process used by the pricing services and has determined that they result in fair values consistent with requirements of SSAP 100, *Fair Value Measurements*. The Company had no other assets or liabilities subject to fair value measurement at December 31, 2011 or 2010.

Based on an analysis of the inputs, the Company's financial assets that are carried at fair value due to their NAIC designation at December 31, 2011 and 2010, have been categorized as follows:

	Level 1	Level 2	Level 3	December 31 2011
Investments:				
Bonds:				
Industrial and miscellaneous	**$ –**	**$ 1,243,081**	**$ –**	**$ 1,243,081**
Residential mortgage-backed	**–**	**109,926**	**–**	**109,926**
Common stocks	**–**	**18,162**	**–**	**18,162**
	$ –	**$ 1,371,169**	**$ –**	**$ 1,371,169**

10. Fair Value Measurements (continued)

	Level 1	Level 2	Level 3	December 31 2010
Investments:				
Bonds:				
Industrial and miscellaneous	$ –	$ 165,972	$ –	$ 165,972
Residential mortgage-backed	–	619,785	–	619,785
	$ –	$ 785,757	$ –	$ 785,757

Transfers between levels are recognized at the end of the reporting period. The Company had no transfers between Level 1 and Level 2 or between Level 2 and Level 3 during 2011.

11. Related-Party Transactions

TBA produces CPI and GAP business under an agency agreement with the Company. Following is a summary of the Company's affiliated agency balances, direct and assumed, as of and for the years ended December 31:

	2011	2010
Earned premiums	**$ 95,471,439**	$ 105,510,464
Commission expense incurred	**50,705,826**	59,860,850
Net receivable	**979,967**	2,129,703

Under the terms of a management agreement between TBA and the Company, TBA provides management services to the Company for the oversight of the Company's business development and underwriting operations. Fees incurred by the Company for such services were $12,835,510 and $11,977,155 during 2011 and 2010, respectively. Payable to affiliates related to the management agreement is $2,471,285 and $3,567,745 at December 31, 2011 and 2010, respectively.

The Company leases office space in its current home office building to TBA, an affiliate (see Note 13).

At December 31, 2011 and 2010, the net amount due from NSIC related to intercompany pooling is $1,516,244 and $1,453,248, respectively. At December 31, 2011 and 2010, the net amount payable to USIC related to intercompany pooling is $1,560,762 and $629,547, respectively.

12. Commitments and Contingencies

The Company is party to various legal proceedings that have arisen in the normal course of business. Those proceedings are considered by the Company in estimating the liability for unpaid losses and loss adjustment expenses. Management does not anticipate that the outcome of such legal actions will have a material effect on the Company's financial position or its results of operations.

The Company is subject to assessments from various insurance regulatory agencies related to insurance company insolvencies. Management is not aware of any material assessments for which notice has not yet been received. However, to the extent that such assessments are made, the Company has the contractual right to recover these amounts from the underlying reinsurer(s).

In July 2009, the Company formed a Collateral Protection Alliance (the Alliance) with CUMIS Insurance Society, Inc., a subsidiary of CUNA, to administer and write CPI business for their customers. The Alliance includes an agency agreement and a reinsurance agreement whereby the Company cedes 50% of the business to CUNA. The Company did not account for the Alliance as a business combination. In connection with the Alliance, the Company has a purchase option and CUNA has an option to sell, whereby the Company is obligated to purchase CUNA's right to participate in future program business in the event of termination of the Alliance.

13. Leases

SNIC owns its current home office building, which it leases in part to TBA, an affiliate. Rental income earned from this operating lease was $2,086,305 and $2,081,810 for the years ended December 31, 2011 and 2010, respectively. Future minimum lease payments associated with the TBA lease are $2,008,958 for each of the succeeding five years.

Additionally, the Company leases the remaining portion of its home office building to an unaffiliated third party under the terms of an operating lease. Rental income was $1,346,254 and $1,346,254 for the years ended December 31, 2011 and 2010, respectively. Future minimum lease payments associated with the lease are as follows: 2012 – $1,310,603; 2013 – $1,289,242; 2014 – $1,295,382; 2015 – $1,362,914; and 2016 – $1,362,914.

14. Concentration of Risk

The Company maintains cash and short-term investments in accounts with various financial institutions in excess of the amounts insured by the Federal Deposit Insurance Corporation. The Company monitors the financial stability of these depository institutions, and Management does not believe there is significant risk associated with deposits in excess of federally insured amounts.

A significant portion of the Company's premium writings occurs in California, New York, Texas, Illinois, North Carolina, and New Jersey. During 2011, three program managers comprised approximately 36% of the Company's program writings and three reinsurers represented 53% of the Company's unsecured ceded balances.

15. Regulatory Examination

At periodic intervals, the Department routinely examines the Company's statutory-basis financial statements as part of its legally prescribed oversight of the insurance industry. Based on these examinations, the regulators can direct that the Company's statutory-basis financial statements be adjusted in accordance with their findings. The December 31, 2006 through December 31, 2010 statutory-basis financial statements are currently under the examination of the Department, with examination completion estimated to be in calendar 2012.

16. Transferable State Tax Credits

The Company purchased $165,000 of transferrable Louisiana CAPCO credits at a discount in 2011 and expects to fully utilize them in 2012. In 2011, the Company fully utilized the transferrable Louisiana CAPCO credits purchased at a discount in 2010 of $165,000.

17. 401(k) Profit-Sharing Plan and Trust

The Company participates in a 401(k) profit-sharing plan, sponsored by TBA, for employees that covers substantially all officers and employees who are at least 18 years of age. The Company is required to make a matching contribution of 50% of employees' contributions, limited to 6% of eligible employees' compensation. Also, the Company may make additional matching and profit-sharing contributions that are discretionary and are determined at the end of each plan year. The employer contribution expense included in other underwriting expenses is $179,866 and $241,949 for the years ended December 31, 2011 and 2010, respectively.

18. Subsequent Events

Effective January 1, 2012, the terms of the intercompany pooling arrangement between SNIC, NSIC, and USIC were modified. USIC and NSIC will continue to cede 100% of their net business, after other unaffiliated reinsurance, to SNIC; however, SNIC will then cede 20% and 35% to NSIC and USIC, respectively, of the companies' combined business. Additionally, the pooling arrangement was modified to exclude pooling of investment income. In conjunction with increasing USIC's and NSIC's participation in the pool, SNIC contributed $15,000,000 and $10,000,000 of additional paid in capital to USIC and NSIC, respectively.

The Company has evaluated subsequent events from the balance sheet date through May 10, 2012, which is the date the financial statements were available to be issued.

Supplementary Information

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Report of Independent Auditors on Supplementary Information

The Board of Directors
State National Insurance Company, Inc.

Our audits were conducted for the purpose of forming an opinion on the statutory-basis financial statements as a whole. The accompanying supplemental investment disclosures and reinsurance disclosures are presented to comply with the National Association of Insurance Commissioners' Annual Statement Instructions and the National Association of Insurance Commissioners' Accounting Practices and Procedures Manual and for purposes of additional analysis and are not a required part of the statutory-basis financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the financial statements. The information has been subjected to the auditing procedures applied in our audit of the statutory-basis financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information is fairly stated in all material respects in relation to the statutory-basis financial statements as a whole.

This report is intended solely for the information and use of the Company and state insurance departments to whose jurisdiction the Company is subject and is not intended to be and should not be used by anyone other than these specified parties.

Ernst & Young LLP

May 10, 2012

State National Insurance Company, Inc.

Investment Risk Interrogatories

December 31, 2011

1. The reporting entity's total admitted assets as reported on page 2 of the Annual Statement as of December 31, 2011 was $204,377,323.

2. The 10 largest exposures to a single issuer/borrower/investment, excluding (i) U.S. Government, U.S. Government agency securities, and those U.S. Government money market funds listed in the Appendix to the *SVO Purposes and Procedures Manual* as exempt, (ii) property occupied by the Company, and (iii) policy loans, are as follows:

	Investment Category		**Amount**	**Percentage of Total Admitted Assets**
a.	Stocks – United Specialty Insurance Company (affiliate)	$	33,698,077	16.49%
b.	Stocks – National Specialty Insurance Company (affiliate)	$	19,060,537	9.33%
c.	Bonds – Birmingham Alabama GO	$	1,556,363	0.76%
d.	Bonds – South Carolina St Pub Svc Auth Rev	$	1,552,366	0.76%
e.	Bonds – Houston TX Ref – Pub Impt Ser A	$	1,504,071	0.74%
f.	Bonds – Bear Stearns CMBS 2005-Top 20	$	1,500,442	0.73%
g.	Bonds – Washington St Var	$	1,093,151	0.53%
h.	Bonds – Illinois St Toll Hwy Auth Toll	$	1,043,157	0.51%
i.	Bonds – Clark Cnty Ref-Pk-C	$	1,024,590	0.50%
j.	Bonds – Honolulu-B	$	1,021,401	0.50%

3. The amounts and percentages of the reporting entity's total admitted assets held in bonds, short-term investments, and preferred stocks, by NAIC rating, are as follows:

Bonds & Short-Term Investments				**Preferred Stocks**			
NAIC Rating		**Amount**	**Percentage of Total Admitted Assets**	**NAIC Rating**		**Amount**	**Percentage of Total Admitted Assets**
NAIC-1	$	95,421,025	46.69%	P/PSF-1	$	–	0.00%
NAIC-2	$	11,539,367	5.65%	P/PSF-2	$	150,666	0.07%
NAIC-3	$	2,256,524	1.10%	P/PSF-3	$	972,449	0.48%
NAIC-4	$	368,513	0.18%	P/PSF-4	$	–	0.00%
NAIC-5	$	109,926	0.05%	P/PSF-5	$	–	0.00%
NAIC-6	$	523,703	0.26%	P/PSF-6	$	–	0.00%

4. Assets held in foreign investments are less than 2.5% of the Company's total admitted assets.

5. Assets held in Canadian investments are less than 2.5% of the Company's total admitted assets.

6. Assets held in investments with contractual sales restrictions are less than 2.5% of the Company's total admitted assets.

7. The amounts and percentages of admitted assets held in the largest 10 equity interests (including investments in the shares of mutual funds, preferred stocks, publicly traded equity securities, and other equity securities, and excluding money market and bond mutual funds listed in the Appendix to the *SVO Practices and Procedures Manual* as exempt or Class 1) are as follows:

	Investment Category		**Amount**	**Percentage of Total Admitted Assets**
a.	Stocks – United Specialty Insurance Company (affiliate)	$	33,698,077	16.49%
b.	Stocks – National Specialty Insurance Company (affiliate)	$	19,060,537	9.33%
c.	Stocks – Bunge, Ltd	$	360,020	0.18%
d.	Stocks – Centerpoint Energy Inc Convertible	$	152,043	0.07%
e.	Stocks – Stanley Black & Decker PFD	$	150,666	0.07%
f.	Stocks – New York Cmnty Cap	$	144,136	0.07%
g.	Stocks – AMG Cap Tr II	$	136,710	0.07%
h.	Stocks – Fifth Third Bancorp	$	112,815	0.06%
i.	Stocks – Newell Financial Trust I	$	66,725	0.03%
j.	Stocks – Teva Pharmaceutical Indus	$	18,162	0.01%

8. Assets held in nonaffiliated, privately placed equities are less than 2.5% of the Company's total admitted assets.

9. Assets held in general partnership interests are less than 2.5% of the Company's total admitted assets.

10. Mortgage loans reported in Schedule B are less than 2.5% of the Company's total admitted assets.

11. The five largest investments in one parcel or group of contiguous parcels of real estate reported in Schedule A are less than 2.5% of the Company's total admitted assets.

12. The Company has no assets subject to securities lending, repurchase agreements, reserve repurchase agreements, dollar repurchase agreements, or dollar reserve repurchase agreements.

13. The Company has no warrants.

14. The Company has no potential for exposure for collars, swaps, and forwards.

15. The Company has no potential for exposure for futures contracts.

State National Insurance Company, Inc.

Summary Investment Schedule

December 31, 2011

Investment Categories	Gross Investment Holdings*		Admitted Assets as Reported in the Annual Statement	
Bonds:				
U.S. Treasury securities	$ 3,402,257	1.9%	$ 3,402,257	1.9%
U.S. Government agency and corporate obligations (excluding mortgage-backed securities):				
Issued by U.S. Government agencies	537,172	0.3%	537,172	0.3%
Securities issued by states, territories and possessions, and political subdivisions in the U.S.:				
States, territories, and possessions general obligations	2,847,821	1.5%	2,847,821	1.5%
Political subdivisions of states, territories and possessions, and political subdivisions general obligations	2,802,764	1.5%	2,802,764	1.5%
Revenue and assessment obligations	17,323,174	9.5%	17,323,174	9.5%
Industrial development and similar obligations				
Mortgage-backed securities (includes residential and commercial MBS):				
Pass-through securities:				
Issued or guaranteed by GNMA	616,267	0.3%	616,267	0.3%
Issued or guaranteed by FNMA and FHLMC	21,302,392	11.6%	21,302,392	11.6%
All other	312,707	0.2%	312,707	0.2%
CMOs and REMICs:				
Issued or guaranteed by GNMA, FNMA, FHLMC, or VA	13,382,545	7.3%	13,382,545	7.3%
Privately issued and collateralized by MBS issued or guaranteed by GNMA, FNMA, FHLMC, or VA	1,814,283	1.0%	1,814,283	1.0%
All other	8,993,996	4.9%	8,993,996	4.9%
Other debt and other fixed income securities (excluding short-term):				
Unaffiliated domestic securities (includes credit tenant loans rated by the SVO)	24,816,229	13.6%	24,816,229	13.6%
Unaffiliated non-U.S. securities (including Canada)	111,288	0.1%	111,288	0.1%
Affiliated securities				
Equity interests:				
Investments in mutual funds				
Preferred stocks:				
Affiliated				
Unaffiliated	1,123,115	0.6%	1,123,115	0.6%
Other equity securities:				
Affiliated	52,758,614	28.8%	52,758,614	28.8%
Unaffiliated	18,162	0.0%	18,162	0.0%
Real estate investments:				
Property occupied by company	15,483,746	8.5%	15,483,746	8.5%
Property held for sale	1,034,000	0.6%	1,034,000	0.6%
Cash, cash equivalents, and short-term investments	14,233,494	7.8%	14,233,494	7.8%
Total invested assets	$ 182,914,026	100.0%	$ 182,914,026	100.0%

*Gross investment holdings, as valued in compliance with the NAIC's *Accounting Practices and Procedures Manual.*

State National Insurance Company, Inc.

Schedule of Reinsurance Disclosures

December 31, 2011

State National Insurance Company, Inc. (the Company) has twelve reinsurance contracts containing provisions that have allowed the Company to reinsure risk with other entities under quota share reinsurance contracts that include provisions that would limit the reinsurer's losses below the stated quota share percentage (e.g., a deductible, a loss ratio corridor, a loss cap, an aggregate limit, or similar provisions). The amount of reinsurance credit taken reflects the reduction in quota share coverage caused by any applicable limiting provision.

For the year ended December 31, 2011, the Company has not ceded any risk under any reinsurance contract (or under multiple contracts with the same reinsurer or its affiliates) for which: (i) it recorded a positive or negative underwriting result greater than 5% of prior year-end surplus as regards policyholders or it reported calendar year written premium ceded or year-end loss and loss expense reserves ceded greater than 5% of prior year-end surplus as regards policyholders; (ii) it accounted for that contract as reinsurance and not as a deposit; and (iii) the contract contains one or more of the following features that would have similar results:

a. A contract term longer than two years and the contract is noncancelable by the reporting entity during the contract term;

b. A limited or conditional cancellation provision under which cancellation triggers an obligation by the reporting entity, or an affiliate of the reporting entity, to enter into a new reinsurance contract with the reinsurer, or an affiliate of the reinsurer;

c. Aggregate stop-loss reinsurance coverage;

d. An unconditional or unilateral right by either party to commute the reinsurance contract, except for such provisions which are only triggered by a decline in the credit status of the other party;

e. A provision permitting reporting of losses, or payment of losses, less frequently than on a quarterly basis (unless there is no activity during the period); or

f. Payment schedules, accumulating retentions from multiple years, or any features inherently designed to delay timing of the reimbursement to the ceding entity.

For the year ended December 31, 2011, the Company has not ceded any risk under any reinsurance contract (or under multiple contracts with the same reinsurer or its affiliates) for which, during the period covered by the statement, it recorded a positive or negative underwriting result greater than 5% of prior year-end surplus as regards policyholders or it reported calendar year written premium ceded or year-end loss and loss expense reserves ceded greater than 5% of prior year-end surplus as regards policyholders; excluding cessions to approved pooling arrangements or to captive insurance companies that are directly or indirectly controlling, controlled by, or under common control with (i) one or more unaffiliated policyholders of the reporting entity, or (ii) an association of which one or more unaffiliated policyholders of the reporting entity is a member, whereby:

a. The written premium ceded to the reinsurer by the reporting entity or its affiliates represents fifty percent (50%) or more of the entire direct and assumed premium written by the reinsurer based on its most recently available financial statement; or

b. Twenty-five percent (25%) or more of the written premium ceded to the reinsurer has been retroceded back to the reporting entity or its affiliates.

Except for transactions meeting the requirements of paragraph 32 of SSAP No. 62R, *Property and Casualty Reinsurance*, the Company has not ceded any risk under any reinsurance contract (or multiple contracts with the same reinsurer or its affiliates), during the year ended December 31, 2011, and either:

a. Accounted for that contract as reinsurance (either prospective or retroactive) under statutory accounting principles (SAP) and as a deposit under generally accepted accounting principles (GAAP); or

b. Accounted for that contract as reinsurance under GAAP and as a deposit under SAP.

State National Insurance Company, Inc.

Note to Supplementary Information

December 31, 2011

Note – Basis of Presentation

The accompanying supplemental schedules present selected statutory-basis financial data as of December 31, 2011, and for the year then ended for purposes of complying with the National Association of Insurance Commissioners' *Accounting Practices and Procedures Manual* and agree to or are included in the amounts reported in the Company's 2011 Statutory Annual Statement as filed with the Texas Department of Insurance.

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Assurance | Tax | Transactions | Advisory