

INFINITY PROPERTY & CASUALTY CORP

Form 10-Q

November 08, 2012

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INFINITY PROPERTY AND CASUALTY CORPORATION 10-Q

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended September 30, 2012

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 No. 0-50167

INFINITY PROPERTY AND CASUALTY CORPORATION

(Exact name of registrant as specified in its charter)

Incorporated under

the Laws of Ohio

(State or other jurisdiction of

incorporation or organization)

3700 Colonnade Parkway, Suite 600, Birmingham, Alabama 35243

(Address of principal executive offices and zip code)

(205) 870-4000

(Registrant's telephone number, including area code)

Not Applicable

(Former name, former address and former fiscal year, if changed since last report)

03-0483872

(I.R.S. Employer

Identification No.)

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 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 (§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 the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated filer

Non-accelerated filer (Do not check if smaller reporting company)

Smaller reporting company

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

As of October 31, 2012 there were 11,673,041 shares of the registrant's common stock outstanding.

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Exhibit 32	Certification of the Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350.
101.INS	XBRL Instance Document

101.SCH XBRL Taxonomy Extension Schema
101.CAL XBRL Taxonomy Extension Calculation Linkbase
101.DEF XBRL Taxonomy Extension Definition Linkbase
101.LAB XBRL Taxonomy Extension Label Linkbase
101.PRE XBRL Taxonomy Extension Presentation Linkbase

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PART I
FINANCIAL INFORMATIONITEM 1
Financial StatementsINFINITY PROPERTY AND CASUALTY CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF EARNINGS(in thousands, except per share data)
(unaudited)

	Three months ended September 30,			Nine months ended September 30,				
	2012	2011	% Change	2012	2011	% Change		
		(as adjusted see Note 1)			(as adjusted see Note 1)			
Revenues:								
Earned premium	\$301,463	\$255,138	18.2	%	\$872,730	\$745,703	17.0	%
Net investment income	9,018	10,166	(11.3)	)%	28,364	31,117	(8.8))%
Net realized gains on investments ¹	268	722	(62.8)	)%	2,673	5,604	(52.3))%
Gain on sale of subsidiary	2,922	0	0.0	%	2,922	0	0.0	%
Other income	63	101	(37.8)	)%	430	201	113.7	%
Total revenues	313,734	266,127	17.9	%	907,119	782,625	15.9	%
Costs and Expenses:								
Losses and loss adjustment expenses	238,261	195,275	22.0	%	683,946	566,685	20.7	%
Commissions and other underwriting expenses	63,353	57,199	10.8	%	186,356	172,128	8.3	%
Interest expense	3,199	2,702	18.4	%	8,604	8,105	6.2	%
Corporate general and administrative expenses	1,750	1,729	1.2	%	5,850	5,654	3.5	%
Other expenses	585	1,026	(43.0)	)%	931	1,425	(34.7))%
Total costs and expenses	307,148	257,931	19.1	%	885,687	753,997	17.5	%
Earnings before income taxes	6,586	8,196	(19.6)	)%	21,431	28,628	(25.1))%
Provision for income taxes	1,432	1,462	(2.1)	)%	5,029	4,839	3.9	%
Net Earnings	\$5,154	\$6,733	(23.4)	)%	\$16,402	\$23,789	(31.1))%
Net Earnings per Common Share:								
Basic	\$0.44	\$0.56	(21.4)	)%	\$1.40	\$1.95	(28.2))%
Diluted	0.43	0.55	(21.8)	)%	1.37	1.90	(27.9))%
Average Number of Common Shares:								
Basic	11,631	12,070	(3.6)	)%	11,689	12,230	(4.4))%
Diluted	11,893	12,344	(3.7)	)%	11,959	12,524	(4.5))%
Cash Dividends per Common Share	\$0.225	\$0.180	25.0	%	\$0.675	\$0.540	25.0	%
¹ Net realized gains before impairment losses	\$479	\$1,146	(58.2)	)%	\$3,949	\$6,873	(42.5))%
Total other-than-temporary impairment (OTTI) losses	(211)	(442)	(52.2)	)%	(1,245)	(2,121)	(41.3))%
Non-credit portion in other comprehensive income	0	19	(100.0)	)%	1	1,036	(99.9))%
OTTI losses reclassified from other comprehensive income	0	(1)	(100.0))%	(32)	(185)	(82.5))%

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Net impairment losses recognized in earnings	(211)	(424)	(50.2)%	(1,277)	(1,270)	0.5	%
Total net realized gains on investments	\$268		\$722		(62.8)%	\$2,673		\$5,604		(52.3)%

See Condensed Notes to Consolidated Financial Statements.

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INFINITY PROPERTY AND CASUALTY CORPORATION 10-Q

INFINITY PROPERTY AND CASUALTY CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(in thousands)

(unaudited)

	Three months ended		Nine months ended	
	September 30, 2012	2011 (as adjusted see Note 1)	September 30, 2012	2011 (as adjusted see Note 1)
Net earnings	\$5,154	\$6,733	\$16,402	\$23,789
Other comprehensive income before tax:				
Net change in postretirement benefit liability	(6)	(16)	(17)	(48)
Unrealized gains on investments:				
Unrealized holding gains arising during the period	10,662	2,723	20,780	16,483
Less: Reclassification adjustments for gains included in net income	(268)	(722)	(2,673)	(5,604)
Unrealized gains on investments, net	10,394	2,001	18,107	10,879
Other comprehensive income, before tax	10,388	1,985	18,090	10,831
Income tax expense related to components of other comprehensive income	(3,636)	(695)	(6,332)	(3,791)
Other comprehensive income, net of tax	6,752	1,290	11,759	7,040
Comprehensive income	\$11,907	\$8,023	\$28,161	\$30,829

See Condensed Notes to Consolidated Financial Statements.

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INFINITY PROPERTY AND CASUALTY CORPORATION 10-Q

INFINITY PROPERTY AND CASUALTY CORPORATION AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

(in thousands, except share data)

	September 30, 2012 (unaudited)	December 31, 2011 (as adjusted see Note 1)
Assets		
Investments:		
Fixed maturities – at fair value (amortized cost \$1,195,837 and \$1,144,687)	\$1,251,930	\$1,187,987
Equity securities – at fair value (cost \$26,569 and \$26,413)	42,400	36,930
Total investments	\$1,294,330	\$1,224,917
Cash and cash equivalents	126,574	83,767
Restricted cash (See Note 10)	209,879	0
Accrued investment income	10,762	10,761
Agents' balances and premium receivable, net of allowances for doubtful accounts of \$15,010 and \$13,497	445,334	382,621
Property and equipment, net of accumulated depreciation of \$43,303 and \$37,551	40,726	38,694
Prepaid reinsurance premium	2,676	2,131
Recoverables from reinsurers (includes \$758 and \$79 on paid losses and LAE)	15,318	14,719
Deferred policy acquisition costs	92,493	80,071
Current and deferred income taxes	8,811	10,728
Receivable for securities sold	0	1,152
Other assets	20,013	5,535
Goodwill	75,275	75,275
Total assets	\$2,342,192	\$1,930,371
Liabilities and Shareholders' Equity		
Liabilities:		
Unpaid losses and loss adjustment expenses	\$544,318	\$495,403
Unearned premium	557,748	474,528
Payable to reinsurers	0	45
Long-term debt (See Note 6)	469,875	194,810
Commissions payable	32,644	30,605
Payable for securities purchased	4,558	10,818
Other liabilities	58,465	62,373
Total liabilities	\$1,667,608	\$1,268,582
Commitments and contingencies (See Note 10)		
Shareholders' equity:		
Common stock, no par value (50,000,000 shares authorized; 21,420,996 and 21,331,006 shares issued)	\$21,456	\$21,358
Additional paid-in capital	359,858	355,911
Retained earnings	660,896	652,423
Accumulated other comprehensive income, net of tax	47,077	35,319
Treasury stock, at cost (9,732,697 and 9,524,369 shares)	(414,704)	(403,221)
Total shareholders' equity	\$674,584	\$661,789
Total liabilities and shareholders' equity	\$2,342,192	\$1,930,371

See Condensed Notes to Consolidated Financial Statements.

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INFINITY PROPERTY AND CASUALTY CORPORATION 10-Q

INFINITY PROPERTY AND CASUALTY CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

(in thousands)

(unaudited)

	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss), Net of Tax	Treasury Stock	Total
Balance at December 31, 2010	\$21,228	\$349,742	\$625,492	\$24,488	\$(359,766)	\$661,184
Cumulative effect of change in accounting principle	—	—	(6,157)	—	—	(6,157)
Net earnings	—	—	23,789	—	—	23,789
Net change in postretirement benefit liability	—	—	—	(31)	—	(31)
Change in unrealized gain on investments	—	—	—	6,102	—	6,102
Change in non-credit component of impairment losses on fixed maturities	—	—	—	969	—	969
Comprehensive income						\$30,829
Dividends paid to common shareholders	—	—	(6,618)	—	—	(6,618)
Shares issued and share-based compensation expense, including tax benefit	91	4,291	—	—	—	4,383
Acquisition of treasury stock	—	—	—	—	(39,387)	(39,387)
Balance at September 30, 2011, as adjusted	\$21,319	\$354,034	\$636,505	\$31,528	\$(399,153)	\$644,233
Net earnings	\$—	\$—	\$18,044	\$—	\$—	\$18,044
Net change in postretirement benefit liability	—	—	—	(145)	—	(145)
Change in unrealized gain on investments	—	—	—	3,618	—	3,618
Change in non-credit component of impairment losses on fixed maturities	—	—	—	317	—	317
Comprehensive income						\$21,835
Dividends paid to common shareholders	—	—	(2,126)	—	—	(2,126)
Shares issued and share-based compensation expense, including tax benefit	38	1,877	—	—	—	1,916
Acquisition of treasury stock	—	—	—	—	(4,067)	(4,067)
Balance at December 31, 2011, as adjusted	\$21,358	\$355,911	\$652,423	\$35,319	\$(403,221)	\$661,789
Net earnings	\$—	\$—	\$16,402	\$—	\$—	\$16,402
Net change in postretirement benefit liability	—	—	—	(11)	—	(11)
Change in unrealized gain on investments	—	—	—	10,784	—	10,784
Change in non-credit component of impairment losses on fixed maturities	—	—	—	986	—	986
Comprehensive income						\$28,161

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Dividends paid to common shareholders	—	—	(7,929)	—	—	(7,929)
Shares issued and share-based compensation expense, including tax benefit	98	3,947	—	—	—	4,045
Acquisition of treasury stock	—	—	—	—	(11,483)	(11,483)
Balance at September 30, 2012	\$21,456	\$359,858	\$660,896	\$47,077	\$(414,704)	\$674,584

See Condensed Notes to Consolidated Financial Statements.

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INFINITY PROPERTY AND CASUALTY CORPORATION 10-Q

INFINITY PROPERTY AND CASUALTY CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(unaudited)

	Three months ended September 30,	
	2012	2011 (as adjusted See Note 1)
Operating Activities:		
Net earnings	\$5,154	\$6,733
Adjustments:		
Depreciation	2,356	1,850
Amortization	2,580	2,038
Net realized gains on investments	(268)	(722)
Loss on disposal of property and equipment	30	160
Gain on sale of subsidiary	(2,922)	0
Share-based compensation expense	671	967
Excess tax benefits from share-based payment arrangements	0	(169)
Activity related to rabbi trust	37	(65)
Decrease (increase) in accrued investment income	101	(5)
Increase in agents' balances and premium receivable	(18,250)	(14,928)
(Increase) decrease in reinsurance receivables	(1,108)	186
Increase in deferred policy acquisition costs	(2,463)	(2,444)
(Increase) decrease in other assets	(2,685)	5,903
Increase in unpaid losses and loss adjustment expenses	13,446	10,422
Increase in unearned premium	21,645	14,409
Decrease in other liabilities	(1,099)	(5,848)
Net cash provided by operating activities	17,225	18,488
Investing Activities:		
Purchases of fixed maturities	(89,084)	(46,844)
Purchases of equity securities	0	(2,000)
Purchases of property and equipment	(944)	(2,705)
Maturities and redemptions of fixed maturities	62,178	22,416
Proceeds from sale of fixed maturities	9,968	49,360
Proceeds from sale of property and equipment	11	0
Net cash (used in) provided by investing activities	(17,872)	20,228
Financing Activities:		
Proceeds from stock options exercised and employee stock purchases, including tax benefit	396	271
Excess tax benefits from share-based payment arrangements	0	169
Proceeds from issuance of bonds	273,213	0
Increase in restricted cash related to planned redemption of debt	(209,879)	0
Acquisition of treasury stock	(3,194)	(21,284)
Dividends paid to shareholders	(2,629)	(2,170)
Net cash provided by (used in) financing activities	57,906	(23,014)
Net increase in cash and cash equivalents	57,260	15,702
Cash and cash equivalents at beginning of period	69,314	36,455

Cash and cash equivalents at end of period	\$ 126,574	\$ 52,157
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See Condensed Notes to Consolidated Financial Statements.

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INFINITY PROPERTY AND CASUALTY CORPORATION 10-Q

INFINITY PROPERTY AND CASUALTY CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(unaudited)

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	Nine months ended September 30,	
	2012	2011 (as adjusted See Note 1)
Operating Activities:		
Net earnings	\$ 16,402	\$ 23,789
Adjustments:		
Depreciation	6,442	6,676
Amortization	7,137	5,869
Net realized gains on investments	(2,673)	(5,604)
Loss on disposal of property and equipment	44	362
Gain on sale of subsidiary	(2,922)	0
Share-based compensation expense	2,817	2,383
Excess tax benefits from share-based payment arrangements	0	(169)
Activity related to rabbi trust	72	(47)
(Increase) decrease in accrued investment income	(1)	809
Increase in agents' balances and premium receivable	(62,713)	(53,024)
(Increase) decrease in reinsurance receivables	(1,145)	1,596
Increase in deferred policy acquisition costs	(12,421)	(11,196)
Increase in other assets	(8,004)	(4,087)
Increase in unpaid losses and loss adjustment expenses	48,915	15,698
Increase in unearned premium	83,220	63,370
Decrease in payable to reinsurers	(45)	(42)
Decrease in other liabilities	(2,096)	(20,328)
Net cash provided by operating activities	73,029	26,057
Investing Activities:		
Purchases of fixed maturities	(344,520)	(242,707)
Purchases of equity securities	0	(2,000)
Purchases of property and equipment	(8,529)	(20,881)
Maturities and redemptions of fixed maturities	144,171	113,081
Proceeds from sale of fixed maturities	133,510	150,231
Proceeds from sale of equity securities	0	7,871
Proceeds from sale of property and equipment	11	0
Net cash (used in) provided by investing activities	(75,359)	5,596
Financing Activities:		
Proceeds from stock options exercised and employee stock purchases, including tax benefit	1,229	1,999
Excess tax benefits from share-based payment arrangements	0	169
Proceeds from issuance of bonds	273,213	0
Increase in restricted cash related to planned redemption of debt	(209,879)	0
Acquisition of treasury stock	(11,497)	(38,650)
Dividends paid to shareholders	(7,929)	(6,618)
Net cash provided by (used in) financing activities	45,136	(43,100)
Net increase (decrease) in cash and cash equivalents	42,807	(11,447)
Cash and cash equivalents at beginning of period	83,767	63,605
Cash and cash equivalents at end of period	\$ 126,574	\$ 52,157

See Condensed Notes to Consolidated Financial Statements.

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INFINITY PROPERTY AND CASUALTY CORPORATION 10-Q

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2012

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Note 1 Reporting and Accounting Policies

Nature of Operations

We are a holding company that, through subsidiaries, provides personal automobile insurance with a concentration on nonstandard auto insurance. Although licensed to write insurance in all 50 states and the District of Columbia, we focus on select states that we believe offer the greatest opportunity for premium growth and profitability.

Basis of Consolidation and Reporting

The accompanying consolidated financial statements are unaudited and should be read in conjunction with our Annual Report on Form 10-K for the year ended December 31, 2011. This Quarterly Report on Form 10-Q, including the Condensed Notes to Consolidated Financial Statements and Management's Discussion and Analysis of Financial Condition and Results of Operations, focuses on our financial performance since the beginning of the year.

These financial statements reflect certain adjustments necessary for a fair presentation of our results of operations and financial position. Such adjustments consist of normal, recurring accruals recorded to match expenses with their related revenue streams and the elimination of all significant inter-company transactions and balances.

We have evaluated events that occurred after September 30, 2012 for recognition or disclosure in our financial statements and the notes to the financial statements.

Schedules may not foot due to rounding.

Estimates

We based certain accounts and balances within these financial statements upon our estimates and assumptions. The amount of reserves for claims not yet paid, for example, is an item that we can only record by estimation. Unrealized capital gains and losses on investments are subject to market fluctuations, and we use judgment in the determination of whether unrealized losses on certain securities are temporary or other-than-temporary. Should actual results differ significantly from these estimates, the effect on our results of operations could be material. The results of operations for the periods presented may not be indicative of our results for the entire year.

Recently Adopted Accounting Standards

Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts

In October 2010, the Financial Accounting Standards Board ("FASB") issued an accounting standards update intended to reduce diversity in practice for the accounting of deferred policy acquisition costs. The guidance modifies the definition of acquisition costs to require that costs be directly related to the successful acquisition of a new or renewal insurance contract to be deferred. We adopted this standard as of January 1, 2012. Pursuant to the guidance, we

elected to adopt this standard on a retrospective basis and recognized an adjustment to beginning retained earnings for the earliest period shown in the Consolidated Statements of Changes in Shareholders' Equity of \$6.2 million, net of taxes.

The following table illustrates the effect of adopting this standard on the Consolidated Balance Sheets (in millions):

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Condensed Notes to Consolidated Financial Statements

	December 31, 2011		
	As Reported	As Adjusted	Difference
Deferred policy acquisition costs	\$89.9	\$80.1	\$(9.8)
Current and deferred income taxes	7.3	10.7	3.4
Total assets	1,936.8	1,930.4	(6.4)
Shareholders' equity	668.2	661.8	(6.4)

The following table illustrates the effect of adopting this standard on the Consolidated Statements of Earnings (in millions, except per share amounts):

	Three months ended September 30, 2011			Nine months ended September 30, 2011		
	As Reported	As Adjusted	Difference	As Reported	As Adjusted	Difference
Commissions and other underwriting expenses	\$58.1	\$57.2	\$(0.9)	\$170.7	\$172.1	\$1.4
Provision for income taxes	1.1	1.5	0.3	5.3	4.8	(0.5)
Net earnings	6.1	6.7	0.6	24.7	23.8	(0.9)
Net earnings per common share:						
Basic	\$0.51	\$0.56	\$0.05	\$2.02	\$1.95	\$(0.07)
Diluted	0.50	0.55	0.05	1.97	1.90	(0.07)

We also adjusted the Consolidated Statements of Cash Flows for these changes for the three and nine months ended September 30, 2011.

Presentation of Comprehensive Income

In June and December 2011, the FASB issued guidance amending the presentation of comprehensive income and its components. We adopted this standard as of January 1, 2012. Under the new guidance, a reporting entity has the option to present comprehensive income in a single continuous statement or in two separate but consecutive statements, as we elected. The impact of adoption was not material to our results of operations or financial position.

Amendments to Fair Value Measurement and Disclosure Requirements

In May 2011, the FASB issued guidance that clarifies the application of existing fair value measurement and disclosure requirements and amends certain fair value measurement principles, requirements and disclosures. We adopted this standard as of January 1, 2012. The impact of adoption was not material to our results of operations or financial position. Additional disclosures required by this standard are located in Note 4 to the Consolidated Financial Statements.

Intangibles – Goodwill and Other

In September 2011, the FASB issued guidance providing the option to first assess qualitative factors, such as macroeconomic conditions and industry and market considerations, to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If the qualitative assessment indicates impairment, an entity must perform the two-step goodwill impairment test. If an entity does not elect the option to perform the qualitative assessment, the guidance requiring the two-step goodwill impairment test is unchanged. We adopted this standard as of January 1, 2012. The impact of adoption had no impact on our results of operations or financial position.

Note 2 Share-Based Compensation

Restricted Stock Plan

We established the Restricted Stock Plan in 2002 and amended it on July 31, 2007. There are 500,000 shares of our common stock reserved for issuance under the Restricted Stock Plan, of which we have issued 278,843 shares as of September 30, 2012. We expense the fair value of shares issued under the Restricted Stock Plan over the vesting periods of the awards based on the market value of our stock on the date of grant.

On July 31, 2007, our Compensation Committee (“Committee”) approved the grant of 72,234 shares of restricted stock to certain officers under the Restricted Stock Plan. These shares of restricted stock vested in full on July 31, 2011. On August 2,

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Condensed Notes to Consolidated Financial Statements

2011, the Committee approved the grant of an additional 72,234 shares of restricted stock to certain officers under the Restricted Stock Plan. These shares will vest in full on August 2, 2014. During the vesting period, the shares of restricted stock will not have voting rights and will accrue dividends, which we will not pay until the shares have vested. We treat the restricted shares as issued and outstanding for calculation of diluted earnings per share only. Until fully vested, we will not consider the shares issued and outstanding for purposes of the basic earnings per share calculation.

Non-employee Directors' Stock Ownership Plan

In May 2005, our shareholders approved the Non-employee Directors' Stock Ownership Plan ("Directors' Plan"). The purpose of the Directors' Plan is to include our common stock as part of the compensation provided to our non-employee directors and to provide for stock ownership requirements for our non-employee directors. There are 200,000 shares of our common stock reserved for issuance under the Directors' Plan, of which we have issued 49,461 shares as of September 30, 2012. Under the terms of the Directors' Plan, we grant shares on or about June 1 of each year and we restrict these shares from sale or transfer by any recipient for six months from the date of grant. In June 2011, we issued 6,657 shares of our common stock, valued pursuant to the Directors' Plan at \$350,000, to our non-employee directors. In June 2012, we issued 5,502 shares of our common stock, valued pursuant to the Directors' Plan at \$300,000, to our non-employee directors. We treat participants' shares as issued and outstanding for basic and diluted earnings per share calculations.

Employee Stock Purchase Plan

We established our Employee Stock Purchase Plan ("ESPP") in 2004 and amended and restated it on August 3, 2010. Under the ESPP, all eligible full-time employees may purchase shares of our common stock at a 15% discount to the current market price. Employees may allocate up to 25% of their base salary with a maximum annual participation amount of \$25,000. If a participant sells any shares purchased under the ESPP within one year, we preclude that employee from participating in the ESPP for one year from the date of sale. The source of shares issued to participants is treasury shares or authorized but previously unissued shares. The maximum number of shares that we may issue under the ESPP may not exceed 1,000,000, of which we have issued 52,244 as of September 30, 2012. Our ESPP is qualified under Section 423 of the Internal Revenue Code of 1986, as amended. We treat participants' shares as issued and outstanding for basic and diluted earnings per share calculations.

Performance Share Plan

Our shareholders approved the Performance Share Plan ("PSP") on May 20, 2008 and an amended and restated PSP on May 26, 2010. The purpose of the PSP is to align further the interest of management with our long-term shareholders by including performance-based compensation, payable in shares of common stock, as a component of an executive's annual compensation. The Committee administers the PSP and will (i) establish the performance goals, which may include but are not limited to, combined ratio, premium growth, growth within certain specific geographic areas and earnings per share or return on equity over the course of the upcoming three year period, (ii) determine the PSP participants, (iii) set the performance share units to be awarded to such participants, and (iv) set the rate at which performance share units will convert to shares of common stock based upon attainment of the performance goals. The number of shares of common stock that we may issue under the PSP is limited to 500,000 shares. In April 2012 and 2011, we issued 49,098 and 32,957 shares, respectively, under the PSP.

Stock Option Plan

We amended our Stock Option Plan ("SOP") to prohibit any future grant of stock options from the plan after May 20, 2008. We amended the plan again on August 2, 2011. We have granted no options since 2004. We generally granted options with an exercise price equal to the closing price of our stock at the date of grant and these options have a 10-year contractual life. All of the options under the SOP have fully vested. Subject to specific limitations contained in the SOP, our Board of Directors has the ability to amend, suspend or terminate the plan at any time without

shareholder approval. The SOP will continue in effect until the exercise or expiration of all options granted under the SOP.

As permitted by the Stock Compensation topic of the FASB Accounting Standards Codification, we used the modified Black-Scholes model with the assumptions noted below to estimate the value of employee stock options on the date of grant. Expected volatilities are based on historical volatilities of our stock. We selected the expected option life to be 7.5 years, which represents the midpoint between the last vesting date and the end of the contractual term. The risk-free interest rate for periods within the contractual life of the options is based on the yield on 10-year Treasury notes in effect at the time of grant. The dividend yield was based on expected dividends at the time of grant.

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We estimated the weighted-average grant date fair values of options granted during 2004 and 2003 using the modified Black-Scholes valuation model and the following weighted-average assumptions:

	2004 Grants		2003 Grants	
Weighted-average grant date fair value	\$13.87		\$5.97	
Dividend yield	0.7	%	1.4	%
Expected volatility	33.0	%	33.0	%
Risk-free interest rate	4.3	%	4.0	%
Expected life	7.5	years	7.5	years
Weighted-average grant exercise price	\$33.56		\$16.11	
Outstanding at September 30, 2012	78,300		83,599	

The following table describes activity for our Stock Option Plan:

	Number of Options	Weighted-Average Exercise Price	Weighted-Average Remaining Term (in years)	Aggregate Intrinsic Value (a) (in millions)
Outstanding at December 31, 2011	192,455	\$ 23.40		
Granted	0	0		
Exercised	(30,556)	\$ 16.77		
Forfeited	0	0		
Outstanding at September 30, 2012	161,899	\$ 24.65	0.87	\$ 5.8
Vested at September 30, 2012	161,899	\$ 24.65	0.87	\$ 5.8
Exercisable at September 30, 2012	161,899	\$ 24.65	0.87	\$ 5.8

(a) We calculated the intrinsic value for the stock options based on the difference between the exercise price of the underlying awards and our closing stock price as of the reporting date.

Cash received from options exercised for the nine months ended September 30, 2012 and 2011 was approximately \$0.5 million and \$0.9 million, respectively. The actual tax benefit realized for the tax deductions from options exercised totaled \$0.2 million and \$0.5 million for the nine months ended September 30, 2012 and September 30, 2011, respectively. The total intrinsic value of options exercised during the nine months ended September 30, 2012 and 2011 was approximately \$1.2 million and \$1.8 million, respectively.

We have a policy of issuing new stock for the exercise of stock options.

The amount of total compensation cost, by plan, for share-based compensation arrangements was as follows (in thousands):

	Three months ended September 30,				Nine months ended September 30,			
	2012		2011		2012		2011	
	Expense Recognized in Income	Tax Benefit	Expense Recognized in Income	Tax Benefit	Expense Recognized in Income	Tax Benefit	Expense Recognized in Income	Tax Benefit
Restricted Stock Plan	\$298	\$104	\$265	\$93	\$893	\$312	\$662	\$232
Directors' Plan	0	0	0	0	300	105	350	123

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ESPP	13	0	11	0	40	0	30	0
PSP	373	131	702	246	1,624	568	1,371	480
Total	\$684	\$235	\$978	\$338	\$2,856	\$986	\$2,414	\$834

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Note 3 Computation of Net Earnings per Share

The following table illustrates the computation of our basic and diluted net earnings per common share (in thousands, except per share figures):

	Three months ended September		Nine months ended September	
	30, 2012	2011	30, 2012	2011
Net earnings for basic and diluted net earnings per share	\$5,154	\$6,733	\$16,402	\$23,789
Average basic shares outstanding	11,631	12,070	11,689	12,230
Basic net earnings per share	\$0.44	\$0.56	\$1.40	\$1.95
Average basic shares outstanding	11,631	12,070	11,689	12,230
Restricted stock not yet vested	32	71	25	72
Dilutive effect of assumed option exercises	101	104	103	119
Dilutive effect of Performance Share Plan	129	100	141	102
Average diluted shares outstanding	11,893	12,344	11,959	12,524
Diluted net earnings per share	\$0.43	\$0.55	\$1.37	\$1.90

Note 4 Fair Value

Fair values of instruments are based on:

- (i) quoted prices in active markets for identical assets (Level 1),
quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in
- (ii) markets that are not active and model-derived valuations in which all significant inputs are observable in active markets (Level 2) or
- (iii) valuations derived from valuation techniques in which one or more significant inputs are unobservable in the marketplace (Level 3).

The following table presents for each of the fair value hierarchy levels our assets and liabilities for which we report fair value on a recurring basis at September 30, 2012 (in thousands):

	Fair Value			Total
	Level 1	Level 2	Level 3	
Cash and cash equivalents	\$126,574	\$0	\$0	\$126,574
Fixed maturity securities:				
U.S. government	106,669	318	3,735	110,722
Government-sponsored enterprises	0	70,678	0	70,678
State and municipal	0	432,116	4,031	436,147
Mortgage-backed securities:				
Residential	0	238,149	0	238,149
Commercial	0	13,487	0	13,487
Total mortgage-backed securities	\$0	\$251,636	\$0	\$251,636
Collateralized mortgage obligations	0	21,920	0	21,920
Asset-backed securities	0	81,295	2,645	83,940
Corporates	0	265,969	10,918	276,886
Total fixed maturities	\$106,669	\$1,123,932	\$21,329	\$1,251,930

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Equity securities	42,400	0	0	42,400	
Total cash and investments	\$275,643	\$1,123,932	\$21,329	\$1,420,904	
Percentage of total cash and investments	19.4	% 79.1	% 1.5	% 100.0	%

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We do not measure our long-term debt at fair value in the Consolidated Balance Sheets. The \$491.4 million fair value of our long-term debt would be included in Level 2 of the fair value hierarchy if it were reported at fair value.

Level 1 includes cash and cash equivalents, U.S. Treasury securities, an exchange-traded fund and equities invested in a rabbi trust. Level 2 includes securities whose fair value was determined using observable market inputs. Level 3 securities are comprised of (i) securities for which there is no active or inactive market for similar instruments, (ii) securities whose fair value is determined based on unobservable inputs and (iii) securities, other than those backed by the U.S. Government, that are not rated by a nationally recognized statistical rating organization ("NRSRO"). We recognize transfers between levels at the beginning of the reporting period.

A third party nationally recognized pricing service provides the fair value of securities in Level 2. We periodically review the third party pricing methodologies and test for significant differences between the market price used to value the security and recent sales activity.

The following table presents the changes in the Level 3 fair value category (in thousands):

	Three months ended September 30, 2012						
	U.S. Government	State and Municipal	Mortgage-Backed Securities	Collateralized Mortgage Obligations	Corporates	ABS	Total
Balance at beginning of period	\$3,899	\$2,750	\$7,188	\$486	\$9,966	\$1,361	\$25,651
Total gains or (losses), unrealized or realized							
Included in net earnings	0	0	0	(71)	(203)	0	(274)
Included in other comprehensive income	(23)	29	0	86	224	0	316
Purchases	0	4,002	0	0	0	2,645	6,647
Sales	0	0	0	(483)	(1)	0	(485)
Settlements	(141)	(2,750)	0	(18)	(122)	0	(3,031)
Transfers in	0	0	0	0	1,053	0	1,053
Transfers out	0	0	(7,188)	0	0	(1,361)	(8,549)
Balance at end of period	\$3,735	\$4,031	\$0	\$0	\$10,918	\$2,645	\$21,329
	Nine months ended September 30, 2012						
	U.S. Government	State and Municipal	Mortgage-Backed Securities	Collateralized Mortgage Obligations	Corporates	ABS	Total
Balance at beginning of period	\$4,438	\$0	\$0	\$509	\$10,426	\$0	\$15,374
Total gains or (losses), unrealized or realized							
Included in net earnings	0	0	0	(71)	(1,188)	0	(1,259)
Included in other comprehensive income	(106)	2,779	7,188	90	1,501	1	11,452
Purchases	0	4,002	0	0	0	4,005	8,007
Sales	0	0	0	(483)	(254)	0	(737)
Settlements	(597)	(2,750)	0	(44)	(1,387)	0	(4,778)

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Transfers in	0	0	0	0	2,889	0	2,889
Transfers out	0	0	(7,188) 0	(1,070) (1,361) (9,619
Balance at end of period	\$3,735	\$4,031	\$0	\$0	\$10,918	\$2,645	\$21,329

Of the \$21.3 million fair value of securities in Level 3, which consists of 17 securities, we priced 15 based on non-binding broker quotes. We manually calculated the price of 2 securities, which have a combined fair value of \$0.8 million. Quantitative

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information about the significant unobservable inputs used in the fair value measurement of these manually priced securities at September 30, 2012 is as follows (in millions):

	Fair Value	Valuation Technique	Unobservable Input	Value Used
Corporate bond	\$0.1	Recovery rate ¹	Probability of default	100%
Corporate bond	0.8	Discounted cash flow	Comparable credit rating	B+
Total	\$0.8			

¹ Recovery rate for senior unsecured bonds as indicated in Moody's Investor's Service Annual Default Study: Corporate Default and Recovery Rates, 1920-2011.

The significant unobservable inputs used in the fair value measurement of our manually-priced corporate bonds are a probability of default assumption and an assigned credit rating. Significant changes in either of these inputs in isolation could result in a significant change in fair value measurement. Generally, a reduction in probability of default would increase security valuation. A change in the credit rating assumption would change the yield spread associated with that bond, and thus the yield used in discounting the cash flows to arrive at the security's valuation. We transferred approximately \$9.6 million of securities in Level 3 at December 31, 2011 to Level 2 during the nine months ended September 30, 2012 because we obtained a price for those securities from a nationally recognized pricing service. We transferred approximately \$2.9 million of securities into Level 3 from Level 2 during the nine months ended September 30, 2012 because we could not obtain a price from a third party nationally recognized pricing service or because a rating by a NRSRO was not available. There were no transfers between Levels 1 and 2 during the nine months ended September 30, 2012.

The gains or losses included in net earnings are included in the line item net realized gains on investments in the Consolidated Statements of Earnings. We recognize the net gains or losses included in other comprehensive income in the line item unrealized gains (losses) on investments, net in the Consolidated Statements of Comprehensive Income and the line item change in unrealized gain on investments or the line item change in non-credit component of impairment losses on fixed maturities in the Consolidated Statements of Changes in Shareholders' Equity.

The following table presents the carrying value and estimated fair value of our financial instruments (in thousands):

	September 30, 2012		December 31, 2011	
	Carrying Value	Fair Value	Carrying Value	Fair Value
Assets:				
Cash and cash equivalents	\$ 126,574	\$ 126,574	\$ 83,767	\$ 83,767
Available-for-sale securities				
Fixed maturities	1,251,930	1,251,930	1,187,987	1,187,987
Equity securities	42,400	42,400	36,930	36,930
Total cash and investments	\$ 1,420,904	\$ 1,420,904	\$ 1,308,684	\$ 1,308,684
Liabilities:				
Long-term debt	\$ 469,875	\$ 491,414	\$ 194,810	\$ 207,246

See Note 5 to the Consolidated Financial Statements for additional information on investments and Note 6 for additional information on long-term debt.

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Condensed Notes to Consolidated Financial Statements

Note 5 Investments

We consider all fixed maturity and equity securities available-for-sale and report them at fair value with the net unrealized gains or losses reported after-tax (net of any valuation allowance) as a component of other comprehensive income. The proceeds from sales of securities for the three months ended September 30, 2012 and 2011 were \$10.0 million and \$49.4 million, respectively. The proceeds from sales of securities for the nine months ended September 30, 2012 and 2011 were \$133.5 million and \$158.1 million, respectively. The proceeds for the three and nine months ended September 30, 2011 were net of \$5.5 million of receivable for securities sold during the third quarter of 2011 that had not settled at September 30, 2011.

Gains or losses on securities are determined on a specific identification basis.

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Summarized information for the major categories of our investment portfolio follows (in thousands):

	September 30, 2012				OTTI
	Amortized Cost or Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value	Recognized in Accumulated OCI ⁽¹⁾
Fixed maturities:					
U.S. government	\$107,935	\$2,791	\$(3)	\$110,722	\$0
Government-sponsored enterprises	69,021	1,658	0	70,678	0
State and municipal	414,600	21,592	(45)	436,147	(53)
Mortgage-backed securities:					
Residential	224,736	13,412	0	238,149	(738)
Commercial	12,670	824	(7)	13,487	0
Total mortgage-backed securities	\$237,406	\$14,236	\$(7)	\$251,636	\$(738)
Collateralized mortgage obligations	21,395	533	(8)	21,920	(263)
Asset-backed securities	83,620	542	(222)	83,940	(8)
Corporates	261,860	15,108	(81)	276,886	(1,131)
Total fixed maturities	\$1,195,837	\$56,461	\$(367)	\$1,251,930	\$(2,194)
Equity securities	26,569	15,831	0	42,400	0
Total	\$1,222,405	\$72,292	\$(367)	\$1,294,330	\$(2,194)
	December 31, 2011				
	Amortized Cost or Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value	OTTI Recognized in Accumulated OCI ⁽¹⁾
Fixed maturities:					
U.S. government	\$124,378	\$3,428	\$(8)	\$127,798	\$0
Government-sponsored enterprises	55,220	958	(9)	56,170	0
State and municipal	391,436	18,016	(63)	409,388	(70)
Mortgage-backed securities:					
Residential	225,506	10,878	(14)	236,370	(1,157)
Commercial	19,751	760	(142)	20,369	(11)
Total mortgage-backed securities	\$245,257	\$11,638	\$(156)	\$256,739	\$(1,168)
Collateralized mortgage obligations	27,447	757	(102)	28,103	(515)
Asset-backed securities	48,403	368	(143)	48,628	(8)
Corporates	252,546	9,688	(1,072)	261,162	(1,949)
Total fixed maturities	\$1,144,687	\$44,853	\$(1,553)	\$1,187,987	\$(3,711)
Equity securities	26,413	10,554	(38)	36,930	0
Total	\$1,171,100	\$55,408	\$(1,590)	\$1,224,917	\$(3,711)

(1) The total non-credit portion of OTTI recognized in Accumulated OCI reflecting the original non-credit loss at the time the credit impairment was determined.

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The following table sets forth the amount of unrealized loss by investment category and length of time that individual securities have been in a continuous unrealized loss position (in thousands):

	Less than 12 Months				12 Months or More				
	Number of Securities with Unrealized Losses	Fair Value	Gross Unrealized Losses	Unrealized Losses as % of Cost	Number of Securities with Unrealized Losses	Fair Value	Gross Unrealized Losses	Unrealized Losses as % of Cost	
September 30, 2012									
Fixed maturities:									
U.S. government	2	\$7,236	\$(3)	0.0 %	0	\$0	\$0	0.0 %	
State and municipal	7	6,843	(38)	0.6 %	1	518	(7)	1.3 %	
Mortgage-backed securities:									
Commercial	2	377	(2)	0.4 %	2	349	(6)	1.6 %	
Total mortgage-backed securities	2	\$377	\$(2)	0.4 %	2	\$349	\$(6)	1.6 %	
Collateralized mortgage obligations	1	882	(8)	0.9 %	1	1	0	1.4 %	
Asset-backed securities	4	14,035	(107)	0.8 %	3	4,151	(115)	2.7 %	
Corporates	11	5,246	(47)	0.9 %	2	166	(34)	17.0 %	
Total fixed maturities	27	\$34,619	\$(206)	0.6 %	9	\$5,185	\$(162)	3.0 %	
Equity securities	0	0	0	0.0 %	0	0	0	0.0 %	
Total	27	\$34,619	\$(206)	0.6 %	9	\$5,185	\$(162)	3.0 %	
	Less than 12 Months				12 Months or More				
	Number of Securities with Unrealized Losses	Fair Value	Gross Unrealized Losses	Unrealized Losses as % of Cost	Number of Securities with Unrealized Losses	Fair Value	Gross Unrealized Losses	Unrealized Losses as % of Cost	
December 31, 2011									
Fixed maturities:									
U.S. government	1	\$557	\$(8)	1.4 %	0	\$0	\$0	0.0 %	
Government-sponsored enterprises	1	5,032	(9)	0.2 %	0	0	0	0.0 %	
State and municipal	5	7,841	(36)	0.5 %	2	2,885	(28)	0.9 %	
Mortgage-backed securities:									
Residential	1	10,481	(14)	0.1 %	0	0	0	0.0 %	
Commercial	2	1,926	(7)	0.4 %	5	4,505	(135)	2.9 %	
Total mortgage-backed securities	3	\$12,407	\$(21)	0.2 %	5	\$4,505	\$(135)	2.9 %	

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Collateralized mortgage obligations	4	2,714	(9)	0.3	% 1	509	(93)	15.5	%
Asset-backed securities	6	13,653	(143)	1.0	% 1	433	0	0.1	%
Corporates	43	44,695	(1,057)	2.3	% 1	721	(15)	2.0	%
Total fixed maturities	63	\$86,899	\$(1,282)	1.5	% 10	\$9,053	\$(271)	2.9	%
Equity securities	0	0	0	0.0	% 0	0	0	0.0	%
Total	63	\$86,899	\$(1,282)	1.5	% 10	\$9,053	\$(271)	2.9	%

The table above excludes an unrealized gain on equities invested in a rabbi trust of \$34.3 thousand at September 30, 2012 and an unrealized loss of \$37.7 thousand at December 31, 2011.

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The determination of whether unrealized losses are “other-than-temporary” requires judgment based on subjective as well as objective factors. Factors we considered and resources we used in our determination include:

- the intent to sell the security;
- whether it is more likely than not that there will be a requirement to sell the security before our anticipated recovery;
- whether the unrealized loss is credit-driven or a result of changes in market interest rates;
- the length of time the security’s fair value has been below our cost;
- the extent to which fair value is less than cost basis;
- historical operating, balance sheet and cash flow data contained in issuer SEC filings;
- issuer news releases;
- near-term prospects for improvement in the issuer and/or its industry;
- industry research and communications with industry specialists and
- third-party research and credit rating reports.

We regularly evaluate for potential impairment each security position that has any of the following: a fair value of less than 95% of its book value, an unrealized loss that equals or exceeds \$100,000 or one or more impairment charges recorded in the past. In addition, we review positions held related to an issuer of a previously impaired security.

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The following table summarizes those securities, excluding the rabbi trust, with unrealized gains or losses:

	September 30, 2012	December 31, 2011		
Number of positions held with unrealized:				
Gains	714	583		
Losses	36	73		
Number of positions held that individually exceed unrealized:				
Gains of \$500,000	7	5		
Losses of \$500,000	0	0		
Percentage of positions held with unrealized:				
Gains that were investment grade	84	% 83		%
Losses that were investment grade	72	% 73		%
Percentage of fair value held with unrealized:				
Gains that were investment grade	95	% 95		%
Losses that were investment grade	90	% 91		%

The following table sets forth the amount of unrealized loss, excluding the rabbi trust, by age and severity at September 30, 2012 (in thousands):

Age of Unrealized Losses:	Fair Value of Securities with Unrealized Losses	Total Gross Unrealized Losses	Less Than 5%*	5% - 10%*	Greater Than 10%*
Less than or equal to:					
Three months	\$21,709	\$(45)	\$(45)	\$0	\$0
Six months	6,213	(38)	(38)	0	0
Nine months	1,568	(19)	(19)	0	0
Twelve months	5,129	(104)	(104)	0	0
Greater than twelve months	5,185	(162)	(128)	0	(34)
Total	\$39,804	\$(367)	\$(333)	\$0	\$(34)

* As a percentage of amortized cost or cost.

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The change in unrealized gains (losses) on marketable securities included the following (in thousands):

	Pre-tax Fixed Maturities	Equity Securities	Tax Effects	Net
Nine months ended September 30, 2012				
Unrealized holding gains (losses) on securities arising during the period	\$ 15,466	\$ 5,314	\$(7,273)	) \$ 13,507
Realized (gains) losses on securities sold	(3,949)	) 0	1,382	(2,567)
Impairment loss recognized in earnings ⁽¹⁾	1,277	0	(447)	) 830
Change in unrealized gains (losses) on marketable securities, net	\$ 12,793	\$ 5,314	\$(6,338)	) \$ 11,770
Nine months ended September 30, 2011				
Unrealized holding gains (losses) on securities arising during the period	\$ 19,943	\$(3,460)	) \$(5,769)	) \$ 10,714
Realized (gains) losses on securities sold	(4,126)	) (2,748)	) 2,406	(4,468)
Impairment loss recognized in earnings ⁽¹⁾	1,270	0	(444)	) 825
Change in unrealized gains (losses) on marketable securities, net	\$ 17,087	\$(6,207)	) \$(3,808)	) \$ 7,072

(1) Tax excludes valuation reserve

For fixed maturity securities that are other-than-temporarily impaired, we assess our intent to sell and the likelihood that we will be required to sell the security before recovery of our amortized cost. If a fixed maturity security is considered other-than-temporarily impaired but we do not intend to and are not more than likely to be required to sell the security before our recovery to amortized cost, we separate the amount of the impairment into a credit loss component and the amount due to all other factors. The excess of the amortized cost over the present value of the expected cash flows determines the credit loss component of an impairment charge on a fixed maturity security. The present value is determined using the best estimate of cash flows discounted at (1) the effective interest rate implicit at the date of acquisition for non-structured securities or (2) the book yield for structured securities. The techniques and assumptions for determining the best estimate of cash flows vary depending on the type of security. We recognize the credit loss component of an impairment charge in net earnings and the non-credit component in accumulated other comprehensive income. If we intend to sell or will, more likely than not, be required to sell a security, we treat the entire amount of the impairment as a credit loss.

The following table is a progression of credit losses on fixed maturity securities that were bifurcated between a credit and non-credit component (in thousands):

	Nine months ended September 30,	
	2012	2011
Beginning balance	\$ 1,728	\$ 1,828
Additions for:		
Previously impaired securities	0	37
Newly impaired securities	9	694
Reductions for:		
Securities sold and paid down	(362)) (519)
Securities that no longer have a non-credit component	(735)) 0

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Ending balance	\$640	\$2,040
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The table below sets forth the scheduled maturities of fixed maturity securities at September 30, 2012, based on their fair values (in thousands). We report securities that do not have a single maturity date at average maturity. Actual maturities may differ from contractual maturities because certain securities may be called or prepaid by the issuers.

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Condensed Notes to Consolidated Financial Statements

Maturity	Fair Value			Amortized Cost	
	Securities with Unrealized Gains	Securities with Unrealized Losses	Securities with No Unrealized Gains or Losses	All Fixed Maturity Securities	All Fixed Maturity Securities
One year or less	\$52,635	\$0	\$327	\$52,962	\$51,902
After one year through five years	553,858	10,833	1,347	566,038	543,658
After five years through ten years	208,191	5,618	280	214,089	200,021
After ten years	57,787	3,558	0	61,345	57,835
Mortgage-backed, asset-backed and collateralized mortgage obligations	337,701	19,795	0	357,496	342,421
	\$1,210,172	\$39,804	\$1,954	\$1,251,930	\$1,195,837

Note 6 Long-Term Debt

Our outstanding debt consisted of the following (in millions):

	September 30, 2012		December 31, 2011	
	Carrying Value	Fair Value	Carrying Value	Fair Value
5.5% Senior Notes due 2014	\$194.9	\$205.3	\$194.8	\$207.2
5.0% Senior Notes due 2022	275.0	286.1	0.0	0.0
Total	\$469.9	\$491.4	\$194.8	\$207.2

In February 2004, we issued \$200 million principal of senior notes due February 2014 (the "5.5% Senior Notes"). The 5.5% Senior Notes accrue interest at an effective yield of 5.55% and bear a coupon of 5.5%, payable semiannually. At the time we issued the Senior Notes, we capitalized \$2.1 million of debt issuance costs, which we are amortizing over the term of the 5.5% Senior Notes. During 2009, we repurchased \$5.0 million of our debt, bringing the outstanding principal to \$195.0 million. We calculated the September 30, 2012 fair value of \$205.3 million using a 139 basis point spread to the two-year U.S. Treasury Note of 0.232%. The 5.5% Senior Notes were fully redeemed on October 17, 2012 at a price of 106.729%, or \$208.1 million, plus accrued interest of \$1.8 million.

In September 2012, we issued \$275 million principal of senior notes due September 2022 (the "5.0% Senior Notes"). The 5.0% Senior Notes accrue interest at 5.0%, payable semiannually. At the time we issued the 5.0% Senior Notes, we capitalized \$2.2 million of debt issuance costs, which we are amortizing over the term of the 5.0% Senior Notes. We calculated the September 30, 2012 fair value of \$286.1 million using a 286 basis point spread to the ten-year U.S. Treasury Note of 1.634%.

In August 2011, we renewed our agreement for a \$50 million three-year revolving credit facility (the "Credit Agreement") that requires us to meet certain financial and other covenants. At September 30, 2012 we were in technical violation of one of these covenants due to the issuance of the 5.0% Senior Notes. The 5.5% Senior Notes required 30 days' notice for redemption, therefore, at September 30, 2012 both bond issuances were outstanding causing our leverage ratio to exceed the maximum ratio set forth in the covenants. We were granted a temporary waiver and the 5.5% Senior Notes were redeemed on October 17, 2012. Upon redemption of the 5.5% Senior Notes, the covenant violation was cured.

At September 30, 2012, there were no borrowings outstanding under the Credit Agreement.

Note 7 Income Taxes

The following table reconciles our income taxes at statutory rates to our effective provision for income taxes (in thousands):

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	Three months ended September 30,		Nine months ended September 30,		
	2012	2011	2012	2011	
Earnings before income taxes	\$6,586	\$8,196	\$21,431	\$28,628	
Income taxes at statutory rates	\$2,305	\$2,868	\$7,501	\$10,020	
Effect of:					
Dividends-received deduction	(44	) (35	) (123	) (101
Tax-exempt interest	(824	) (887	) (2,468	) (2,647
Adjustment to valuation allowance	36	(510	) 117	(2,454
Other	(42	) 25	3	21
Provision for income taxes	\$1,432	\$1,462	\$5,029	\$4,839	
GAAP effective tax rate	21.7	% 17.8	% 23.5	% 16.9	%

During the nine months ended September 30, 2011, we decreased our tax valuation allowance by \$2.5 million due to both a decrease in the reserve for other-than-temporary impaired securities and utilization of our capital loss carryforward.

Note 8 Additional Information

Supplemental Cash Flow Information

We made the following payments that we do not separately disclose in the Consolidated Statements of Cash Flows (in thousands):

	Three months ended September 30,		Nine months ended September 30,	
	2012	2011	2012	2011
Income tax payments	\$4,000	\$0	\$9,000	\$9,203
Interest payments on debt	5,363	5,363	10,725	10,725

Negative Cash Book Balances

Negative cash book balances, included in the line item "Other liabilities" in the Consolidated Balance Sheets, were \$5.9 million at December 31, 2011. There were no negative cash book balances at September 30, 2012.

Gain on Sale of Subsidiary

On September 30, 2012, we completed the sale of an inactive, shell subsidiary company to an unaffiliated third party. The total gain recorded on a GAAP basis was \$2.9 million. In the future we intend to sell or dissolve other inactive shell companies. The primary reason for the sale of the companies is to reduce the administrative costs associated with maintaining licenses that are no longer needed to support our insurance operations.

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Condensed Notes to Consolidated Financial Statements

Note 9 Insurance Reserves

Insurance reserves include liabilities for unpaid losses, both known and estimated for incurred but not reported (“IBNR”), and unpaid loss adjustment expenses (“LAE”). The following table provides an analysis of changes in the liability for unpaid losses and LAE on a GAAP basis (in thousands):

	Three months ended September 30,		Nine months ended September 30,	
	2012	2011	2012	2011
Balance at Beginning of Period				
Unpaid losses on known claims	\$202,622	\$188,189	\$181,972	\$180,334
IBNR losses	182,630	160,992	177,645	164,140
LAE	145,620	133,928	135,787	133,359
Total unpaid losses and LAE	530,872	483,108	495,403	477,833
Reinsurance recoverables	(13,798	) (14,880	) (14,640	) (16,521
Unpaid losses and LAE, net of reinsurance recoverables	517,074	468,228	480,764	461,312
Current Activity				
Loss and LAE incurred:				
Current accident year	232,940	190,459	676,822	561,846
Prior accident years	5,321	4,816	7,124	4,839
Total loss and LAE incurred	238,261	195,275	683,946	566,685
Loss and LAE payments:				
Current accident year	(165,714	) (131,711	) (368,230	) (301,638
Prior accident years	(59,864	) (53,016	) (266,722	) (247,582
Total loss and LAE payments	(225,578	) (184,727	) (634,953	) (549,220
Balance at End of Period				
Unpaid losses and LAE, net of reinsurance recoverables	529,757	478,777	529,757	478,777
Add back reinsurance recoverables	14,561	14,754	14,561	14,754
Total unpaid losses and LAE	\$544,318	\$493,531	\$544,318	\$493,531
Unpaid losses on known claims	\$201,804	\$194,164	\$201,804	\$194,164
IBNR losses	193,959	162,809	193,959	162,809
LAE	148,556	136,557	148,556	136,557
Total unpaid losses and LAE	\$544,318	\$493,531	\$544,318	\$493,531

Increases in severities in both bodily injury coverage in California and personal injury protection coverage in Florida related to accident year 2011 was the primary sources of the \$5.3 million and \$7.1 million of unfavorable reserve development during the three and nine months ended September 30, 2012, respectively.

Increases in severities in both liability coverage in California as well as personal injury protection coverage in Florida relating to accident year 2010 were the primary source of the unfavorable development during the third quarter of 2011. An increase in severity in Florida personal injury protection coverage related to accident year 2010 was the primary source of the unfavorable

development during the nine months ended September 30, 2011.

Note 10 Commitments and Contingencies

Commitments

At September 30, 2012 we held \$209.9 million of restricted cash in our Consolidated Balance Sheets. We classified this cash as restricted as it was our intention to use the funds to redeem the the 5.5% Senior Notes. We fully redeemed the 5.5% Senior Notes on October 17, 2012 at a price of 106.729% of par, or \$208.1 million, plus accrued interest of \$1.8 million.

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Condensed Notes to Consolidated Financial Statements

There have been no other material changes from the commitments discussed in the Form 10-K for the year ended December 31, 2011. For a description of our previously reported commitments, refer to Note 14 Commitments and Contingencies in the Form 10-K for the year ended December 31, 2011.

Contingencies

There have been no material changes from the contingencies discussed in the Form 10-K for the year ended December 31, 2011. For a description of our previously reported contingencies, refer to Note 14 Commitments and Contingencies, in the Form 10-K for the year ended December 31, 2011.

Note 11 Subsequent Events

On October 17, 2012 we fully redeemed the \$195.0 million principal outstanding of the 5.5% Senior Notes at a price of 106.729%, or \$208.1 million, plus accrued interest of \$1.8 million. In the fourth quarter of 2012, we will recognize a pre-tax loss on redemption as follows (in thousands):

Redemption price	\$208,122	
Amortized cost at redemption	(194,878)
Unamortized issuance costs	352	
Loss on redemption of debt, pre-tax	\$13,595	

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Management's Discussion and Analysis of Financial Condition and Results of Operations

ITEM 2

CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS

This Quarterly Report on Form 10-Q contains certain "forward-looking statements" which anticipate results based on our estimates, assumptions and plans that are subject to uncertainty. We make these statements subject to the safe-harbor provisions of the Private Securities Litigation Reform Act of 1995. All statements in this report not dealing with historical results or current facts are forward-looking and we base them on estimates, assumptions and projections. Statements which include the words "assumes," "believes," "seeks," "expects," "may," "should," "intends," "likely," "targets," "plans," "anticipates," "estimates" or the negative version of those words and similar statements of a future or forward-looking nature identify forward-looking statements. Examples of such forward-looking statements include statements relating to expectations concerning market conditions, premium growth, earnings, investment performance, expected losses, rate changes and loss experience.

The primary events or circumstances that could cause actual results to differ materially from what we expect include determinations with respect to reserve adequacy, realized gains or losses on the investment portfolio (including other-than-temporary impairments for credit losses), rising bodily injury loss cost trends, undesired business mix or risk profile for new business, elevated unemployment rates and the proliferation of illegal immigration legislation in key Focus States. We undertake no obligation to publicly update or revise any of the forward-looking statements. For a more detailed discussion of some of the foregoing risks and uncertainties which could cause actual results to differ from those contained in the forward-looking statements see "Risk Factors" contained in Part I, Item 1A of our Annual Report on Form 10-K for the twelve months ended December 31, 2011.

OVERVIEW

In the third quarter of 2012 our gross written premium grew 19.9%. This quarter marks the twelfth consecutive quarter that we have experienced growth in written premiums. Approximately 92% of this growth came from California (15%) and Florida (77%), our two most profitable states. Premiums fell in three of the seven Focus States during the third quarter of 2012 as a result of our efforts to improve profitability through rate increases and more restrictive underwriting. See Results of Operations – Underwriting – Premium for a more detailed discussion of our gross written premium growth.

Net earnings and diluted earnings per share for the three months ended September 30, 2012 were \$5.2 million and \$0.43, respectively, compared to \$6.7 million and \$0.55, respectively, for the three months ended September 30, 2011. Net earnings and diluted earnings per share for the nine months ended September 30, 2012 were \$16.4 million and \$1.37, respectively, compared to \$23.8 million and \$1.90, respectively, for the nine months ended September 30, 2011. The decrease in diluted earnings per share for the three and nine months ended September 30, 2012 was primarily due to an increase in unfavorable development recognized in 2012 coupled with a decline in investment income.

Included in net earnings for the three months ended September 30, 2012 and 2011 were \$3.5 million (\$5.3 million pre-tax) and \$3.1 million (\$4.8 million pre-tax), respectively, of unfavorable development on prior accident year loss and LAE reserves. Included in net earnings for the nine months ended September 30, 2012 and 2011 were \$4.6 million (\$7.1 million pre-tax) and \$3.1 million (\$4.8 million pre-tax), respectively, of unfavorable development on prior accident year loss and LAE reserves. The following table displays combined ratio results by accident year developed through September 30, 2012.

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Accident Year	Accident Year Combined Ratio Developed Through					Prior Accident Year Favorable / (Unfavorable) Development		(\$ in millions) Prior Accident Year Favorable / (Unfavorable) Development	
	Sept 2011	Dec 2011	Mar 2012	Jun 2012	Sept 2012	Q3 2012	YTD 2012	Q3 2012	YTD 2012
	(as adjusted see Note 1)								
Prior								\$(0.7)	\$(1.0)
2004	84.9	% 84.9	% 84.9	% 85.0	% 85.0	% 0.0	% 0.0	% (0.1)	(0.1)
2005	87.9	% 87.8	% 87.8	% 87.8	% 87.8	% 0.0	% 0.0	% (0.1)	0.1
2006	90.5	% 90.4	% 90.3	% 90.3	% 90.3	% 0.0	% 0.1	% 0.2	1.4
2007	92.7	% 92.7	% 92.5	% 92.5	% 92.5	% 0.0	% 0.2	% 0.1	2.3
2008	91.7	% 91.7	% 91.6	% 91.5	% 91.5	% 0.0	% 0.2	% 0.2	2.0
2009	92.9	% 92.9	% 92.7	% 92.6	% 92.6	% 0.0	% 0.3	% 0.3	2.5
2010	99.4	% 99.4	% 99.8	% 99.6	% 99.5	% 0.1	% (0.1)	% 0.9	(0.5)
2011	98.4	% 97.6	% 97.9	% 98.3	% 98.9	% (0.6)	% (1.4)	% (6.2)	(13.9)
2012 YTD			99.9	% 99.2	% 98.9	%			
								\$(5.3)	\$(7.1)

Recent accident years are less developed than prior years and must be interpreted with caution. However, the upward trend in the 2010 through 2012 accident period combined ratios compared to prior periods reflects an increase in new business during 2010 through 2012. Our new business combined ratios typically run 20 to 30 points higher than renewal business combined ratios due to higher commission and acquisition expenses as well as typically higher loss ratios. See Results of Operations – Underwriting – Profitability for a more detailed discussion of our underwriting results.

Pre-tax net investment income for the three months ended September 30, 2012 was \$9.0 million compared to \$10.2 million for the three months ended September 30, 2011. Pre-tax net investment income for the nine months ended September 30, 2012 was \$28.4 million compared to \$31.1 million for the nine months ended September 30, 2011. The decrease in pre-tax net investment income for the three and nine months ended September 30, 2012 is a result of low and declining new market investment yields at which cash from maturing and prepaid securities was invested. Our book value per share increased 3.0% from \$56.05 at December 31, 2011 to \$57.71 at September 30, 2012. This increase was primarily due to earnings, net of shareholder dividends, and the increase in unrealized gains on investments for the nine months ended September 30, 2012.

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RESULTS OF OPERATIONS

Underwriting

Premium

Our insurance subsidiaries provide personal automobile insurance products with a concentration on nonstandard auto insurance. While there is no industry-recognized definition of nonstandard auto insurance, we believe that it is generally understood to mean coverage for drivers who, because of their driving record, age or vehicle type, represent higher than normal risks and pay higher rates for comparable coverage. We also write commercial vehicle insurance and insurance for classic collectible automobiles ("Classic Collector").

We offer three primary products to individual drivers: the Low Cost product, which offers the most restrictive coverage, the Value Added product, which offers broader coverage and higher limits, and the Premier product, which we designed to offer the broadest coverage for standard and preferred risk drivers.

We are licensed to write insurance in all 50 states and the District of Columbia, but we focus our operations in targeted urban areas ("Urban Zones") identified within selected Focus States that we believe offer the greatest opportunity for premium growth and profitability.

We classify the states in which we operate into three categories:

• "Focus States" – We have identified Urban Zones in these states, which include Arizona, California, Florida, Georgia, Nevada, Pennsylvania and Texas.

• "Maintenance States" – We are maintaining our writings in these states, which include Alabama, Colorado, Illinois, South Carolina and Tennessee. We believe each state offers us an opportunity for underwriting profit.

• "Other States" – Includes eight states where we maintain a renewal book of personal auto business.

We further classify territories within the Focus States into two categories:

• "Urban Zones" – include the following urban areas:

Arizona – Phoenix and Tucson

California – Bay Area, Los Angeles, Sacramento, San Diego and San Joaquin Valley

Florida – Jacksonville, Miami, Orlando, Sarasota and Tampa

Georgia – Atlanta

Nevada – Las Vegas

Pennsylvania – Allentown and Philadelphia

Texas – Dallas, Fort Worth, Houston and San Antonio

• "Non-urban Zones" – include all remaining areas in the Focus States located outside of a designated Urban Zone.

We continually evaluate our market opportunities; thus, the Focus States, Urban Zones, Maintenance States and Other States may change over time as new market opportunities arise, as the allocation of resources changes or as regulatory environments change. At the beginning of 2012, we reclassified Illinois from a Focus State to a Maintenance State due to its low premium volume and underwriting profits. In the tables below, we have restated 2011 premium, policies in force and combined ratios to be consistent with the 2012 definition of Urban Zones, Focus States, Maintenance States and Other States.

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Our net earned premium was as follows (\$ in thousands):

	Three months ended September 30,				
	2012	2011	Change	% Change	
Net earned premium					
Gross written premium					
Personal Auto					
Focus States					
Urban Zones	\$250,863	\$215,105	\$35,758	16.6	%
Non-urban Zones	41,885	29,462	12,423	42.2	%
Total Focus States	292,748	244,567	48,181	19.7	%
Maintenance States	7,553	6,386	1,167	18.3	%
Other States	1,744	1,629	116	7.1	%
Total Personal Auto	302,045	252,581	49,464	19.6	%
Commercial Vehicle	19,471	15,538	3,933	25.3	%
Classic Collector	3,450	3,010	440	14.6	%
Other	(1	) 0	(1	) 0.0	%
Total gross written premium	324,966	271,129	53,836	19.9	%
Ceded reinsurance	(1,994	) (1,575	) (419	) 26.6	%
Net written premium	322,972	269,554	53,418	19.8	%
Change in unearned premium	(21,509	) (14,417	) (7,092	) 49.2	%
Net earned premium	\$301,463	\$255,138	\$46,326	18.2	%

	Nine months ended September 30,				
	2012	2011	Change	% Change	
Net earned premium					
Gross written premium					
Personal Auto					
Focus States					
Urban Zones	\$747,495	\$641,627	\$105,869	16.5	%
Non-urban Zones	117,985	88,099	29,886	33.9	%
Total Focus States	865,480	729,725	135,755	18.6	%
Maintenance States	22,904	22,031	874	4.0	%
Other States	5,389	5,534	(145	) (2.6)%
Total Personal Auto	893,774	757,290	136,483	18.0	%
Commercial Vehicle	57,736	47,878	9,857	20.6	%
Classic Collector	9,735	8,456	1,280	15.1	%
Other	(1	) 0	(1	) 0.0	%
Total gross written premium	961,244	813,625	147,619	18.1	%
Ceded reinsurance	(5,733	) (4,810	) (924	) 19.2	%
Net written premium	955,511	808,815	146,696	18.1	%
Change in unearned premium	(82,781) (63,112) (19,669) 31.2	%
Net earned premium	\$872,730	\$745,703	\$127,027	17.0	%

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The following table summarizes our policies in force:

	At September 30,				
	2012	2011	Change	% Change	
Policies in Force					
Personal Auto					
Focus States					
Urban Zones	756,141	695,036	61,105	8.8	%
Non-urban Zones	109,936	85,657	24,279	28.3	%
Total Focus States	866,077	780,693	85,384	10.9	%
Maintenance States	26,853	26,513	340	1.3	%
Other States	3,761	4,123	(362)	(8.8))%
Total Personal Auto	896,691	811,329	85,362	10.5	%
Commercial Vehicle	38,868	35,042	3,826	10.9	%
Classic Collector	37,815	35,167	2,648	7.5	%
Total policies in force	973,374	881,538	91,836	10.4	%

Gross written premium grew 19.9% and 18.1% during the third quarter and first nine months of 2012, respectively, compared with the same periods of 2011. During the first nine months of 2012, Infinity implemented rate revisions in various states with an overall rate increase of 5.6%. Excluding the effect of rate changes in California, our largest state, the overall rate increase was 8.3%. Policies in force at September 30, 2012 increased 10.4% compared with the same period in 2011. Gross written premium grew more than policies in force due to a shift in overall business mix toward policies offering broader coverage and higher average premium as well as growth in Florida business, which has a higher average premium per policy than our other states.

During the third quarter and first nine months of 2012, personal auto insurance gross written premium in our Focus States grew 19.7% and 18.6%, respectively, when compared with the same periods of 2011. The increase in gross written premium in both periods is primarily due to growth in California and Florida.

California gross written premium grew 5.7% and 7.9%, respectively, during the third quarter and first nine months of 2012. Rate actions taken by competitors and a shift in business mix to policies offering broader coverage and higher average premium have stimulated premium growth in the state.

Florida gross written premium grew 85.4% and 76.1%, respectively, during the third quarter and first nine months of 2012. This growth is primarily a result of an increase in new business application count, higher business retention, an increase in average premium from rate increases, and competitor rate increases.

Declines of 14.2% and 13.0% in Texas, respectively, during the third quarter and first nine months of 2012 partially offset the growth in California and Florida. The decline in Texas gross written premium is primarily due to actions taken, such as rate increases and the elimination of annual policies, to improve profitability in the state.

Gross written premium in the Maintenance States grew 18.3% and 4.0%, respectively, during the third quarter and first nine months of 2012 primarily due to growth in Alabama premium as a result of increased marketing efforts in the state. This growth was partially offset by a decline in Illinois premium.

Our Commercial Vehicle gross written premium grew 25.3% and 20.6%, respectively, during the third quarter and first nine months of 2012. This growth is primarily due to higher average premium and better retention for this product.

Gross written premium in our Classic Collector product grew 14.6% and 15.1%, respectively, during the third quarter and first nine months of 2012. This growth is primarily due to growth in Florida and Texas resulting from an increase in the number of agencies actively producing business for this product.

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Profitability

A key operating performance measure of insurance companies is underwriting profitability, as opposed to overall profitability or net earnings. We measure underwriting profitability by the combined ratio. When the combined ratio is under 100%, we consider underwriting results profitable; when the ratio is over 100%, we consider underwriting results unprofitable. The combined ratio does not reflect investment income, other income, interest expense, corporate general and administrative expenses, other expenses or federal income taxes.

While we report financial results in accordance with GAAP for shareholder and other users' purposes, we report it on a statutory basis for insurance regulatory purposes. We evaluate underwriting profitability based on a combined ratio calculated using statutory accounting principles. The statutory combined ratio represents the sum of the following ratios: (i) losses and LAE incurred as a percentage of net earned premium and (ii) underwriting expenses incurred, net of fees, as a percentage of net written premium. Certain expenses are treated differently under statutory and GAAP accounting principles. Under GAAP, commissions, premium taxes and other variable costs incurred in connection with writing new and renewal business are capitalized as deferred policy acquisition costs and amortized on a pro rata basis over the period in which the related premium is earned; on a statutory basis these items are expensed as incurred. Additionally, bad debt charge-offs on agent balances and premium receivables are included only in the GAAP combined ratios.

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The following table presents the statutory and GAAP combined ratios:

	Three months ended September 30,									
	2012			2011			% Point Change			
	Loss & LAE Ratio	Underwriting Ratio	Combined Ratio	Loss & LAE Ratio	Underwriting Ratio	Combined Ratio	Loss & LAE Ratio	Underwriting Ratio	Combined Ratio	
Personal Auto:										
Focus States:										
Urban Zones	79.5	% 17.8	% 97.3	% 76.7	% 19.9	% 96.6	% 2.7	%(2.0	)%0.7	%
Non-urban Zones	77.1	% 18.6	% 95.7	% 80.6	% 20.1	% 100.7	% (3.5	)%(1.5	)%(5.0)%
Total Focus States	79.1	% 17.9	% 97.1	% 77.2	% 19.9	% 97.1	% 1.9	%(2.0	)%0.0	%
Maintenance States	84.5	% 21.6	% 106.1	% 87.7	% 26.9	% 114.6	% (3.2	)%(5.4	)%(8.5)%
Other States	NM	NM	NM	NM	NM	NM	NM	NM	NM	
Subtotal	79.4	% 18.0	% 97.4	% 77.5	% 20.0	% 97.6	% 1.9	%(2.1	)%(0.2)%
Commercial Vehicle	76.4	% 17.8	% 94.1	% 62.8	% 17.8	% 80.6	% 13.6	% 0.0	% 13.6	%
Classic Collector	60.2	% 40.7	% 101.0	% 64.5	% 36.1	% 100.6	% (4.2	)%4.6	% 0.4	%
Total statutory ratios	79.1	% 18.3	% 97.4	% 76.6	% 19.9	% 96.5	% 2.5	%(1.6	)%0.9	%
Total statutory ratios excluding development	76.4	% 18.3	% 94.7	% 76.1	% 19.9					