21ST CENTURY HOLDING CO
Form 10-Q
May 15, 2012

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-Q

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE QUARTERLY PERIOD ENDED March 31, 2012
OR

o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE TRANSITION PERIOD FROM ___________________TO _______________________

Commission File number 0-2500111

21st Century Holding Company

(Exact name of registrant as specified in its charter)

Florida	65-0248866
(State or Other Jurisdiction of Incorporation or Organization)	(IRS Employer Identification Number)

14050 N.W. 14th Street, Suite 180, Sunrise, Florida 33323
(Address of principal executive offices) (Zip Code)

954-581-9993
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes x No o

Indicate by check mark whether the registrant has electronically submitted and posted on its corporate website, 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 x No o

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 o Accelerated filer o Non-accelerated filer o Smaller reporting company x

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes o No x

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Common Stock, $.01 par value –7,947,384 outstanding as of May 15, 2012

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21ST CENTURY HOLDING COMPANY

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PART I: FINANCIAL INFORMATION
Item 1 Financial Statements

21st CENTURY HOLDING COMPANY
CONSOLIDATED BALANCE SHEETS
(UNAUDITED)

	Period Ending	
	March 31, 2012	December 31, 2011
ASSETS	(Dollars in Thousands)	
Investments		
Debt maturities, available for sale, at fair value	$106,284	$ 104,311
Debt maturities, held to maturity, at amortized cost	7,171	7,128
Equity securities, available for sale, at fair value	18,394	18,028
Total investments	131,849	129,467
Cash and short term investments	15,476	15,205
Prepaid reinsurance premiums	5,120	8,339
Premiums receivable, net of allowance for credit losses of $75 and $73, respectively	7,350	5,616
Reinsurance recoverable, net	1,780	2,087
Deferred policy acquisition costs	8,588	7,718
Deferred income taxes, net	7,399	8,612
Property, plant and equipment, net	814	842
Other assets	4,948	2,094
Total assets	$183,324	$ 179,980
LIABILITIES AND SHAREHOLDERS' EQUITY		
Unpaid losses and LAE	$55,308	$ 59,983
Unearned premiums	54,682	47,933
Premiums deposits and customer credit balances	3,162	2,804
Bank overdraft	7,223	7,930
Income taxes payable	125	77
Accounts payable and accrued expenses	2,370	3,109
Total liabilities	122,870	121,836
Shareholders' equity:		
Common stock, $0.01 par value. Authorized 25,000,000 shares; issued and outstanding 7,946,384 and 7,946,384, respectively	79	79
Preferred stock, $0.01 par value. Authorized 1,000,000 shares; none issued or outstanding	-	-
Additional paid-in capital	51,004	50,940
Accumulated other comprehensive income		
Unrealized net gains on investments, available for sale	2,051	877
Total accumulated other comprehensive income	2,051	877
Retained earnings	7,320	6,248

Total shareholders' equity	60,454	58,144
Total liabilities and shareholders' equity	$183,324	$ 179,980

SEE ACCOMPANYING NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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21ST CENTURY HOLDING COMPANY
CONSOLIDATED STATEMENTS OF OPERATIONS
(UNAUDITED)

	Three Months Ended March 31, 2012	2011
	(Dollars in Thousands except EPS and share and dividend data)	
Revenue:		
Gross premiums written	$ 31,274	$ 27,144
Gross premiums ceded	(1,858)	(1,505)
Net premiums written	29,416	25,639
Decrease in prepaid reinsurance premiums	(9,849)	(11,520)
Increase in unearned premiums	(6,749)	(2,975)
Net change in prepaid reinsurance premiums and unearned premiums	(16,598)	(14,495)
Net premiums earned	12,818	11,144
Commission income	307	297
Finance revenue	114	120
Managing general agent fees	533	461
Net investment income	961	970
Net realized investment losses	(10)	(103)
Regulatory assessments recovered	-	106
Other income	20	131
Total revenue	14,743	13,126
Expenses:		
Losses and LAE	5,728	8,447
Operating and underwriting expenses	2,411	2,713
Salaries and wages	2,211	2,199
Policy acquisition costs - amortization	2,748	2,940
Total expenses	13,098	16,299
Income (loss) before provision for income tax expense (benefit)	1,645	(3,173)
Provision for income tax expense (benefit)	573	(1,166)
Net income (loss)	$ 1,072	$ (2,007)
Net income (loss) per share - basic	$ 0.13	$ (0.25)
Net income (loss) per share - diluted	$ 0.13	$ (0.25)
	7,946,384	7,946,384

Weighted average number of common shares outstanding - basic				
Weighted average number of common shares outstanding - diluted		7,962,295		7,946,384
Dividends paid per share	$	-	$	-

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21ST CENTURY HOLDING COMPANY
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)
(UNAUDITED)

	Three Months Ended March 31,	
	2012	2011
	(Dollars in Thousands)	
Net income (loss)	$ 1,072	$ (2,007)
Change in net unrealized gains on investments available for sale	1,883	587
Comprehensive income (loss) before tax	2,955	(1,420)
Income tax expense related to items of other comprehensive income (loss)	(708)	(221)
Comprehensive income (loss)	$ 2,247	$ (1,641)

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21ST CENTURY HOLDING COMPANY
CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)

	Three Months Ended March 31,	
	2012	2011
	(Dollars in Thousands)	
Cash flow from operating activities:		
Net income (loss)	$ 1,072	$ (2,007)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Amortization of investment premium discount, net	323	347
Depreciation and amortization of property plant and equipment, net	48	52
Net realized investment losses	10	103
Provision for credit losses, net	-	9
Recovery for uncollectible premiums receivable	(2)	(34)
Non-cash compensation	42	49
Changes in operating assets and liabilities:		
Premiums receivable	(1,732)	(1,038)
Prepaid reinsurance premiums	3,220	5,939
Reinsurance recoverable, net	307	2,458
Deferred income tax expense, net of other comprehensive income	504	(1,175)
Policy acquisition costs, net of amortization	(869)	(532)
Other assets	(2,854)	34
Unpaid losses and LAE	(4,675)	(2,039)
Unearned premiums	6,749	2,975
Premium deposits and customer credit balances	358	361
Income taxes payable	48	-
Bank overdraft	(706)	(3,000)
Accounts payable and accrued expenses	(740)	1,125
Net cash provided by operating activities	1,103	3,627
Cash flow used by investing activities:		
Proceeds from sale of investment securities	18,257	41,532
Purchases of investment securities available for sale	(19,090)	(45,505)
Purchases of property and equipment	(20)	(51)
Net cash used by investing activities	(853)	(4,024)
Cash flow provided by financing activities:		
Tax benefit related to non-cash compensation	21	24
Net cash provided by financing activities	21	24
Net increase (decrease) in cash and short term investments	271	(373)
Cash and short term investments at beginning of period	15,205	16,206
Cash and short term investments at end of period	$ 15,476	$ 15,833

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21ST CENTURY HOLDING COMPANY
CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)

(continued)	Three Months Ended March 31, 2012	2011
	(Dollars in Thousands)	
Supplemental disclosure of cash flow information:		
Cash paid during the period for:		
Income taxes	$ -	$ -
Non-cash investing and finance activities:		
Accrued dividends payable	$ -	$ -

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21st Century Holding Company
Notes to Condensed Consolidated Financial Statements

(1)Organization and Business

In this Quarterly Report on Form 10-Q, "21st Century" and the terms "Company", "we", "us" and "our" refer to 21st Century Holding Company and its subsidiaries, unless the context indicates otherwise.

21st Century Holding Company is an insurance holding company that controls substantially all steps in the insurance underwriting, distribution and claims processes through our subsidiaries and our contractual relationships with our independent agents and general agents.

We are authorized to underwrite, and/or place through our wholly owned subsidiaries, homeowners' multi-peril ("homeowners"), commercial general liability, personal and commercial automobile, personal umbrella, fire, allied lines, workers' compensation and commercial inland marine insurance in Florida and various other states. We market and distribute our own and third-party insurers' products and our other services through a network of independent agents. We also utilize a select number of general agents for the same purpose.

Our primary insurance subsidiary is Federated National Insurance Company ("Federated National"). Federated National is licensed as an admitted carrier in Florida. An admitted carrier is an insurance company that has received a license from the state department of insurance giving the company the authority to write specific lines of insurance in that state. Through contractual relationships with a network of approximately 3,000 independent agents, of which approximately 600 actively sell and service our products, Federated National is authorized to underwrite homeowners', fire, allied lines and personal and commercial automobile insurance in Florida. Federated National is also licensed as an admitted carrier in Alabama, Louisiana, Georgia and Texas, and underwrites commercial general liability insurance in those states. Federated National operated as a non-admitted carrier in Arkansas, California, Kentucky, Maryland, Missouri, Nevada, Oklahoma, South Carolina, Tennessee and Virginia, and could underwrite commercial general liability insurance in all of these states. A non-admitted carrier is allowed to do business in that state and is strictly regulated to protect policyholders from a variety of illegal and unethical practices, including fraud. Sometimes, non-admitted carriers are referred to as "excess and surplus" lines carriers. Non-admitted carriers are subject to considerably less regulation with respect to policy rates and forms. Non-admitted carriers are not required to financially contribute to and benefit from the state guarantee fund, which is used to pay for losses if an insurance carrier becomes insolvent or unable to pay the losses due their policyholders.

In January 2011, we merged Federated National and our other wholly owned insurance subsidiary, American Vehicle Insurance Company ("American Vehicle"), with Federated National continuing the operations of both entities. As part of its approval of the merger between Federated National and American Vehicle, the Florida Office of Insurance Regulation ("Florida OIR"), the Company, Federated National and American Vehicle entered into a consent order with the Florida OIR dated January 25, 2011 (the "Consent Order") pursuant to which the Company and the resulting company in the merger (the "Merged Company") have agreed to the following:

- The Merged Company retained the following licenses: (010) Fire, (020) Allied Lines, (040) Homeowners Multi Peril, (050) Commercial Multi Peril, (090) Inland Marine, (170) Other Liability, (192) Private Passenger Auto Liability, (194) Commercial Auto Liability, (211) Private Passenger Auto Physical Damage and (212) Commercial Auto Physical Damage.

- The Merged Company will not write commercial multi peril policy premium without prior approval from the Florida OIR. The Merged Company has no commercial multi peril policy premium in force.

- The Merged Company surrendered its surety license. The Merged Company has no surety policy premium in force.

- The Merged Company will not write new commercial habitation condominium associations without prior approval from the Florida OIR. The current commercial habitation book of business is approximately $1.0 million of policy premium, which will renew pursuant to normal underwriting guidelines.

- The Merged Company agreed to reduce the total number of its homeowners’ policies in Miami-Dade, Broward and Palm Beach counties (the “Tri-County Area”) to 40% of its entire homeowners’ book by December 31, 2011 and limit its new homeowners’ policies in the Tri-County Area to $500,000 of new policy premium per month. The 40% was achieved through the increased writing of property located outside of the Tri-County Area, the non-renewal of certain policies located within the Tri-County Area, and limiting the writing of new property located within the Tri-County Area. As of March 31, 2012, the Company had approximately 28.9% of its homeowners’ policies located within Tri-County Area.

21st Century Holding Company
Notes to Condensed Consolidated Financial Statements

- The managing general agency fees payable by the Merged Company to Assurance MGA a wholly owned subsidiary of the Company, which were traditionally 6% of gross written premium, were reduced and will not exceed 4% without prior approval from the Florida OIR. The Merged Company has lowered the fee to 2% of gross written to further support the Federated National's results of operations. This will have no impact on the Company's consolidated financial results.

- The claims service fees payable by the Merged Company to Superior were reduced from the traditional 4.5% of gross earned premium to 3.6% of gross earned premium. This will have no impact on the Company's consolidated financial results.

- The Company provided the Florida OIR with a plan of operation and has agreed to provide certain reports to the Florida OIR on a monthly basis, and agreed to obtain the Florida OIR's approval prior to making any changes to the officers of the Merged Company during the first year following the effective date of the Merger.

The merger of Federated National and American Vehicle will be an ongoing transition, many aspects of which will take effect over time. References to the companies contained herein are intended to be references to the operations of the newly formed Federated National following the January 2011 merger. References to the historical activities of American Vehicle are appropriately identified throughout this document.

During the three months ended March 31, 2012, 86.6%, 7.7%, 3.5% and 2.2% of the premiums we underwrote were for homeowners', commercial general liability, federal flood, and automobile insurance, respectively. During the three months ended March 31, 2011, 82.5%, 10.3%, 3.6% and 3.6% of the premiums we underwrote were for homeowners', commercial general liability, federal flood, and personal automobile insurance, respectively.

Our business, results of operations and financial condition are subject to fluctuations due to a variety of factors. Abnormally high severity or frequency of claims in any period could have a material adverse effect on us. When our estimated liabilities for unpaid losses and loss adjustment expenses ("LAE") are less than the actuarially determined amounts, we increase the expense in the current period. Conversely, when our estimated liabilities for unpaid losses and LAE are greater than the actuarially determined amounts, we decrease the expense in the current period.

We are focusing our marketing efforts on continuing to expand our distribution network. We market our products and services throughout Florida and in other states by establishing relationships with additional independent agents and general agents. There can be no assurance, however, that we will be able to obtain the required regulatory approvals to offer additional insurance products or expand into other states.

Assurance Managing General Agents, Inc. ("Assurance MGA") a wholly owned subsidiary of the Company, acts as Federated National's exclusive managing general agent in Florida and is also licensed as a managing general agent in the States of Alabama, Georgia, Illinois, Louisiana, North Carolina, Mississippi, Missouri, New York, Nevada, South Carolina, Texas and Virginia. Assurance MGA has contracted with several unaffiliated insurance companies to sell commercial general liability, workers compensation, personal umbrella and inland marine insurance through Assurance MGA's existing network of agents.

Assurance MGA earns commissions and fees for providing policy administration, marketing, accounting and analytical services, and for participating in the negotiation of reinsurance contracts. Assurance MGA earns a $25 per policy fee, and traditionally a 6% commission fee from its affiliates Federated National and American Vehicle. During the fourth quarter of 2010, Assurance MGA, pursuant to the Consent Order as discussed above, reduced its fee, to earn amounts varying between 2% and 4%, which we anticipate will return to 6% at an unknown future date with approval from the Florida OIR. A formal agreement reflecting this fee modification was executed during January 2011.

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We internally process claims made by our insureds through our wholly owned claims adjusting company, Superior Adjusting, Inc. (“Superior”). Our agents have no authority to settle claims or otherwise exercise control over the claims process. Furthermore, we believe that the retention of independent adjusters, in addition to the employment of salaried claims personnel, results in reduced ultimate loss payments, lower LAE and improved customer service for our claimants and policyholders. We also employ an in-house legal department to cost-effectively manage claims-related litigation and to monitor our claims handling practices for efficiency and regulatory compliance.

Until June 2011, our wholly owned subsidiary, Federated Premium, offered premium financing to our own and third-party insureds. Premium financing has been marketed through our distribution network of general agents and independent agents.

Insure-Link, Inc. (“Insure-Link”) was formed in March 2008 to serve as an independent insurance agency. The insurance agency markets direct to the public to provide a variety of insurance products and services to individual clients, as well as business clients, by offering a full line of insurance products including, but not limited to, homeowners’, flood, personal and commercial automobile, commercial general liability and workers’ compensation insurance through their agency appointments with over fifty different carriers. Insure-Link intends to expand its business through marketing and by acquiring other insurance agencies. There were no other agency relationships with affiliated captive or franchised agents during 2011 or the three months ended March 31, 2012.

(2)Basis of Presentation

The accompanying unaudited condensed consolidated financial statements for the Company and its subsidiaries have been prepared in accordance with accounting principles generally accepted in the United States of America referred to as Generally Accepted Accounting Principles (“GAAP”) for interim financial information, and the Securities and Exchange Commission (“SEC”) rules for interim financial reporting. Certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to such rules and regulations. However, in the opinion of management, the accompanying financial statements reflect all normal recurring adjustments necessary to present fairly the Company’s financial position as of March 31, 2012 and the results of operations and cash flows for the periods presented. The results of operations for the interim periods presented are not necessarily indicative of the results of operations to be expected for any subsequent interim period or for the fiscal year ending December 31, 2012. The accompanying unaudited condensed consolidated financial statements and notes thereto should be read in conjunction with the audited consolidated financial statements for the year ended December 31, 2011 included in the Company’s Form 10-K, which was filed with the SEC on March 30, 2012.

In preparing the interim unaudited condensed consolidated financial statements, management was required to make certain estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, expenses and related disclosures at the financial reporting date and throughout the periods being reported upon. Certain of the estimates result from judgments that can be subjective and complex and consequently actual results may differ from these estimates.

Material estimates that are particularly susceptible to significant change in the near-term relate to the determination of loss and LAE, ceded reinsurance balances payable, the recoverability of Deferred Policy Acquisition Costs (“DPAC”), the determination of federal income taxes, and the net realizable value of reinsurance recoverables. Although considerable variability is inherent in these estimates, management believes that the amounts provided are reasonable. These estimates are continually reviewed and adjusted as necessary. Such adjustments are reflected in current operations.

All significant intercompany balances and transactions have been eliminated. No reclassifications have been made to the prior-period balances to conform to the current-period presentation.

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21st Century Holding Company
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(3)Summary of Significant Accounting Policies and Practices

(A) Critical Accounting Policies

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions about future events that affect the amounts reported in the financial statements and accompanying notes. Future events and their effects cannot be determined with absolute certainty. Therefore, the determination of estimates requires the exercise of judgment. Actual results inevitably will differ from those estimates, and such differences may be material to the financial statements.

The most significant accounting estimates inherent in the preparation of our financial statements include estimates associated with management's evaluation of the determination of (i) liability for unpaid losses and LAE, (ii) the amount and recoverability of amortization of DPAC, and (iii) estimates for our reserves with respect to finance contracts, premiums receivable and deferred income taxes. Various assumptions and other factors underlie the determination of these significant estimates, which are described in greater detail in Footnote 2 of the Company's audited consolidated financial statements for the fiscal year ended December 31, 2011, which we included in the Company's Annual Report on Form 10-K which was filed with the SEC on March 30, 2012.

We believe that there were no significant changes in those critical accounting policies and estimates during the first three months of fiscal 2012. Senior management has reviewed the development and selection of our critical accounting policies and estimates and their disclosure in this Form 10-Q with the Audit Committee of our Board of Directors.

The process of determining significant estimates is fact-specific and takes into account factors such as historical experience, current and expected economic conditions, and in the case of unpaid losses and LAE, an actuarial valuation. Management regularly reevaluates these significant factors and makes adjustments where facts and circumstances dictate. In selecting the best estimate, we utilize various actuarial methodologies. Each of these methodologies is designed to forecast the number of claims we will be called upon to pay and the amounts we will pay on average to settle those claims. In arriving at our best estimate, our actuaries consider the likely predictive value of the various loss development methodologies employed in light of underwriting practices, premium rate changes and claim settlement practices that may have occurred, and weight the credibility of each methodology. Our actuarial methodologies take into account various factors, including, but not limited to, paid losses, liability estimates for reported losses, paid allocated LAE, salvage and other recoveries received, reported claim counts, open claim counts and counts for claims closed with and without payment for loss.

Accounting for loss contingencies pursuant to Financial Accounting Standards Board ("FASB") issued guidance involves the existence of a condition, situation or set of circumstances involving uncertainty as to possible loss that will ultimately be resolved when one or more future event(s) occur or fail to occur. Additionally, accounting for a loss contingency requires management to assess each event as probable, reasonably possible or remote. Probable is defined as the future event or events are likely to occur. Reasonably possible is defined as the chance of the future event or events occurring is more than remote but less than probable, while remote is defined as the chance of the future event or events occurring is slight. An estimated loss in connection with a loss contingency shall be recorded by a charge to current operations if both of the following conditions are met: First, the amount can be reasonably estimated, and second, the information available prior to issuance of the financial statements indicates that it is probable that a liability has been incurred at the date of the financial statements. It is implicit in this condition that it is probable that one or more future events will occur confirming the fact of the loss or incurrence of a liability.

We are required to review the contractual terms of all our reinsurance purchases to ensure compliance with FASB issued guidance. The guidance establishes the conditions required for a contract with a reinsurer to be accounted for as reinsurance and prescribes accounting and reporting standards for those contracts. Contracts that do not result in the reasonable possibility that the reinsurer may realize a significant loss from the insurance risk assumed generally do not meet the conditions for reinsurance accounting and must be accounted for as deposits. The guidance also requires us to disclose the nature, purpose and effect of reinsurance transactions, including the premium amounts associated with reinsurance assumed and ceded. It also requires disclosure of concentrations of credit risk associated with reinsurance receivables and prepaid reinsurance premiums.

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FASB issued guidance addresses accounting and reporting for (a) investments in equity securities that have readily determinable fair values and (b) all investments in debt securities. The guidance requires that these securities be classified into one of three categories: Held-to-maturity, Trading, or Available-for-sale securities.

Investments classified as held-to-maturity include debt securities wherein the Company's intent and ability are to hold the investment until maturity. The accounting treatment for held-to-maturity investments is to carry them at amortized cost without consideration to unrealized gains or losses. Investments classified as trading securities include debt and equity securities bought and held primarily for the sale in the near term. The accounting treatment for trading securities is to carry them at fair value with unrealized holding gains and losses included in current period operations. Investments classified as available-for-sale include debt and equity securities that are not classified as held-to-maturity or as trading security investments. The accounting treatment for available-for-sale securities is to carry them at fair value with unrealized holding gains and losses excluded from earnings and reported as a separate component of shareholders' equity, namely "Other Comprehensive Income".

A decline in the fair value of an available-for-sale security below cost that is deemed other-than temporary results in a charge to income, resulting in the establishment of a new cost basis for the security. Premiums and discounts are amortized or accreted, respectively, over the life of the related debt security as an adjustment to yield using a method that approximates the effective interest method. Dividends and interest income are recognized when earned. Realized gains and losses are included in earnings and are derived using the specific-identification method for determining the cost of securities sold.

Financial instruments, which potentially expose us to concentrations of credit risk, consist primarily of investments, premiums receivable, amounts due from reinsurers on paid and unpaid losses and finance contracts. We have not experienced significant losses related to premiums receivable from individual policyholders or groups of policyholders in a particular industry or geographic area. We believe no credit risk beyond the amounts provided for collection losses is inherent in our premiums receivable or finance contracts. In order to reduce credit risk for amounts due from reinsurers, we seek to do business with financially sound reinsurance companies and regularly review the financial strength of all reinsurers used. Additionally, our credit risk in connection with our reinsurers is mitigated by the establishment of irrevocable clean letters of credit in favor of Federated National.

The fair value of our investments is estimated based on prices published by financial services or quotations received from securities dealers and is reflective of the interest rate environment that existed as of the close of business on March 31, 2012 and December 31, 2011. Changes in interest rates subsequent to March 31, 2012 and December 31, 2011 may affect the fair value of our investments.

The carrying amounts for the following financial instrument categories approximate their fair values at March 31, 2012 and December 31, 2011 because of their short-term nature: cash and short term investments, premiums receivable, finance contracts, due from reinsurers, revolving credit outstanding, bank overdraft, accounts payable and accrued expenses.

(B) Impact of New Accounting Pronouncements

In June 2011, the FASB issued ASU No. 2011-05: Comprehensive Income (Topic 220): Presentation of Comprehensive Income. The guidance in this ASU is intended to increase the prominence of items reported in other comprehensive income in the financial statements by presenting the total of comprehensive income, the components of net income and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. This ASU eliminates the option to present the components of other comprehensive income as part of the statement of changes in stockholders' equity. The guidance in this ASU does not change the items that must be reported in other comprehensive income or when an item of other comprehensive income must be reclassified to net income. Upon adoption, this update is to be applied retrospectively and is effective during interim and annual periods beginning after December 15, 2011. Early adoption is permitted. The adoption of this ASU did not have a material impact on our financial condition, results of operations or cash flows.

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In December 2011, the FASB issued Accounting Standard Update ("ASU") No. 2011-12: Comprehensive Income (Topic 220): Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05. The guidance defers certain provisions contained in ASU No. 2011-05 requiring the requirement to present components of reclassifications of other comprehensive income on the face of the income statement or in the notes to the financial statements. However, this deferral does not impact the other requirements contained in the new standard on comprehensive income as described above. This ASU is effective during interim and annual periods beginning after December 15, 2011. The adoption of this ASU did not have a material impact on our financial condition, results of operations or cash flows.

In September 2011, the FASB issued ASU No. 2011-08: Intangibles – Goodwill and Other (Topic 350): Testing Goodwill for Impairment, which amends ASC Topic 350, Intangibles-Goodwill and Other. The guidance in this ASU permits an entity to first assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount as a basis for determining whether it is necessary to perform the two-step goodwill impairment test described in ASC Topic 350. Under the amendments in this ASU, an entity is not required to calculate the fair value of a reporting unit unless the entity determines that it is more likely than not that its fair value is less than its carrying amount. The amendments are effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011. Early adoption is permitted, including for annual and interim goodwill impairment tests performed as of a date before September 15, 2011, if an entity's financial statements for the most recent annual or interim period have not yet been issued or, for nonpublic entities, have not yet been made available for issuance. The adoption of this ASU did not have a material impact on our financial condition, results of operations or cash flows.

In December 2011, the FASB issued ASU No. 2011-11: Balance Sheet (Topic 210): Disclosures about Offsetting Assets and Liabilities, which requires new disclosure requirements mandating that entities disclose both gross and net information about instruments and transactions eligible for offset in the statement of financial position as well as instruments and transactions subject to an agreement similar to a master netting arrangement. In addition, the standard requires disclosure of collateral received and posted in connection with master netting agreements or similar arrangements. This ASU is effective for annual reporting periods beginning on or after January 1, 2013, and interim periods within those annual periods. The adoption of this ASU will not have a material impact on our financial condition, results of operations or cash flows.

In October 2010, the FASB issued ASU No. 2010-26: Financial Services – Insurance (Topic 944): Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts, a consensus of FASB Emerging Issues Task Force. The amendments in this update modify the definition of the types of costs incurred by insurance entities that can be capitalized in the acquisition of new and renewal contracts. The amendments in this update specify that the costs must be based on successful efforts (that is, acquiring a new or renewal contract). The amendments also specify that advertising costs should be included as deferred acquisition costs under certain circumstances. The amendments in this update are effective for fiscal years, and interim period within those fiscal years, beginning after December 15, 2011. The amendments in this update should be applied prospectively upon adoption. Retrospective application to all prior periods presented upon the date of adoption also is permitted. The adoption of this ASU did not have a material impact on the Company's consolidated financial statements.

Other recent accounting pronouncements issued by FASB, the American Institute of Certified Public Accountants ("AICPA"), and the SEC did not or are not believed by management to have a material impact on the Company's present or future financial statements.

(C) Stock Options

Effective January 1, 2006, the Company adopted the fair value recognition provisions of FASB issued guidance using the modified-prospective-transition method. Under that transition method, compensation cost recognized during the three months ended March 31, 2012 includes compensation cost for all share-based payments granted subsequent to January 1, 2006, based on the grant date fair value estimated in accordance with the guidance.

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(D) Earnings (Loss) per Share

Basic earnings (loss) per share ("Basic EPS") is computed by dividing net (loss) income by the weighted average number of common shares outstanding during the period presented. Diluted earnings (loss) per share ("Diluted EPS") is computed by dividing net (loss) income by the weighted average number of shares of common stock and common stock equivalents outstanding during the period presented; outstanding warrants and stock options are considered common stock equivalents and are included in the calculation using the treasury stock method.

(E) Reclassifications

No reclassification of the 2011 financial statements was necessary to conform to the 2012 presentation.

(4)Commitments and Contingencies

Management has a responsibility to continually measure and monitor its commitments and its contingencies. The nature of the Company's commitments and contingencies can be grouped into three major categories: insured claim activity, assessment related activities and operational matters.

(A) Insured Claim Activity

We are involved in claims and legal actions arising in the ordinary course of business. The amount of liability for these claims and lawsuits is uncertain. Revisions to our estimates are based on our analysis of subsequent information that we receive regarding various factors, including: (i) per claim information; (ii) company and industry historical loss experience; (iii) legislative enactments, judicial decisions, legal developments in the awarding of damages; and (iv) trends in general economic conditions, including the effects of inflation. Management revises its estimates based on the results of its analysis. This process assumes that experience, adjusted for the effects of current developments and anticipated trends, is an appropriate basis for estimating the ultimate settlement of all claims. There is no precise method for subsequently evaluating the impact of any specific factor on the adequacy of the reserves, because the eventual redundancy or deficiency is affected by multiple factors. In the opinion of management, the ultimate disposition of these matters may have a material adverse effect on our consolidated financial position, results of operations, or liquidity.

The Company's subsidiaries are, from time to time, named as defendants in various lawsuits incidental to their insurance operations. Legal actions relating to claims made in the ordinary course of seeking indemnification for a loss covered by the insurance policy are considered by the Company in establishing loss and LAE reserves.

The Company also faces, in the ordinary course of business, lawsuits that seek damages beyond policy limits. During 2010, one such suit was brought against one of the Company's affiliates. This suit was dismissed and the dismissal is currently under appeal. In the opinion of management, the ultimate disposition of this matter will not have a material adverse effect on our financial condition or results of operations. The Company continually evaluates potential liabilities and reserves for litigation of these types using the criteria established by FASB issued guidance. Under this guidance, reserves for a loss are recorded if the likelihood of occurrence is probable and the amount can be reasonably estimated. If a loss, while not probable, is judged to be reasonably possible, management will make an estimate of a possible range of loss or state that an estimate cannot be made. Management considers each legal action using this guidance and records reserves for losses as warranted.

(B) Assessment Related Activity

We operate in a regulatory environment where certain entities and organizations have the authority to require us to participate in assessments. Currently these entities and organizations include, but are not limited to, Florida Insurance Guaranty Association ("FIGA"), Citizens Property Insurance Corporation ("Citizens"), Florida Hurricane Catastrophe Fund ("FHCF") and Florida Joint Underwriters Insurance Company ("JUA"). As a direct premium writer in the state of Florida, we are required to participate in certain insurer solvency associations under Florida Statutes Section 631.57(3)(a), administered by FIGA.

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Related to statutory accounting, in October 2010, the National Association of Insurance Commissioners ("NAIC") issued substantive revisions in Statement of Statutory Accounting Principles ("SSAP") No. 35 Revised ("SSAP No. 35R"), Guaranty Fund and Other Assessments. For statutory accounting, SSAP No. 35R, effective January 1, 2011, requires assessments that could be recouped through future premium surcharges to be expensed and not be recognized as an asset. The impact is there might be an effect on statutory policyholder surplus once the liability for the assessments is recognized. The adoption of SSAP No. 35R rule will not have a material effect on our 2012 operations.

Federated National and American Vehicle are also required to participate in an insurance apportionment plan under Florida Statutes Section 627.351, which is referred to as a JUA Plan. The JUA Plan provides for the equitable apportionment of any profits realized, or losses and expenses incurred, among participating automobile insurers. In the event of an underwriting deficit incurred by the JUA Plan which is not recovered through the policyholders in the JUA Plan, such deficit shall be recovered from the companies participating in the JUA Plan in the proportion that the net direct written premiums of each such member during the preceding calendar year bear to the aggregate net direct premiums written in this state by all members of the JUA Plan. Neither Federated National nor American Vehicle was assessed by the JUA Plan during 2012 or 2011. Future assessments by this association are undeterminable at this time.

(C) Operational Matters

The Company's consolidated federal and state income tax returns for 2005-2010 are open for review by the Internal Revenue Service ("IRS") and various state taxing authorities. The federal income tax returns for 2003 and 2002 have been examined by the IRS. The IRS concluded its examination for 2003 and 2002 and there were no material changes in the tax liability for those years. The 2005 and 2006 income tax returns and net operating loss carry-back from tax year 2009 have been reviewed by the Joint Committee on Taxation. The Joint Committee on Taxation completed its consideration in September 2011 and took no exception to the conclusions reached by the IRS regarding the net operating loss carry-back from tax year 2009.

The Company has recorded a net deferred tax asset of $7.4 million and $8.6 million as of March 31, 2012 and December 31, 2011, respectively. Realization of net deferred tax asset is dependent on generating sufficient taxable income in future periods. Management believes that it is more likely than not that the deferred tax assets will be realized and as such no valuation allowance has been recorded against the net deferred tax asset. Management considers the scheduled reversal of deferred tax liabilities, projected future taxable income and tax planning strategies in making this assessment. At March 31, 2012, based upon the level of historical taxable income and projections for future taxable income over the periods in which the deferred tax assets are deductible, management believes it is more likely than not that the Company will realize the benefits of these deductible differences. When assessing the need for valuation allowances, the Company considers future taxable income and ongoing prudent and feasible tax planning strategies. Should a change in circumstances lead to a change in judgment about the realizability of deferred tax assets in future years, the Company would record valuation allowances as deemed appropriate in the period that the change in circumstances occurs, along with a corresponding increase or charge to net income. The resolution of tax reserves and changes in valuation allowances could be material to the Company's results of operations for any period, but is not expected to be material to the Company's financial position.

Relative to the Company's commitments stemming from operational matters, on or about March 1, 2006 we sold our interest in the building that housed our operations in Lauderdale Lakes through December 16, 2011, to an unrelated party. As part of this transaction, we agreed to lease the same facilities for a five-year term. We amended the lease agreement and the note receivable on September 1, 2010. As part of the amendment, we discounted the note receivable and have discontinued the interest on the note. In consideration, we paid a reduced lease payment for the remainder of the lease. Our lease for this office space expired in December 2011.

Our executive offices are now located at 14050 N.W. 14th Street, Suite 180, Sunrise, Florida 33323 in an 18,500 square feet office facility. All of our operations are consolidated within this facility. We believe that the facilities are well maintained, in substantial compliance with environmental laws and regulations, and adequately covered by insurance. We also believe that these leased facilities are not unique and could be replaced, if necessary, at the end of the lease term. Our lease for this office space will expire in May 2017.

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The expected future lease payouts in connection with this lease are as follows.

Fiscal Year		Lease Payments (Dollars in Thousands)
2012		130
2013		229
2014		236
2015		243
2016		251
2017		108
Total	$	1,197

The Company is not currently involved in any material legal actions arising from the ordinary course of business that are not related to the insured claims activity.

(5)Investments

FASB issued guidance addresses accounting and reporting for (a) investments in equity securities that have readily determinable fair values and (b) all investments in debt securities. FASB issued guidance requires that these securities be classified into one of three categories: (i) held-to-maturity, (ii) trading securities or (iii) available-for-sale. Investments classified as held-to-maturity include debt securities wherein the Company's intent and ability are to hold the investment until maturity. The accounting treatment for held-to-maturity investments is to carry them at amortized cost without consideration to unrealized gains or losses. Investments classified as trading securities include debt and equity securities bought and held primarily for sale in the near term. The accounting treatment for trading securities is to carry them at fair value with unrealized holding gains and losses included in current period operations. Investments classified as available-for-sale include debt and equity securities that are not classified as held-to-maturity or as trading security investments. The accounting treatment for available-for-sale securities is to carry them at fair value with unrealized holding gains and losses excluded from earnings and reported as a separate component of shareholders' equity, namely "Other Comprehensive Income".

Total investments increased $2.3 million, or 1.8%, to $131.8 million as of March 31, 2012, compared with $129.5 million as of December 31, 2011.

The debt and equity securities that are available-for-sale and carried at fair value represent 95% and 94% of total investments as of March 31, 2012 and of December 31, 2011, respectively.

We did not hold any trading investment securities during the three months ended March 31, 2012.

The FASB issued guidance also addresses the determination as to when an investment is considered impaired, whether that impairment is other-than-temporary, and the measurement of an impairment loss. The Company's policy for the valuation of temporarily impaired securities is to determine impairment based on the analysis of the following factors.

- rating downgrade or other credit event (e.g., failure to pay interest when due);
- length of time and the extent to which the fair value has been less than amortized cost;

- financial condition and near term prospects of the issuer, including any specific events which may influence the operations of the issuer such as changes in technology or discontinuance of a business segment;

- prospects for the issuer's industry segment;

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- intent and ability of the Company to retain the investment for a period of time sufficient to allow for anticipated recovery in market value;
- historical volatility of the fair value of the security.

Pursuant to FASB issued guidance, the Company records the unrealized losses, net of estimated income taxes, that are associated with that part of our portfolio classified as available-for-sale through the shareholders' equity account titled "Other Comprehensive Income". Management periodically reviews the individual investments that comprise our portfolio in order to determine whether a decline in fair value below our cost either is other-than temporarily or permanently impaired. Factors used in such consideration include, but are not limited to, the extent and length of time over which the market value has been less than cost, the financial condition and near-term prospects of the issuer and our ability and intent to keep the investment for a period sufficient to allow for an anticipated recovery in market value.

In reaching a conclusion that a security is either other-than-temporarily or permanently impaired we consider such factors as the timeliness and completeness of expected dividends, principal and interest payments, ratings from nationally recognized statistical rating organizations such as Standard and Poor's ("S&P") and Moody's Investors Service, Inc. ("Moody's"), as well as information released via the general media channels. During the three months ended March 31, 2012, in connection with this process, we have charged approximately $44,000 of net realized investment losses to operations.

As of March 31, 2012 and December 31, 2011, respectively, all of our securities are in good standing and not impaired as defined by FASB issued guidance, except as noted above.

As of March 31, 2012 and December 31, 2011, our investments consisted primarily of corporate bonds held in various industries, municipal bonds and United States government bonds. As of March 31, 2012, 65% of our debt portfolio was in diverse industries and 35% is in United States government bonds. As of March 31, 2012, approximately 82% of our equity holdings were in equities related to diverse industries and 18% were in mutual funds. As of December 31, 2011, 61% of our debt portfolio was in diverse industries and 39% is in United States government bonds. As of December 31, 2011, approximately 83% of our equity holdings were in equities related to diverse industries and 17% were in mutual funds.

As of March 31, 2012 and December 31, 2011, we have classified $7.2 million and $7.1 million, respectively, of our bond portfolio as held-to-maturity. We only classify bonds as held-to-maturity to support securitization of credit requirements. Fully funded trust agreements used for such purposes totaled $4.6 million as of March 31, 2012 and December 31, 2011.

During the three months ended March 31, 2012 and 2011, respectively, we did not re-classify any of our bond portfolio between available-for-sale and held-to-maturity.

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(A) Debt and Equity Securities

The following table summarizes, by type, our investments as of March 31, 2012 and December 31, 2011.

	March 31, 2012		December 31, 2011	
	Carrying Amount	Percent of Total	Carrying Amount	Percent of Total
	(Dollars in Thousands)			
Debt securities, at market:				
United States government obligations and authorities	$ 32,639	24.75 %	$ 37,217	28.75 %
Obligations of states and political subdivisions	2,288	1.74 %	2,303	1.77 %
Corporate	68,935	52.28 %	63,268	48.87 %
International	2,422	1.84 %	1,523	1.18 %
	106,284	80.61 %	104,311	80.57 %
Debt securities, at amortized cost:				
Corporate	1,062	0.81 %	962	0.74 %
United States government obligations and authorities	6,109	4.63 %	6,166	4.76 %
	7,171	5.44 %	7,128	5.50 %
Total debt securities	113,455	86.05 %	111,439	86.07 %
Equity securities, at market:	18,394	13.95 %	18,028	13.93 %
Total investments	$ 131,849	100.00 %	$ 129,467	100.00 %

The following table shows the realized gains (losses) for debt and equity securities for the three months ended March 31, 2012 and 2011.

	Three Months Ended March 31,			
	2012		2011	
	Gains (Losses)	Fair Value at Sale	Gains (Losses)	Fair Value at Sale
	(Dollars in Thousands)			
Debt securities	$233	$6,496	$225	$66,680
Equity securities	516	3,073	319	8,305
Total realized gains	749	9,569	544	74,985
Debt securities	(206)	5,042	(432)	18,086
Equity securities	(553)	1,666	(215)	3,510
Total realized losses	(759)	6,708	(647)	21,596
Net realized losses on investments	$(10)	$16,277	$(103)	$96,581

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A summary of the amortized cost, estimated fair value and gross unrealized gains and losses of debt and equity securities at March 31, 2012 and December 31, 2011 is as follows.

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
	(Dollars in Thousands)			
March 31, 2012				
Debt Securities - Available-For-Sale:				
United States government obligations and authorities	$32,367	$662	$390	$32,639
Obligations of states and political subdivisions	2,164	129	5	2,288
Corporate	66,965	2,215	245	68,935
International	2,423	15	16	2,422
	$103,919	$3,021	$656	$106,284
Debt Securities - Held-To-Maturity:				
United States government obligations and authorities	$6,109	$190	$1	$6,298
Corporate	1,062	39	1	1,100
	$7,171	$229	$2	$7,398
Equity securities - common stocks	$17,470	$1,862	$938	$18,394
December 31, 2011				
Debt Securities - Available-For-Sale:				
United States government obligations and authorities	$36,558	$686	$27	$37,217
Obligations of states and political subdivisions	2,165	138	-	2,303
Corporate	61,724	1,934	390	63,268
International	1,519	9	5	1,523
	$101,966	$2,767	$422	$104,311
Debt Securities - Held-To-Maturity:				
United States government obligations and authorities	$6,166	$249	$-	$6,415
Corporate	962	39	1	1,000
	$7,128	$288	$1	$7,415
Equity securities - common stocks	$18,966	$1,057	$1,995	$18,028

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The table below reflects our unrealized investment losses by investment class, aged for length of time in a continuous unrealized loss position as of March 31, 2012.

	Unrealized (Losses)	Less than 12 months	12 months or longer
	(Dollars in Thousands)		
Debt securities:			
United States government obligations and authorities	$(390)	$ (390)	$ -
Obligations of states and political subdivisions	(5)	(5)	-
Corporate	(245)	(226)	(19)
International	(16)	(16)	-
	(656)	(637)	(19)
Equity securities:			
Common stocks	(938)	(515)	(423)
Total debt and equity securities	$(1,594)	$ (1,152)	$ (442)

The table below reflects our unrealized investment losses by investment class, aged for length of time in a continuous unrealized loss position as of December 31, 2011.

	Unrealized (Losses)	Less than 12 months	12 months or longer
	(Dollars in Thousands)		
Debt securities:			
United States government obligations and authorities	$(27)	$ (27)	$ -
Obligations of states and political subdivisions	-	-	-
Corporate	(390)	(390)	-
International	(4)	(4)	-
	(421)	(421)	-
Equity securities:			
Common stocks	(1,996)	(1,620)	(376)
Total debt and equity securities	$(2,417)	$ (2,041)	$ (376)

Below is a summary of debt securities at March 31, 2012 and December 31, 2011, by contractual or expected maturity periods. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	March 31, 2012		December 31, 2011	
	Amortized Cost	Estimated Fair Value	Amortized Cost	Estimated Fair Value
	(Dollars in Thousands)			
Due in one year or less	$10,327	$10,454	$8,284	$8,376
Due after one through five years	48,920	50,180	47,294	48,314
Due after five through ten years	37,209	38,473	36,525	37,448

Due after ten years	14,634	14,575	16,991	17,588
Total	$111,090	$113,682	$109,094	$111,726

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United States Treasury notes with a book value of $2,002,728 and $64,202, maturing in 2012 and 2016, respectively, were on deposit with the Florida OIR as of March 31, 2012, as required by law for Federated National, and are included with other investments held until maturity.

The table below sets forth investment results for the three months ended March 31, 2012 and 2011.

	Three Months Ended March 31, 2012	2011
	(Dollars in Thousands)	
Interest on debt securities	$ 878	$ 899
Dividends on equity securities	82	70
Interest on cash and cash equivalents	1	1
Total investment income	$ 961	$ 970
Net realized losses	$ (10)	$ (103)

Proceeds from sales, pay downs and maturities of debt securities and proceeds from sales of equity securities during the three months ended March 31, 2012 and 2011, were approximately $18.3 million and $41.5 million, respectively.

The table below sets forth a summary of net realized and unrealized investment gains (losses) during the three months ended March 31, 2012 and 2011.

	Three Months Ended March 31, 2012	2011
	(Dollars in Thousands)	
Net realized gains (losses)		
Debt securities	$ 27	$ (207)
Equity securities	(37)	104
Total	$ (10)	$ (103)
Net unrealized gains (losses)		
Debt securities	$ 2,365	$ (120)
Equity securities	924	1,541
Total	$ 3,289	$ 1,421

(6) Fair Value Disclosure

In April 2009, the FASB issued accounting guidance that if an entity determines that either the volume and/or level of activity for an investment security has significantly decreased (from normal conditions for that investment security) or price quotations or observable inputs are not associated with orderly transactions, increased analysis and management judgment will be required to estimate fair value. This guidance was effective for interim and annual periods ending after June 15, 2009, with early adoption permitted. This guidance was applied prospectively. The adoption of this guidance did not have an impact on the Company’s financial statements or condition.

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In October 2008, the FASB issued accounting guidance to clarify the application of GAAP in determining fair value of financial instruments in a market that is not active. The guidance was effective upon issuance, including prior periods for which financial statements had not been issued. Our adoption of this guidance does not have a material effect on our financial position, results of operations, cash flows or disclosures.

In September 2006, FASB issued accounting guidance that defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for an asset or liability in an orderly transaction between market participants on the measurement date. This guidance also establishes a fair value hierarchy that requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The guidance also categorizes assets and liabilities at fair value into one of three different levels depending on the observation of the inputs employed in the measurement, as follows.

Level 1 — inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets. A quoted price for an identical asset or liability in an active market provides the most reliable fair value measurement because it is directly observable to the market.

Level 2 — inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs are observable for an asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.

Level 3 — inputs to the valuation methodology are unobservable and significant to the fair value measurement.

Securities available for sale: The fair value of securities available for sale is determined by obtaining quoted prices on nationally recognized security exchanges.

Assets measured at fair value on a recurring basis as of March 31, 2012, presented in accordance with this guidance, are as follows.

	As of March 31, 2012			
	Level 1	Level 2	Level 3	Total
	(Dollars in Thousands)			
Debt securities:				
United States government obligations and authorities	$-	$32,639	$-	$32,639
Obligations of states and political subdivisions	-	2,288	-	2,288
Corporate	68,935	-	-	68,935
International	-	2,422	-	2,422
	68,935	37,349	-	106,284
Equity securities:				
Common stocks	18,394	-	-	18,394
	18,394	-	-	18,394
Total debt and equity securities	$87,329	$37,349	$-	$124,678

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Assets measured at fair value on a recurring basis as of December 31, 2011, presented in accordance with this guidance, are as follows.

	As of December 31, 2011			
	Level 1	Level 2	Level 3	Total
	(Dollars in Thousands)			
Debt securities:				
United States government obligations and authorities	$-	$37,217	$-	$37,217
Obligations of states and political subdivisions	-	2,303	-	2,303
Corporate	63,268	-	-	63,268
International	-	1,523	-	1,523
	63,268	41,043	-	104,311
Equity securities:				
Common stocks	18,028	-	-	18,028
	18,028	-	-	18,028
Total debt and equity securities	$81,296	$41,043	$-	$122,339

(7) Reinsurance Agreements

Financing risk generally involves a combination of risk retention and risk transfer techniques. “Retention”, similar to a deductible, involves financing losses by funds internally generated. “Transfer” involves the existence of a contractual arrangement designed to shift financial responsibility to another party in exchange for premium. Secondary to the primary risk-transfer agreements we use reinsurance agreements to transfer a portion of the risks insured under our policies to other companies through the purchase of reinsurance. We utilize reinsurance to reduce exposure to catastrophic and non-catastrophic risks and to help manage the cost of capital. Reinsurance techniques are designed to lessen earnings volatility, improve shareholder return, and to support the required statutory surplus requirements. We also use reinsurance to realize an arbitrage of premium rates, benefit from the availability of our reinsurers’ expertise, and benefit from the management of a profitable portfolio of insureds by way of enhanced analytical capacities.

In addition to reinsurance agreements, we also from time to time enter into retro-cessionary reinsurance agreements; each designed to shift financial responsibility based on predefined conditions. Generally, there are three separate kinds of reinsurance structures – quota share, excess of loss, and facultative, each considered either proportional or non-proportional. Our reinsurance structures are maintained to protect our insurance subsidiary against the severity of losses on individual claims or unusually serious occurrences in which the frequency and or the severity of claims produce an aggregate extraordinary loss from catastrophic events.

Although reinsurance does not discharge us from our primary obligation to pay for losses insured under the policies we issue, reinsurance does make the assuming reinsurer liable to the insurance subsidiary for the reinsured portion of the risk. A credit risk exposure exists with respect to ceded losses to the extent that any reinsurer is unable or unwilling to meet the obligations assumed under the reinsurance contracts. The collectability of reinsurance is subject to the solvency of the reinsurers, interpretation of contract language and other factors. A reinsurer's insolvency or inability to make payments under the terms of a reinsurance contract could have a material adverse effect on our results of operations and financial condition. Our reinsurance structure has significant risks, including the fact that the FHCF may not be able to raise sufficient money to pay its claims or impair its ability to pay its claims in a timely manner. This could result in significant financial, legal and operational challenges to all property and casualty companies associated with FHCF, including our company.

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The availability and costs associated with the acquisition of reinsurance will vary year to year. These fluctuations, which can be significant, are not subject to our control and may limit our ability to purchase adequate coverage. For example, FHCF has restricted its very affordable reinsurance capacity for the 2011–2012 and 2010–2011 hurricane seasons and is expected to continue constricting its claim paying capacity for future seasons. This gradual restriction is requiring us to replace that capacity with more expensive private market reinsurance. The recovery of increased reinsurance costs through rate action is not immediate and cannot be presumed, as it is subject to Florida OIR approval. Our reinsurance program is subject to approval by the Florida OIR and review by Demotech, Inc. ("Demotech").

Our property lines of business include homeowners' and fire. For the 2011–2012 hurricane season, the excess of loss and FHCF treaties will insure the property lines for approximately $298.0 million of aggregate catastrophic losses and LAE with a maximum single event coverage totaling approximately $226.0 million, with the Company retaining the first $7.0 million of losses and LAE for each event. Our reinsurance program includes coverage purchased from the private market, which affords optional reinstatement premium protection that provides coverage beyond the first event, along with any remaining coverage from the FHCF. Coverage afforded by the FHCF totals approximately $154.1 million, or 51.7% of the $298.0 million of aggregate catastrophic losses and LAE. The FHCF affords coverage for the entire season, subject to maximum payouts, without regard to any particular insurable event.

The estimated cost to the Company for the excess of loss reinsurance products for the 2011-2012 hurricane season, inclusive of approximately $11.7 million payable to the FHCF and the prepaid automatic premium reinstatement protection, is approximately $39.7 million.

Annually, the cost and amounts of reinsurance are based on management's analysis of Federated National's exposure to catastrophic risk as of June 30 and estimated to September 30. Our data is then subjected to actual exposure level analysis as of September 30. This analysis of our exposure level in relation to the total exposures to the FHCF and excess of loss treaties may produce changes in limits and reinsurance premiums as a result of the reconciliation of estimated to actual exposure level. The September 30, 2010 change to total limits was an increase of $10.3 million of probable maximum loss or 2.9% and the change to reinsurance premiums was an increase of $3.7 million or 8.7%. The September 30, 2011 change to total limits was an increase of $172.2 million of total insured value or 1.4 % and the change to reinsurance premiums was an increase of $0.5 million or 1.1%. The subsequent change to management's June 30, 2011 exposure analysis, as of September 30, 2011 is being amortized over the underlying policy term.

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The 2011-2012 private reinsurance companies and their respective A.M. Best Company (“A.M. Best”) rating are listed in the table as follows.

Reinsurer	A.M. Best Rating		
UNITED STATES			
American Agricultural Insurance	A-		
Everest Reinsurance Company	A+		(2)
Houston Casualty Co. (UK Branch)	A+		(2)
Munich Reinsurance America, Inc.	A+		(2)
Odyssey Reinsurance Company	A		
QBE Reinsurance Corporation	A		(2)
BERMUDA			
ACE Tempest Reinsurance Ltd.	A+	*	(2)
Arch Reinsurance Limited	A		(2)
Ariel Reinsurance Company Limited	A-	*	
DaVinci Reinsurance Limited	A	*	(2)
D.E. Shaw Re (Bermuda) Ltd.	NR		(1)
JC Re Ltd (Juniperus)	NR	*	(1)
Montpelier Reinsurance Ltd.	A-		
Renaissance Reinsurance Limited	A+	*	(2)
Torus Insurance (Bermuda) Limited	A-	*	
UNITED KINGDOM			