

FINANCIAL STATEMENTS – STATUTORY
BASIS AND SUPPLEMENTARY INFORMATION

State National Insurance Company, Inc.
Years Ended December 31, 2012 and 2011
With Report of Independent Auditors

Ernst & Young LLP

 **ERNST & YOUNG**

State National Insurance Company, Inc.

Financial Statements – Statutory Basis
and Supplementary Information

Years Ended December 31, 2012 and 2011

Contents

Report of Independent Auditors.....	1
Financial Statements – Statutory Basis	
Balance Sheets – Statutory Basis.....	3
Statements of Income – Statutory Basis	4
Statements of Changes in Capital and Surplus – Statutory Basis.....	5
Statements of Cash Flow – Statutory Basis	6
Notes to Financial Statements – Statutory Basis	7
Supplementary Information	
Report of Independent Auditors on Supplementary Information	40
Investment Risk Interrogatories.....	41
Summary Investment Schedule.....	44
Schedule of Reinsurance Disclosures	45
Note to Supplementary Information	47

Report of Independent Auditors

The Board of Directors
State National Insurance Company, Inc.

We have audited the accompanying statutory-basis financial statements of State National Insurance Company, Inc., which comprise the balance sheets as of December 31, 2012 and 2011, and the related statements of income, changes in capital and surplus, and cash flow for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in conformity with accounting practices prescribed or permitted by the Texas Department of Insurance. Management also is responsible for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free of material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.

Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinions.

Basis for Adverse Opinion on U.S. Generally Accepted Accounting Principles

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

Adverse Opinion on U.S. Generally Accepted Accounting Principles

In our opinion, because of the effects of the matter described in the preceding paragraph, the statutory-basis financial statements referred to above do not present fairly, in conformity with U.S. generally accepted accounting principles, the financial position of State National Insurance Company, Inc. at December 31, 2012 and 2011, or the results of its operations or its cash flow for the years then ended.

Opinion on Statutory-Basis of Accounting

However, in our opinion, the statutory-basis financial statements referred to above present fairly, in all material respects, the financial position of State National Insurance Company, Inc. at December 31, 2012 and 2011, and the results of its operations and its cash flow for the years then ended in conformity with accounting practices prescribed or permitted by the Texas Department of Insurance.

Ernst + Young LLP

May 23, 2013

State National Insurance Company, Inc.

Balance Sheets – Statutory Basis

	December 31	
	2012	2011
Admitted assets		
Bonds	\$ 61,582,602	\$ 98,262,895
Preferred stocks	1,313,549	1,123,115
Common stocks	16,803	18,162
Common stocks of affiliates	81,384,332	52,758,614
Real estate, net	16,805,744	16,517,746
Cash, cash equivalents, and short-term investments	23,433,124	14,233,494
Total cash and invested assets	<u>184,536,154</u>	<u>182,914,026</u>
Agents' balances receivable	12,225,676	10,627,563
Reinsurance receivables	5,175,673	4,079,785
Equipment, net	4,423	14,276
Income taxes recoverable	48,308	–
Deferred taxes recoverable, net	3,317,837	4,825,920
Other assets	1,577,865	1,915,753
Total admitted assets	<u>\$ 206,885,936</u>	<u>\$ 204,377,323</u>
Liabilities and capital and surplus		
Liabilities:		
Unpaid losses and loss adjustment expenses	\$ 4,384,334	\$ 5,306,773
Unearned premiums	16,244,046	21,475,812
Ceded reinsurance premiums payable	12,219,941	7,032,599
Reinsurance payables	5,566,794	3,977,177
Agents' balances payable	1,063,584	1,044,463
Commissions payable	5,838,447	5,995,940
Taxes, licenses, and fees payable	2,489,684	679,215
Federal income taxes payable	–	203,019
Payable to affiliates	162,393	2,498,387
Deferred ceding fees	5,382,738	9,014,717
Guaranty fund payable	7,609	15,218
Other liabilities	5,717,384	6,425,637
Total liabilities	<u>59,076,954</u>	<u>63,668,957</u>
Capital and surplus:		
Common stock, \$1 par value, 6,500,000 shares authorized; 3,500,000 shares issued and outstanding	3,500,000	3,500,000
Paid-in surplus	32,998,230	32,998,230
Unassigned surplus	111,310,752	104,210,136
Total capital and surplus	<u>147,808,982</u>	<u>140,708,366</u>
Total liabilities and capital and surplus	<u>\$ 206,885,936</u>	<u>\$ 204,377,323</u>

See accompanying notes.

State National Insurance Company, Inc.

Statements of Income – Statutory Basis

	Year Ended December 31	
	2012	2011
Underwriting income:		
Premiums written	\$ 30,328,481	\$ 51,925,610
Change in unearned premiums	5,231,766	1,243,622
Premiums earned	35,560,247	53,169,232
Losses and loss adjustment expenses	13,959,106	20,994,611
Commissions	6,906,042	1,609,875
Taxes, licenses, and fees	6,238,895	9,527,614
Management fees, affiliate	4,426,878	12,835,510
Other underwriting expenses	2,553,700	3,923,120
Net underwriting income	1,475,626	4,278,502
Investment income:		
Net investment income	2,565,860	4,048,607
Net realized investment gains, net of tax	777,178	241,465
Net investment income	3,343,038	4,290,072
Other (expense) income	(55,106)	124,276
Income before federal income taxes	4,763,558	8,692,850
Federal income tax (benefit) expense	(162,208)	3,001,256
Net income	\$ 4,925,766	\$ 5,691,594

See accompanying notes.

State National Insurance Company, Inc.

Statements of Changes in Capital and Surplus – Statutory Basis

	Common Stock	Paid-In Surplus	Unassigned Surplus	Total
Balance at December 31, 2010	\$ 3,500,000	\$ 32,998,230	\$ 94,859,561	\$ 131,357,791
Net income	–	–	5,691,594	5,691,594
Change in net unrealized capital gains	–	–	3,250,784	3,250,784
Change in net deferred taxes	–	–	390,886	390,886
Change in nonadmitted assets	–	–	17,311	17,311
Balance at December 31, 2011	3,500,000	32,998,230	104,210,136	140,708,366
Net income	–	–	4,925,766	4,925,766
Change in net unrealized capital gains	–	–	3,661,895	3,661,895
Change in net deferred taxes	–	–	(1,489,196)	(1,489,196)
Change in nonadmitted assets	–	–	2,151	2,151
Balance at December 31, 2012	\$ 3,500,000	\$ 32,998,230	\$ 111,310,752	\$ 147,808,982

See accompanying notes.

State National Insurance Company, Inc.

Statements of Cash Flow – Statutory Basis

	Year Ended December 31	
	2012	2011
Operating activities		
Premiums collected, net of reinsurance	\$ 40,141,057	\$ 53,308,414
Net investment income received	4,462,668	5,521,901
Losses and loss adjustment expenses paid	(14,881,545)	(22,266,449)
Received from affiliates for reinsurance settlements	933,907	469,094
Commissions and expenses paid	(19,180,991)	(28,682,489)
Federal income taxes paid	(465,782)	(3,074,426)
Miscellaneous income (expense)	(55,106)	124,274
Net cash provided by operations	<u>10,954,208</u>	5,400,319
Investing activities		
Proceeds from sales and maturities of investments	22,072,982	19,336,676
Cost of investment securities acquired	(22,760,204)	(24,219,560)
Cost of real estate acquired	(1,067,356)	(2,612)
Net cash used in investing activities	<u>(1,754,578)</u>	(4,885,496)
Net change in cash, cash equivalents, and short-term investments	9,199,630	514,823
Cash, cash equivalents, and short-term investments:		
Cash, cash equivalents, and short-term investments at beginning of year	<u>14,233,494</u>	<u>13,718,671</u>
Cash, cash equivalents, and short-term investments at end of year	<u>\$ 23,433,124</u>	<u>\$ 14,233,494</u>

See accompanying notes.

State National Insurance Company, Inc.

Notes to Financial Statements – Statutory Basis

December 31, 2012

1. Summary of Significant Accounting Policies

Business

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

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

SNIC entered into a pooling arrangement with NSIC in 2002 and with USIC in 2006, whereby NSIC and USIC ceded 100% of their net business to SNIC, and SNIC retroceded 10% and 25% of the companies' combined net business to NSIC and USIC, respectively. On January 1, 2012, the pooling percentages changed to 20% and 35% for NSIC and USIC, respectively. (See Note 11 regarding changes to the pooling arrangement). The cessions to unaffiliated reinsurers are prior to the cession of the pooled business.

Basis of Presentation

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

State National Insurance Company, Inc.

Notes to Financial Statements – Statutory Basis (continued)

1. Summary of Significant Accounting Policies (continued)

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

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

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

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

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

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

State National Insurance Company, Inc.

Notes to Financial Statements – Statutory Basis (continued)

1. Summary of Significant Accounting Policies (continued)

Deferred Income Taxes: Deferred income tax assets are limited to: 1) the amount of federal income taxes paid in prior years that can be recovered through loss carrybacks for existing temporary differences that reverse during a time frame corresponding with the Internal Revenue Service tax loss carryback provisions, not to exceed three years, plus 2) the lesser of the remaining gross deferred income tax assets expected to be realized within three years of the balance sheet date or 15% of capital and surplus excluding any net deferred income tax assets, electronic data processing equipment and operating software and any net positive goodwill, plus 3) the amount of remaining gross deferred income tax assets that can be offset against existing gross deferred income tax liabilities after considering the character (i.e., ordinary versus capital) of the deferred tax assets and liabilities. The remaining deferred income tax assets are nonadmitted. Only gross deferred tax assets that are more likely than not to generate a tax benefit are potentially admissible.

Deferred income taxes do not include amounts for state taxes. Under GAAP, state taxes are included in the computation of deferred income taxes.

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

Permitted Practices

The Company has received permission from the Department for recording fees receivable from general agents or program managers in a manner that differs from NAIC SAP. According to the permitted practice, fees not associated with premiums that are due from general agents and program managers are recorded as an aggregate write-in for other-than-invested assets. There is no monetary effect on 2012 or 2011 net income or statutory surplus from the use of this practice.

State National Insurance Company, Inc.

Notes to Financial Statements – Statutory Basis (continued)

1. Summary of Significant Accounting Policies (continued)

New Accounting Pronouncements

In November 2011, the NAIC issued Statement of Statutory Accounting Principles (SSAP) No. 101, *Income Taxes*, a replacement of SSAP No. 10R. This statement, which is a permanent replacement of existing guidance, establishes statutory accounting principles for current and deferred federal and foreign income taxes and current state income taxes. This statement changes the statutory accounting for income taxes in two key areas related to the recognition of tax loss contingencies and the admissibility of deferred tax assets. This guidance became effective January 1, 2012. The Company has adopted this accounting standard on its statutory-basis financial statements and it did not have a material impact on the Company.

Investments

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

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

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

In 2012 and 2011, all investment income due and accrued was less than 90 days past due. Accordingly, no such due and accrued investment income has been non-admitted.

State National Insurance Company, Inc.

Notes to Financial Statements – Statutory Basis (continued)

1. Summary of Significant Accounting Policies (continued)

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

Real Estate, Equipment, and Depreciation

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

Unpaid Losses and Loss Adjustment Expenses

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

Program Business

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

State National Insurance Company, Inc.

Notes to Financial Statements – Statutory Basis (continued)

1. Summary of Significant Accounting Policies (continued)

Deferred Ceding Fees

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

Premiums

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

Reinsurance

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

Commissions

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

Other Liabilities

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

Estimates

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

State National Insurance Company, Inc.

Notes to Financial Statements – Statutory Basis (continued)

2. Investments

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

	Book/Adjusted Carrying Value	Unrealized Gains	Unrealized Losses	Fair Value
December 31, 2012				
Bonds:				
Government	\$ 4,340,245	\$ 211,293	\$ (3,584)	\$ 4,547,954
Government agency	531,427	28,038	–	559,465
State and municipality	11,152,231	548,213	–	11,700,444
Industrial and miscellaneous	21,975,753	1,781,066	(70,199)	23,686,620
Residential mortgage-backed	21,548,878	816,924	(118,907)	22,246,895
Commercial mortgage-backed	2,034,068	164,858	–	2,198,926
Total bonds	\$ 61,582,602	\$ 3,550,392	\$ (192,690)	\$ 64,940,304
December 31, 2011				
Bonds:				
Government	\$ 3,402,257	\$ 289,997	\$ –	\$ 3,692,254
Government agency	537,172	37,894	–	575,066
State and municipality	22,973,759	1,358,722	–	24,332,481
Industrial and miscellaneous	25,549,630	1,767,113	(214,830)	27,101,913
Residential mortgage-backed	39,092,822	1,640,740	(228,319)	40,505,243
Commercial mortgage-backed	6,707,255	399,639	–	7,106,894
Total bonds	\$ 98,262,895	\$ 5,494,105	\$ (443,149)	\$ 103,313,851

Bonds that carry NAIC designations of 3 to 6 are reflected in the accompanying statutory-basis balance sheets at lower of amortized cost or fair value. As a result, the amortized cost of bonds at December 31, 2012 and 2011, has been reduced by \$87,994 and \$85,291, respectively.

State National Insurance Company, Inc.

Notes to Financial Statements – Statutory Basis (continued)

2. Investments (continued)

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

	Book/Adjusted Carrying Value	Unrealized Gains	Unrealized Losses	Fair Value
December 31, 2012				
Common stocks	\$ 16,803	\$ –	\$ –	\$ 16,803
Preferred stocks	1,313,549	448,947	–	1,762,496
Total stocks	<u>\$ 1,330,352</u>	<u>\$ 448,947</u>	<u>\$ –</u>	<u>\$ 1,779,299</u>
December 31, 2011				
Common stocks	\$ 18,162	\$ –	\$ –	\$ 18,162
Preferred stocks	1,123,115	367,597	–	1,490,712
Total stocks	<u>\$ 1,141,277</u>	<u>\$ 367,597</u>	<u>\$ –</u>	<u>\$ 1,508,874</u>

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

The following tables show unrealized losses and fair values of bonds, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at December 31, 2012 and 2011:

	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
December 31, 2012						
Government	\$ 788,696	\$ (3,584)	\$ –	\$ –	\$ 788,696	\$ (3,584)
Industrial and miscellaneous	2,115,443	(16,219)	813,677	(53,980)	2,929,120	(70,199)
Residential mortgage-backed	3,502,016	(24,622)	1,158,917	(94,285)	4,660,933	(118,907)
	<u>\$ 6,406,155</u>	<u>\$ (44,425)</u>	<u>\$ 1,972,594</u>	<u>\$ (148,265)</u>	<u>\$ 8,378,749</u>	<u>\$ (192,690)</u>
December 31, 2011						
Industrial and miscellaneous	\$ 4,211,265	\$ (214,830)	\$ –	\$ –	\$ 4,211,265	\$ (214,830)
Residential mortgage-backed	2,730,344	(24,578)	1,214,426	(203,741)	3,944,770	(228,319)
	<u>\$ 6,941,609</u>	<u>\$ (239,408)</u>	<u>\$ 1,214,426</u>	<u>\$ (203,741)</u>	<u>\$ 8,156,035</u>	<u>\$ (\$443,149)</u>

State National Insurance Company, Inc.

Notes to Financial Statements – Statutory Basis (continued)

2. Investments (continued)

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

There are 22 securities in an unrealized loss position at December 31, 2012. These securities are all considered investment-grade based on their NAIC rating at December 31, 2012. The Company does not have the intent to sell these bonds before recovery of the amortized cost and has the ability to hold these investments until maturity or until fair value recovers above amortized cost. Therefore, the Company does not consider these investments to be other-than-temporarily impaired at December 31, 2012.

There were no preferred stocks or common stocks of affiliates in an unrealized loss position at December 31, 2012 or 2011.

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

	<u>2012</u>	<u>2011</u>
Realized gains:		
Bonds	\$ 1,237,409	\$ 838,088
Equity securities	38,059	78,489
Gross realized gains	<u>1,275,468</u>	916,577
Realized losses:		
Bonds	(95,479)	(148,724)
Equity securities	(41)	–
Other-than-temporary impairment losses on bonds	<u>(26,106)</u>	(287,686)
Gross realized losses	<u>(121,626)</u>	(436,410)
	1,153,842	480,167
Net realized investment gains		
Capital gains tax	<u>(376,664)</u>	(238,702)
Net realized investment gains, net of tax	<u>\$ 777,178</u>	<u>\$ 241,465</u>

Proceeds from sales of investment securities during 2012 and 2011 were \$14,122,892 and \$10,478,145, respectively.

State National Insurance Company, Inc.

Notes to Financial Statements – Statutory Basis (continued)

2. Investments (continued)

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

CUSIP	Description	Amortized Cost Basis Before OTTI	Recognized OTTI	Amortized Cost Basis After OTTI	Fair Value at Impairment	Period Impairment Reported
23242M-AD-3	CWL 2006-S3	\$ 749,997	\$ 352,497	\$ 397,500	\$ 397,500	2008
02149V-AG-4	CWALT INC 2007-3T1	209,245	24,052	185,193	185,193	2009
12544L-AA-9	CWHL 2007-11	249,033	20,245	228,788	228,788	2009
12493V-AC-4	CBO HOLDGS VII LTD	99,984	6,065	93,919	93,919	2009
126673-JE-3	CWL 2004-10	395,994	217,589	178,405	178,405	2009
12493V-AC-4	CBO HOLDGS VII LTD	94,940	12,968	81,972	81,972	2010
126673-JE-3	CWL 2004-10	181,063	51,883	129,180	129,180	2010
02149V-AG-4	CWALT INC 2007-3T1	114,593	28,023	86,570	86,570	2011
12544L-AA-9	CWHL 2007-11	155,578	15,613	139,965	139,965	2011
126673-JE-3	CWL 2004-10	132,142	22,216	109,926	109,926	2011
82934H-AD-3	SINO FOREST	162,610	122,310	40,300	40,300	2011
82934H-AD-3	SINO FOREST	44,893	9,243	35,650	35,650	2012
82934H-AD-3	SINO FOREST	38,175	16,863	21,313	21,313	2012
			<u>\$ 899,567</u>			

The following schedule details the maturities of the Company’s bonds as of December 31, 2012. Actual maturities may differ from contractual maturities because certain borrowers have the right to call or prepay obligations, with or without call or prepayment penalties.

	Book/Adjusted Carrying Value	Fair Value
Due in one year or less	\$ 2,934,313	\$ 3,107,958
Due after one through five years	19,861,280	21,018,334
Due after five through ten years	11,075,935	11,926,578
Due after ten years	4,128,128	4,441,613
Residential mortgage-backed securities	21,548,878	22,246,895
Commercial mortgage-backed securities	2,034,068	2,198,926
	<u>\$ 61,582,602</u>	<u>\$ 64,940,304</u>

State National Insurance Company, Inc.

Notes to Financial Statements – Statutory Basis (continued)

2. Investments (continued)

The Company is required by various states and regulatory agencies in which it is licensed to maintain deposits for the benefit of policyholders. These deposits are comprised of bonds totaling \$7,064,858 and \$6,292,382 at December 31, 2012 and 2011, respectively.

The Company entered into an agreement with one of its CPI clients whereby the Company agreed to secure certain unearned premium liabilities arising from CPI business. These liabilities are secured by loan-backed securities and money market funds totaling \$4,033,742 at December 31, 2012. The client has the right to withdraw the deposit only upon a determination of the Company's insolvency by the Department. The Company receives all benefits of the interest, dividends, or benefits generated by the deposited funds.

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

	<u>2012</u>	<u>2011</u>
Interest on investments	\$ 5,365,145	\$ 7,043,386
Dividends	78,206	83,383
Gross investment income	<u>5,443,351</u>	7,126,769
Investment expenses	<u>(2,877,491)</u>	(3,078,162)
Net investment income	<u>\$ 2,565,860</u>	<u>\$ 4,048,607</u>

State National Insurance Company, Inc.

Notes to Financial Statements – Statutory Basis (continued)

2. Investments (continued)

Summarized Financial Information of Affiliates

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

	December 31, 2012		December 31, 2011	
	NSIC	USIC	NSIC	USIC
Total cash and invested assets	\$ 40,987,813	\$ 70,824,983	\$ 26,199,439	\$ 46,867,037
Other assets	9,796,524	10,787,533	8,546,904	7,836,188
Total admitted assets	<u>\$ 50,784,337</u>	<u>\$ 81,612,516</u>	<u>\$ 34,746,343</u>	<u>\$ 54,703,225</u>
Total liabilities	\$ 20,575,281	\$ 30,437,240	\$ 15,685,806	\$ 21,005,148
Capital and surplus	30,209,056	51,175,276	19,060,537	33,698,077
Total liabilities and capital and surplus	<u>\$ 50,784,337</u>	<u>\$ 81,612,516</u>	<u>\$ 34,746,343</u>	<u>\$ 54,703,225</u>
Net underwriting income	\$ 655,834	\$ 1,147,710	\$ 658,231	\$ 1,645,578
Net investment income	1,063,711	2,440,249	695,790	1,680,897
Other income	(24,492)	(42,861)	19,119	47,799
Net income	505,517	1,859,215	886,585	2,167,489

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

	Statutory Carrying Value	Cost	Unrealized Gains
December 31, 2012			
National Specialty Insurance Company	\$ 30,209,056	\$ 21,750,000	\$ 8,459,056
United Specialty Insurance Company	51,175,276	35,000,000	16,175,276
	<u>\$ 81,384,332</u>	<u>\$ 56,750,000</u>	<u>\$ 24,634,332</u>
December 31, 2011			
National Specialty Insurance Company	\$ 19,060,537	\$ 11,750,000	\$ 7,310,537
United Specialty Insurance Company	33,698,077	20,000,000	13,698,077
	<u>\$ 52,758,614</u>	<u>\$ 31,750,000</u>	<u>\$ 21,008,614</u>

State National Insurance Company, Inc.

Notes to Financial Statements – Statutory Basis (continued)

3. Real Estate, Equipment, and Depreciation

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

	December 31	
	2012	2011
Land held for use	\$ 3,443,119	\$ 2,375,763
Land held for sale	1,034,000	1,034,000
Building	15,126,799	15,126,799
Computer equipment and software	68,416	68,656
	19,672,334	18,605,218
Accumulated depreciation	(2,862,167)	(2,073,196)
Real estate and equipment, net	\$ 16,810,167	\$ 16,532,022
Disclosed as:		
Real estate, net	\$ 16,805,744	\$ 16,517,746
Equipment, net	4,423	14,276
Real estate and equipment, net	\$ 16,810,167	\$ 16,532,022
Depreciation expense	\$ 790,003	\$ 794,276

On November 28, 2007, the Company purchased a tract of land with a plan to build a new home office building for its own use. During 2009, the Company classified this land as held for sale, since it had abandoned its plan to build a new home office and purchased an existing building for its own use. No losses were recognized on real estate and equipment in 2012 or 2011.

State National Insurance Company, Inc.

Notes to Financial Statements – Statutory Basis (continued)

4. Unpaid Losses and Loss Adjustment Expenses

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

	Year Ended December 31	
	2012	2011
Unpaid losses and LAE, net of reinsurance receivables, at January 1	\$ 5,306,773	\$ 6,578,611
Incurred related to:		
Current year	13,916,000	22,719,000
Prior years	43,106	(1,724,389)
Total incurred	13,959,106	20,994,611
Paid related to:		
Current year	11,440,729	19,176,070
Prior years	3,440,816	3,090,379
Total paid	14,881,545	22,266,449
Unpaid losses and LAE, net of reinsurance receivables, at December 31	\$ 4,384,334	\$ 5,306,773

Reserves for incurred losses and LAE attributable to insured events of prior years increased by \$43,106 in 2012 and decreased by \$1,724,389 in 2011, primarily as a result of re-estimation of unpaid losses and LAE, principally on general liability, commercial auto, commercial multi-peril and credit lines of insurance in 2012 and on commercial auto, commercial multi-peril, and credit lines of insurance in 2011. The net change in reserves is the result of ongoing analysis of recent loss development trends. Original estimates are adjusted as additional information becomes known regarding individual claims.

State National Insurance Company, Inc.

Notes to Financial Statements – Statutory Basis (continued)

5. Income Taxes

The Company files its federal income taxes on a consolidated basis with its parent company, SNIH, and its subsidiaries, NSIC and USIC. The method of allocation among companies is subject to a written agreement, approved by the Company's directors, whereby allocation is made primarily on a separate return basis, with a current credit for losses. Tax years ended December 31, 2009 through December 31, 2011, are open for examination by the Internal Revenue Service (IRS).

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

	2012			2011		
	Ordinary	Capital	Total	Ordinary	Capital	Total
Gross deferred tax asset	\$ 3,182,832	\$ 374,326	\$ 3,557,158	\$ 4,756,711	\$ 418,395	\$ 5,175,106
Statutory valuation allowance	–	–	–	–	–	–
Adjusted gross deferred tax asset	3,182,832	374,326	3,557,158	4,756,711	418,395	5,175,106
Gross deferred tax liabilities	(239,321)	–	(239,321)	(349,186)	–	(349,186)
Net deferred tax asset	2,943,511	374,326	3,317,837	4,407,525	418,395	4,825,920
Nonadmitted deferred tax asset	–	–	–	–	–	–
Net deferred tax asset admitted	\$ 2,943,511	\$ 374,326	\$ 3,317,837	\$ 4,407,525	\$ 418,395	\$ 4,825,920
Change in deferred tax asset nonadmitted	\$ –	\$ –	\$ –	\$ –	\$ –	\$ –

Deferred taxes are recorded by the Company to reflect the tax consequences on future years of differences between the tax bases of assets and liabilities and their financial reporting amounts. The Company admits deferred taxes pursuant to SSAP No. 101 for the year ending December 31, 2012.

State National Insurance Company, Inc.

Notes to Financial Statements – Statutory Basis (continued)

5. Income Taxes (continued)

The Company's admitted deferred tax asset is computed as follows, pursuant to SSAP No. 101:

	2012			2011		
	Ordinary	Capital	Total	Ordinary	Capital	Total
Federal tax paid in carryback years 11a	\$ 2,841,840	\$ 374,326	\$ 3,216,166	\$ 4,724,265	\$ 418,395	\$ 5,142,660
Lesser of:						
Deferred taxes expected to be realized following the balance sheet due date 11b(i)	–	–	–	–	–	–
Or						
Adjusted gross deferred tax assets allowed per limitation threshold 11b(ii)	N/A	N/A	21,673,672	N/A	N/A	13,588,245
Lesser of 11b(i) and 11b(ii)	–	–	–	–	–	–
Amount of gross deferred tax assets that can be offset against deferred tax liabilities 11c	340,992	–	340,992	32,446	–	32,446
Total of 11a, 11b, 11c	<u>\$ 3,182,832</u>	<u>\$ 374,326</u>	<u>\$ 3,557,158</u>	<u>\$ 4,756,711</u>	<u>\$ 418,395</u>	<u>\$ 5,175,106</u>
Gross admitted deferred tax assets	\$ 3,182,832	\$ 374,326	\$ 3,557,158	\$ 4,756,711	\$ 418,395	\$ 5,175,106
Gross deferred tax liabilities	(239,321)	–	(239,321)	(349,186)	–	(349,186)
Net admitted deferred tax assets	<u>\$ 2,943,511</u>	<u>\$ 374,326</u>	<u>\$ 3,317,837</u>	<u>\$ 4,407,525</u>	<u>\$ 418,395</u>	<u>\$ 4,825,920</u>

There are no deferred tax liabilities not recognized as of December 31, 2012 and 2011.

State National Insurance Company, Inc.

Notes to Financial Statements – Statutory Basis (continued)

5. Income Taxes (continued)

The risk-based capital level to determine the applicable realization period and percentage from the Realization Threshold Limitation Table for RBC Reporting Entities is:

	2012	2011
Admitted deferred tax assets	\$ 3,317,837	\$ 4,825,920
Admitted assets	206,855,936	204,377,323
Statutory surplus	147,808,982	140,708,366
Total adjusted capital & surplus	144,491,145	140,708,366
Authorized control level of risk-based capital	25,201,727	31,255,666
Ratio percentage used to determine recovery period and threshold limitation	573%	450%

State National Insurance Company, Inc.

Notes to Financial Statements – Statutory Basis (continued)

5. Income Taxes (continued)

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

	<u>2012</u>	<u>2011</u>
Deferred tax assets:		
Capital:		
Bonds	\$ 297,241	\$ 321,496
Stocks	77,085	96,899
Total gross capital deferred tax asset	<u>374,326</u>	418,395
Nonadmitted capital deferred tax asset	–	–
Admitted capital deferred tax asset	<u>374,326</u>	418,395
Ordinary:		
Compensation and benefits	55,694	55,694
Unearned premiums	1,114,342	1,473,241
Unpaid losses and LAE	118,589	129,783
Uncollected premiums	42,720	–
Deferred ceding fees	1,846,279	3,092,048
Other	5,208	5,945
Total gross ordinary deferred tax asset	<u>3,182,832</u>	4,756,711
Nonadmitted ordinary deferred tax asset	–	–
Admitted ordinary deferred tax asset	<u>3,182,832</u>	4,756,711
Deferred tax liabilities:		
Ordinary:		
Bonds discount amortization	(49,481)	(73,550)
Real estate and equipment	(187,060)	(274,009)
Other	(2,780)	(1,627)
Total ordinary deferred tax liabilities	<u>(239,321)</u>	(349,186)
Total deferred tax liabilities	<u>(239,321)</u>	(349,186)
Net admitted deferred tax assets	<u>\$ 3,317,837</u>	<u>\$ 4,825,920</u>

State National Insurance Company, Inc.

Notes to Financial Statements – Statutory Basis (continued)

5. Income Taxes (continued)

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

	<u>December 31</u>		
	<u>2012</u>	<u>2011</u>	<u>Change</u>
Gross deferred tax assets	\$ 3,557,158	\$ 5,175,106	\$ (1,617,948)
Gross deferred tax liabilities	(239,321)	(349,186)	109,865
Net deferred tax asset	<u>\$ 3,317,837</u>	<u>\$ 4,825,920</u>	(1,508,083)
Tax effect of unrealized gains			18,887
Change in net deferred taxes			<u>\$ 1,489,196</u>

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

	<u>2012</u>		<u>2011</u>	
	<u>Amount</u>	<u>Effective Tax Rate</u>	<u>Amount</u>	<u>Effective Tax Rate</u>
Provisions computed at statutory rate	\$ 1,763,096	34.3%	\$ 3,063,522	34.3%
Tax-exempt interest income, net of proration	(96,428)	(1.9)	(197,133)	(2.2)
Other	36,984	0.7	(17,317)	(0.2)
Total	<u>\$ 1,703,652</u>	<u>33.1%</u>	<u>\$ 2,849,072</u>	<u>31.9%</u>
Federal income taxes incurred	\$ 214,456		\$ 3,239,958	
Change in net deferred taxes	<u>1,489,196</u>		<u>(390,886)</u>	
Total statutory income taxes	<u>\$ 1,703,652</u>		<u>\$ 2,849,072</u>	

State National Insurance Company, Inc.

Notes to Financial Statements – Statutory Basis (continued)

5. Income Taxes (continued)

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

	2012			2011			Change		
	Ordinary	Capital	Total	Ordinary	Capital	Total	Ordinary	Capital	Total
Percent of total adjusted gross DTAs	0.0%	10.5%	10.5%	0.0%	8.1%	8.1%	0.0%	2.4%	2.4%
Percent of total net admitted gross DTAs	0.0%	10.5%	10.5%	0.0%	8.1%	8.1%	0.0%	2.4%	2.4%

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

	2012	2011
Current income tax (benefit) expense	\$ (177,609)	\$ 3,004,068
Tax on capital gains	376,664	238,702
Prior-year over accrual	15,401	(2,812)
Federal income taxes incurred	<u>\$ 214,456</u>	<u>\$ 3,239,958</u>

At December 31, 2012 and 2011, the Company did not have any unused operating loss carryforwards or capital loss carryforwards available to offset future taxable income.

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

	Ordinary	Capital	Total
2012	\$ (177,609)	\$ 376,664	\$ 199,055
2011	3,019,309	238,833	3,258,142
	<u>\$ 2,841,700</u>	<u>\$ 615,497</u>	<u>\$ 3,457,197</u>

State National Insurance Company, Inc.

Notes to Financial Statements – Statutory Basis (continued)

5. Income Taxes (continued)

No deposits were admitted under Section 6603 of the Internal Revenue Code. The Company recognizes interest and penalties related to uncertain tax positions in general and administrative expenses. There were no penalties or interest recognized during 2012 and 2011.

6. Capital and Surplus

The payment of dividends by the Company is limited and can only be made from earned profits without the prior approval from the Department. The maximum dividend that may be paid without prior approval of the Commissioner of Insurance is limited to the greater of 10% of statutory surplus at the end of the preceding calendar year or the statutory net income of the preceding calendar year. Accordingly, SNIC has unrestricted net assets available for dividends to SNIH in 2012 of \$14,780,898. The minimum required statutory capital and surplus was \$5,000,000 at December 31, 2012. Unassigned surplus at December 31, 2012, contains net unrealized gains of \$24,546,173 and nonadmitted assets of \$15,184.

The Company is subject to certain Risk-Based Capital (RBC) requirements, as specified by the NAIC. Under the RBC standards, risk specific to the Company in such areas as asset risk, insurance risk, interest rate risk, and business risk are calculated and compared to the Company's capital and surplus. In its calculation of risk-based capital, the Company has deducted amounts for which it holds collateral (either trust funds in the name of the Company or irrevocable letters of credit) for amounts recoverable from reinsurance companies. The Company believes this practice to be appropriate because the credit risk for the related reinsurance balances is virtually eliminated due to the protection provided by the collateral. This practice differs from NAIC statutory annual statement instructions. There is no monetary effect on 2012 or 2011 net income or statutory surplus from the use of this practice. If the Company would have used the practice outlined in the NAIC's annual statement instructions, its RBC calculation would not have resulted in a regulatory event in 2012 or 2011.

State National Insurance Company, Inc.

Notes to Financial Statements – Statutory Basis (continued)

7. NAIC SAP to GAAP Reconciliation

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

	Year Ended December 31	
	2012	2011
Shareholder's equity:		
Statutory-basis capital and surplus	\$ 147,808,982	\$ 140,708,366
Adjustments for:		
Commissions payable	8,066,994	7,335,346
Allowance for return commissions	16,174,545	12,860,189
Allowance for policy cancellations	(13,353,133)	(12,665,299)
Deferred acquisition costs	10,467,092	7,416,519
GAAP adjustment effects of pooling agreement	(2,654,865)	540,326
Management fees	(7,334,793)	(4,924,629)
Deferred income taxes	(5,634,400)	(5,922,827)
Unrealized gains on investments	3,806,647	5,418,546
Investment in subsidiaries	7,125,338	5,014,159
Nonadmitted assets	15,183	17,334
Other	182,084	212,316
Shareholder's equity in accordance with GAAP	\$ 164,669,674	\$ 156,010,346
Net income:		
Statutory-basis net income	\$ 4,925,766	\$ 5,691,594
Adjustments for:		
Contingent commissions	731,648	5,652
Allowance for return commissions	3,314,356	(336,574)
Allowance for policy cancellations	(687,834)	496,041
Deferred acquisition costs	3,050,573	(795,446)
GAAP adjustment effects of pooling agreement	(3,195,191)	327,251
Management fees	(2,410,164)	209,226
Deferred income taxes	(1,753,651)	597,452
Equity in earnings of subsidiaries	4,305,221	3,273,629
Other	(30,233)	68,883
Net income in accordance with GAAP	\$ 8,250,491	\$ 9,537,708

State National Insurance Company, Inc.

Notes to Financial Statements – Statutory Basis (continued)

8. Program Managers

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

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

For the years ended December 31, 2012 and 2011, direct premiums written by unaffiliated program managers or an affiliated agent are shown below:

	<u>2012</u>	<u>2011</u>
Appalachian Underwriters, Inc.	\$ 43,528,053	\$ 50,394,874
Cal-Regent Insurance Services Corp.	15,659,580	15,480,891
Climate Insurance Agency, LLC	34,477,341	27,172,363
Direct General Insurance Company	20,061,413	17,726,124
Five-Star Specialty Programs	23,236,160	12,698,587
Knight Management Insurance Services	9,076,193	13,053,923
Personable General Insurance Agency	10,480,801	12,372,903
Restaurant Coverage Association, Inc.	37,236,589	33,072,537
Sure Products Insurance Agency	11,852,165	10,383,549
Torus US Intermediaries/First Indemnity Insurance	30,227,516	25,322,421
T.B.A. Insurance Group, Ltd., affiliate	100,609,165	93,545,212
ULICO Insurance Group, Inc.	39,064,844	16,696,479
Venture Underwriters, Inc.	21,982,366	14,750,597
Others	49,599,125	62,470,647
	<u>\$ 447,091,311</u>	<u>\$ 405,141,107</u>

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

State National Insurance Company, Inc.

Notes to Financial Statements – Statutory Basis (continued)

9. Reinsurance

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

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

	<u>2012</u>	<u>2011</u>
Ceded unearned premium	\$ 170,849,477	\$ 162,766,976
Ceded unpaid losses and LAE	632,565,275	535,951,196
Total reinsurance recoverable	803,414,752	698,718,172
Less secured balances	(510,209,492)	(412,152,231)
Unsecured reinsurance recoverable	<u>\$ 293,205,260</u>	<u>\$ 286,565,941</u>

SNIC holds collateral securing \$510,209,492 of ceded balances at December 31, 2012. The fair value of the collateral is approximately 139% of the related recoverables as of December 31, 2012.

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

	<u>2012</u>		<u>2011</u>	
	<u>Written</u>	<u>Earned</u>	<u>Written</u>	<u>Earned</u>
Direct premiums	\$ 447,091,311	\$ 443,910,906	\$ 405,141,107	\$ 418,312,325
Assumed premiums:				
Affiliates	4,792,711	5,213,146	6,157,686	5,918,255
Nonaffiliates	1,600,305	1,509,540	1,609,098	1,518,864
Ceded premiums:				
Affiliates	(51,752,460)	(43,462,525)	(27,959,944)	(28,629,588)
Nonaffiliates	(371,403,386)	(371,610,820)	(333,022,337)	(343,950,624)
Net premiums	<u>\$ 30,328,481</u>	<u>\$ 35,560,247</u>	<u>\$ 51,925,610</u>	<u>\$ 53,169,232</u>

State National Insurance Company, Inc.

Notes to Financial Statements – Statutory Basis (continued)

9. Reinsurance (continued)

At December 31, 2012, the Company has unsecured reinsurance recoverables that exceed 3% of surplus from the following reinsurers:

Technology Insurance Company	\$ 78,239,284
Torus National Insurance Company	41,089,587
Tower Insurance Company of NY	40,444,811
United States Fire Insurance Company	21,806,834
Hiscox Syndicate 33	17,517,053
North Carolina Reinsurance Facility	16,871,751
United Specialty Insurance Company, affiliate	16,044,296
California Capital Insurance Company	12,690,025
Cumis Insurance Society, Inc.	11,967,832
National Specialty Insurance Company, affiliate	9,168,169
Harco National Insurance Company	9,018,343

The net amount of return commissions payable or recoverable at December 31, 2012, if all assumed and ceded reinsurance treaties were canceled, is summarized as follows:

	Assumed Reinsurance		Ceded Reinsurance		Net	
	Unearned Premium Reserve	Commission Recoverable	Unearned Premium Reserve	Commission Recoverable	Unearned Premium Reserve	Commission Recoverable
Affiliates	\$1,937,272	\$1,227,874	\$ 19,853,834	\$ 9,462,256	\$ (17,916,562)	\$ (8,234,382)
Nonaffiliates	273,000	–	150,995,642	40,748,981	(150,722,642)	(40,748,981)
Total	<u>\$2,210,272</u>	<u>\$1,227,874</u>	<u>\$ 170,849,476</u>	<u>\$ 50,211,237</u>	<u>\$ (168,639,204)</u>	<u>\$ (48,983,363)</u>

State National Insurance Company, Inc.

Notes to Financial Statements – Statutory Basis (continued)

9. Reinsurance (continued)

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

	2012	2011
Direct	\$ 12,447,948	\$ 8,869,285
Assumed	526,379	355,238
Ceded	(7,135,880)	(3,228,583)
Net	<u>\$ 5,838,447</u>	<u>\$ 5,995,940</u>

10. Fair Value Measurements

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

- Level 1: Inputs are quoted prices for identical assets or liabilities in active markets that are accessible at the measurement date.
- Level 2: Inputs include quoted prices for similar assets or liabilities in active markets, quoted prices from those willing to trade in markets that are not active, or other inputs that are observable or can be corroborated by market data for the term of the instrument. These inputs include market interest rates and volatilities, spreads, and yield curves.
- Level 3: Inputs are unobservable. Unobservable inputs reflect the Company's own assumptions about the assumptions market participants would use in pricing the asset or liability based on the best information available in the circumstances.

State National Insurance Company, Inc.

Notes to Financial Statements – Statutory Basis (continued)

10. Fair Value Measurements (continued)

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

- Bonds: Level 2 inputs are used to determine fair value of all bonds. These inputs are obtained from either an independent pricing service using quoted prices or from its third party investment managers and are valued utilizing observable data that may include dealer quotes, market spreads, cash flows, yield curves, live trading levels, trade execution data, market consensus prepayment speeds, credit information, and the security’s terms and conditions, among other information.
- Equity Securities: Level 2 inputs are used to determine fair value of equity securities. For these securities, the Company obtains fair value measurements from an independent pricing service using quoted prices.

Management has reviewed the process used by the pricing services and has determined that they result in fair values consistent with requirements of SSAP No. 100, *Fair Value Measurements*. The Company had no other assets or liabilities subject to fair value measurement at December 31, 2012 or 2011.

Based on an analysis of the inputs, the Company’s financial assets that are measured at fair value on a recurring basis due to their NAIC designation at December 31, 2012 and 2011, have been categorized as follows:

	Level 1	Level 2	Level 3	December 31 2012
Investments:				
Bonds:				
Industrial and miscellaneous	\$ –	\$ 162,450	\$ –	\$ 162,450
Residential mortgage-backed	–	409,129	–	409,129
Common stocks	–	16,803	–	16,803
Preferred stocks	–	286,721	–	286,721
	<u>\$ –</u>	<u>\$ 875,103</u>	<u>\$ –</u>	<u>\$ 875,103</u>

State National Insurance Company, Inc.

Notes to Financial Statements – Statutory Basis (continued)

10. Fair Value Measurements (continued)

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

The aggregate fair value and related hierarchy for the Company's marketable financial instruments at December 31, 2012 and 2011 is as follows:

	Level 1	Level 2	Level 3	December 31 2012
Investments:				
Bonds:				
Government	\$ –	\$ 4,547,954	\$ –	\$ 4,547,954
Government agency	–	559,465	–	559,465
State and municipality	–	11,700,444	–	11,700,444
Industrial and miscellaneous	–	23,686,620	–	23,686,620
Residential mortgage-backed	–	22,246,895	–	22,246,895
Commercial mortgage-backed	–	2,198,926	–	2,198,926
Common stocks	–	16,803	–	16,803
Preferred stocks	–	1,762,496	–	1,762,496
	<u>\$ –</u>	<u>\$ 66,719,603</u>	<u>\$ –</u>	<u>\$ 66,719,603</u>

State National Insurance Company, Inc.

Notes to Financial Statements – Statutory Basis (continued)

10. Fair Value Measurements (continued)

	Level 1	Level 2	Level 3	December 31 2011
Investments:				
Bonds:				
Government	\$ –	\$ 3,692,254	\$ –	\$ 3,692,254
Government agency	–	575,066	–	575,066
State and municipality	–	24,332,481	–	24,332,481
Industrial and miscellaneous	–	27,101,913	–	27,101,913
Residential mortgage-backed	–	40,192,009	313,234	40,505,243
Commercial mortgage-backed	–	7,106,894	–	7,106,894
Common stocks	–	18,162	–	18,162
Preferred stocks	–	1,490,712	–	1,490,712
	<u>\$ –</u>	<u>\$ 104,509,491</u>	<u>\$ 313,234</u>	<u>\$ 104,822,725</u>

Transfers between levels are recognized at the end of the reporting period. The Company had no transfers between Level 1 and Level 2 during 2012. One security was transferred from Level 3 to Level 2 at December 31, 2012.

A reconciliation of the beginning and ending balances for the fixed maturity securities categorized as Level 3 during the years ended December 31, 2012 and 2011, is as follows:

	2012	2011
Beginning balance, January 1	\$ 313,234	\$ 342,716
Total gains or losses:		
Included in realized net investment gains	(12,110)	(21,788)
Included in other comprehensive income	(39,738)	(7,694)
Purchases and issuances	–	–
Sales and settlements	–	–
Transfers out of Level 3	(261,386)	–
Ending balance, December 31	<u>\$ –</u>	<u>\$ 313,234</u>

State National Insurance Company, Inc.

Notes to Financial Statements – Statutory Basis (continued)

11. Related-Party Transactions

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

	<u>2012</u>	<u>2011</u>
Earned premiums	\$ 95,428,600	\$ 95,471,439
Commission expense incurred	57,209,351	50,705,826
Net receivable	2,931,117	979,967

Under the terms of a management agreement between TBA and the Company, TBA provides management services to the Company for the oversight of the Company's business development and underwriting operations. Fees incurred by the Company for such services were \$4,426,878 and \$12,835,510 during 2012 and 2011, respectively. Payable to affiliates related to the management agreement is \$151,453 and \$2,471,285 at December 31, 2012 and 2011, respectively.

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

At December 31, 2012 and 2011, the net amount due to/ (from) from NSIC related to intercompany pooling is \$558,965 and \$(1,516,244), respectively. At December 31, 2012 and 2011, the net amount payable to USIC related to intercompany pooling is \$1,898,378 and \$1,560,762, respectively.

Effective January 1, 2012, the terms of the intercompany pooling arrangement between SNIC, NSIC, and USIC were modified. NSIC and USIC continue to cede 100% of their net business, after other unaffiliated reinsurance, to SNIC. During 2011, SNIC retroceded 10% and 25% of the companies' combined business to NSIC and USIC, respectively. January 1, 2012, SNIC began retroceding 20% and 35% of the companies' combined business to NSIC and USIC, respectively. Additionally, the pooling arrangement was modified to exclude pooling of investment income. In conjunction with increasing USIC's and NSIC's participation in the pool, SNIC contributed \$10,000,000 and \$15,000,000 of additional paid-in capital to NSIC and USIC, respectively.

State National Insurance Company, Inc.

Notes to Financial Statements – Statutory Basis (continued)

12. Commitments and Contingencies

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

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

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

13. Leases

SNIC owns its current home office building, which it leases in part to TBA, an affiliate. Rental income earned from this operating lease was \$2,106,564 and \$2,086,305 for the years ended December 31, 2012 and 2011, respectively. Future minimum lease payments associated with the TBA lease are \$2,008,958 for each of the succeeding five years.

Additionally, the Company leases the remaining portion of its home office building to an unaffiliated third party under the terms of an operating lease. Rental income was \$1,291,254 and \$1,346,254 for the years ended December 31, 2012 and 2011, respectively. Future minimum lease payments associated with the lease are as follows: 2013 – \$1,289,242; 2014 – \$1,295,382; 2015 – \$1,362,914; 2016 – \$1,362,914; and 2017 – \$1,393,610.

State National Insurance Company, Inc.

Notes to Financial Statements – Statutory Basis (continued)

14. Concentration of Risk

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

A significant portion of the Company's premium writings occurs in California, New York, North Carolina, Illinois, and New Jersey. During 2012, five program managers comprised approximately 53% of the Company's program writings and three reinsurers represented 54% of the Company's unsecured ceded balances.

15. Regulatory Examination

At periodic intervals, the Department routinely examines the Company's statutory-basis financial statements as part of its legally prescribed oversight of the insurance industry. Based on these examinations, the regulators can direct that the Company's statutory-basis financial statements be adjusted in accordance with their findings. The Texas Department of Insurance completed its examination of the December 31, 2006 through December 31, 2010 statutory-basis financial statements in 2012, with no significant findings reported.

16. Transferable State Tax Credits

The Company purchased \$165,000 of transferrable Louisiana CAPCO credits at a discount in 2012 and expects to fully utilize them in 2013. In 2012, the Company fully utilized the transferrable Louisiana CAPCO credits purchased at a discount in 2011 of \$165,000.

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

The Company participates in a 401(k) profit-sharing plan, sponsored by TBA, for employees that covers substantially all officers and employees who are at least 18 years of age. The Company is required to make a matching contribution of 50% of employees' contributions, limited to 6% of eligible employees' compensation. Also, the Company may make additional matching and profit-sharing contributions that are discretionary and are determined at the end of each plan year. The employer contribution expense included in other underwriting expenses is \$173,370 and \$179,866 for the years ended December 31, 2012 and 2011, respectively.

State National Insurance Company, Inc.

Notes to Financial Statements – Statutory Basis (continued)

18. Subsequent Events

The Company has evaluated subsequent events from the balance sheet date through May 23, 2013, which is the date the accompanying statutory-basis financial statements were available to be issued.

19. Reconciliation to Annual Statement

The Statement of Cash Flow is different than previously reported to state regulatory agencies in the 2012 Annual Statement due to a change in presentation for noncash transactions related to modifications to the intercompany pooling arrangement and contribution of additional paid-capital to NSIC and USIC (see Note 11). The Company transferred \$37,799,872 in securities at their respective book adjusted/carrying values to NSIC and USIC to settle these transactions and the impacts have been removed from their respective categories in the Statement of Cash Flow for 2012. The net change in cash, cash equivalents and short term investments is unchanged for the year.

	As Reported to Regulatory Authorities	As Reported in Audited Financial Statements	Difference
Premiums collected, net of reinsurance Received from affiliates for reinsurance settlements	\$ 33,533,115	\$ 40,141,057	\$ 6,607,942
Commissions and expenses paid	(639,359)	933,907	1,573,266
Proceeds from sales and maturities of investments	(23,799,655)	(19,180,991)	4,618,664
Cost of investment securities acquired	59,872,854	22,072,982	(37,799,872)
Total	<u>\$ 21,206,751</u>	<u>\$ 21,206,751</u>	<u>\$ –</u>

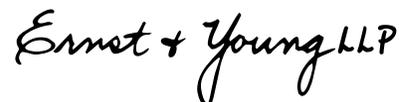
Supplementary Information

Report of Independent Auditors on Supplementary Information

The Board of Directors
State National Insurance Company, Inc.

We have audited the statutory-basis financial statements of State National Insurance Company, Inc. as of and for the years ended December 31, 2012 and 2011, and have issued our report thereon dated May 23, 2013 which contained an unmodified opinion on those financial statements with regard to their conformity with the accounting practices prescribed or permitted by the Texas Department of Insurance. Our audits were conducted for the purpose of forming an opinion on the financial statements as a whole. The accompanying reinsurance disclosures and supplemental investment disclosures are presented to comply with the National Association of Insurance Commissioners' *Annual Statement Instructions* and the National Association of Insurance Commissioners' *Accounting Practices and Procedures Manual* and for purposes of additional analysis and are not a required part of the financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the financial statements. The information has been subjected to the auditing procedures applied in the audit of the statutory-basis financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States. In our opinion, the information is fairly stated in all material respects in relation to the statutory-basis financial statements as a whole.

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



May 23, 2013

State National Insurance Company, Inc.

Investment Risk Interrogatories

December 31, 2012

1. The reporting entity's total admitted assets as reported on page 2 of the Annual Statement as of December 31, 2012, was \$206,885,936.
2. The ten largest exposures to a single issuer/borrower/investment, excluding: (i) U.S. Government, U.S. Government agency securities, and those U.S. Government money market funds listed in the Appendix to the *SVO Purposes and Procedures Manual* as exempt, (ii) property occupied by the Company, and (iii) policy loans, are as follows:

Investment Category	Amount	Percentage of Total Admitted Assets
a. Stocks – United Specialty Insurance Company (affiliate)	\$ 51,175,276	24.74%
b. Stocks – National Specialty Insurance Company (affiliate)	30,209,056	14.60
c. Bonds – Birmingham Alabama GO	1,539,748	0.74
d. Bonds – South Carolina St Pub Svc Auth Rev	1,526,660	0.74
e. Bonds – Washington St Var	1,075,929	0.52
f. Bonds – Intel Corp	983,793	0.48
g. Bonds – Wellpoint Inc.	907,398	0.44
h. Bonds – Bear Stearns CMBS 2005-Top 20	750,160	0.36
i. Bonds – Credit Suisse First Boston MTG PTC 2003-C4	641,881	0.31
j. Bonds – Houston, TX Ref – Pub Impt Ser A	582,771	0.28

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

Bonds and Short-Term Investments			Preferred Stocks		
NAIC Rating	Amount	Percentage of Total Admitted Assets	NAIC Rating	Amount	Percentage of Total Admitted Assets
NAIC-1	\$ 67,868,868	32.80%	P/PSF-1	\$ –	0.00%
NAIC-2	10,813,203	5.23	P/PSF-2	286,721	0.14
NAIC-3	1,707,813	0.83	P/PSF-3	1,001,390	0.48
NAIC-4	472,429	0.23	P/PSF-4	25,438	0.01
NAIC-5	379,296	0.18	P/PSF-5	–	0.00
NAIC-6	108,480	0.05	P/PSF-6	–	0.00

State National Insurance Company, Inc.

Investment Risk Interrogatories (continued)

4. Assets held in foreign investments are less than 2.5% of the Company's total admitted assets.
5. Assets held in Canadian investments are less than 2.5% of the Company's total admitted assets.
6. Assets held in investments with contractual sales restrictions are less than 2.5% of the Company's total admitted assets.
7. The amounts and percentages of admitted assets held in the largest ten equity interests (including investments in the shares of mutual funds, preferred stocks, publicly traded equity securities, and other equity securities, and excluding money market and bond mutual funds listed in the Appendix to the *SVO Practices and Procedures Manual* as exempt or Class 1) are as follows:

Investment Category	Amount	Percentage of Total Admitted Assets
a. Stocks – United Specialty Insurance Company (affiliate)	\$ 51,175,276	24.74%
b. Stocks – National Specialty Insurance Company (affiliate)	30,209,056	14.60
c. Stocks – Bunge, Ltd	383,303	0.19
d. Stocks – Stanley Black & Decker PFD	286,721	0.14
e. Stocks – Centerpoint Energy Inc Convertible	199,154	0.10
f. Stocks – New York Cmnty Cap	169,408	0.08
g. Stocks – AMG Cap Tr II	136,710	0.07
h. Stocks – Fifth Third Bancorp	112,815	0.05
i. Stocks – Inerpublic Group Cos Inc	25,438	0.01
j. Stocks – Teva Pharmaceutical Indus	16,803	0.01

8. Assets held in nonaffiliated, privately placed equities are less than 2.5% of the Company's total admitted assets.
9. Assets held in general partnership interests are less than 2.5% of the Company's total admitted assets.
10. Mortgage loans reported in Schedule B are less than 2.5% of the Company's total admitted assets.

State National Insurance Company, Inc.

Investment Risk Interrogatories (continued)

11. The five largest investments in one parcel or group of contiguous parcels of real estate reported in Schedule A are less than 2.5% of the Company's total admitted assets.
12. The Company has no assets subject to securities lending, repurchase agreements, reserve repurchase agreements, dollar repurchase agreements, or dollar reserve repurchase agreements.
13. The Company has no warrants.
14. The Company has no potential for exposure for collars, swaps, and forwards.
15. The Company has no potential for exposure for futures contracts.

State National Insurance Company, Inc.

Summary Investment Schedule

December 31, 2012

Investment Categories	Gross Investment Holdings*		Admitted Assets as Reported in the Annual Statement			
Bonds:						
U.S. Treasury securities	\$	4,340,245	2.4%	\$	4,340,245	2.4%
U.S. Government agency and corporate obligations (excluding mortgage-backed securities):						
Issued by U.S. Government agencies		531,427	0.3		531,427	0.3
Securities issued by states, territories, and possessions, and political subdivisions in the U.S.:						
States, territories, and possessions general obligations		692,946	0.4		692,946	0.4
Political subdivisions of states, territories and possessions, and political subdivisions general obligations		2,835,442	1.5		2,835,442	1.5
Revenue and assessment obligations		7,623,843	4.1		7,623,843	4.1
Industrial development and similar obligations		-	0.0		-	0.0
Mortgage-backed securities (includes residential and commercial MBS):						
Pass-through securities:						
Issued or guaranteed by GNMA		429,693	0.2		429,693	0.2
Issued or guaranteed by FNMA and FHLMC		8,485,650	4.6		8,485,650	4.6
All other		257,388	0.1		257,388	0.1
CMOs and REMICs:						
Issued or guaranteed by GNMA, FNMA, FHLMC, or VA		9,501,360	5.1		9,501,360	5.1
Privately issued and collateralized by MBS issued or guaranteed by GNMA, FNMA, FHLMC, or VA		1,532,611	0.8		1,532,611	0.8
All other		3,376,245	1.8		3,376,245	1.8
Other debt and other fixed income securities (excluding short-term):		21,869,222	11.9		21,869,222	11.9
Unaffiliated domestic securities (includes credit tenant loans rated by the SVO)		-	0.0		-	0.0
Unaffiliated non-U.S. securities (including Canada)		106,530	0.1		106,530	0.1
Affiliated securities		-	0.0		-	0.0
Equity interests:						
Investments in mutual funds						
Preferred stocks:						
Affiliated						
Unaffiliated		1,313,549	0.7		1,313,549	0.7
Other equity securities:						
Affiliated		81,384,332	44.1		81,384,332	44.1
Unaffiliated		16,803	0.0		16,803	0.0
Real estate investments:						
Property occupied by Company		15,771,744	8.6		15,771,744	8.6
Property held for sale		1,034,000	0.6		1,034,000	0.6
Cash, cash equivalents, and short-term investments		23,433,124	12.7		23,433,124	12.7
Total invested assets	\$	184,536,154	100.0%	\$	184,536,154	100.0%

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

State National Insurance Company, Inc.

Schedule of Reinsurance Disclosures

December 31, 2012

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

For the year ended December 31, 2012, the Company has not ceded any risk under any reinsurance contract (or under multiple contracts with the same reinsurer or its affiliates) for which: (i) it recorded a positive or negative underwriting result greater than 5% of prior year-end surplus as regards policyholders or it reported calendar year written premium ceded or year-end loss and loss expense reserves ceded greater than 5% of prior year-end surplus as regards policyholders; (ii) it accounted for that contract as reinsurance and not as a deposit; and (iii) the contract contains one or more of the following features that would have similar results:

- a. A contract term longer than two years and the contract is noncancelable by the reporting entity during the contract term;
- b. A limited or conditional cancellation provision under which cancellation triggers an obligation by the reporting entity, or an affiliate of the reporting entity, to enter into a new reinsurance contract with the reinsurer, or an affiliate of the reinsurer;
- c. Aggregate stop-loss reinsurance coverage;
- d. An unconditional or unilateral right by either party to commute the reinsurance contract, except for such provisions which are only triggered by a decline in the credit status of the other party;
- e. A provision permitting reporting of losses, or payment of losses, less frequently than on a quarterly basis (unless there is no activity during the period); or
- f. Payment schedules, accumulating retentions from multiple years, or any features inherently designed to delay timing of the reimbursement to the ceding entity.

State National Insurance Company, Inc.

Schedule of Reinsurance Disclosures (continued)

For the year ended December 31, 2012, the Company has not ceded any risk under any reinsurance contract (or under multiple contracts with the same reinsurer or its affiliates) for which, during the period covered by the statement, it recorded a positive or negative underwriting result greater than 5% of prior year-end surplus as regards policyholders or it reported calendar year written premium ceded or year-end loss and loss expense reserves ceded greater than 5% of prior year-end surplus as regards policyholders; excluding cessions to approved pooling arrangements or to captive insurance companies that are directly or indirectly controlling, controlled by, or under common control with: (i) one or more unaffiliated policyholders of the reporting entity, or (ii) an association of which one or more unaffiliated policyholders of the reporting entity is a member, whereby:

- a. The written premium ceded to the reinsurer by the reporting entity or its affiliates represents fifty percent (50%) or more of the entire direct and assumed premium written by the reinsurer based on its most recently available financial statement; or
- b. Twenty-five percent (25%) or more of the written premium ceded to the reinsurer has been retroceded back to the reporting entity or its affiliates.

Except for transactions meeting the requirements of paragraph 32 of SSAP No. 62R, *Property and Casualty Reinsurance*, the Company has not ceded any risk under any reinsurance contract (or multiple contracts with the same reinsurer or its affiliates), during the year ended December 31, 2012, and either:

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

State National Insurance Company, Inc.

Note to Supplementary Information

December 31, 2012

Note – Basis of Presentation

The accompanying supplemental schedules present selected statutory-basis financial data as of December 31, 2012, and for the year then ended for purposes of complying with the National Association of Insurance Commissioners' *Accounting Practices and Procedures Manual* and agree to or are included in the amounts reported in the Company's 2012 Statutory Annual Statement as filed with the Texas Department of Insurance.

Ernst & Young LLP

Assurance | Tax | Transactions | Advisory

About Ernst & Young

Ernst & Young is a global leader in assurance, tax, transaction and advisory services. Worldwide, our 167,000 people are united by our shared values and an unwavering commitment to quality. We make a difference by helping our people, our clients and our wider communities achieve their potential.

For more information, please visit www.ey.com

Ernst & Young refers to the global organization of member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. This Report has been prepared by Ernst & Young LLP, a client serving member firm located in the United States.

