

MGA INSURANCE COMPANY, INC.

Statutory Financial Statements and Supplemental Schedules

December 31, 2013 and 2012

(With Independent Auditor's Report Thereon)



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700 North Pearl, Suite 2000
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Independent Auditor's Report

The Board of Directors and Shareholders
MGA Insurance Company, Inc.
Dallas, Texas

We have audited the accompanying financial statements of MGA Insurance Company, Inc., which comprise the statements of admitted assets, liabilities and capital and surplus (statutory basis) as of December 31, 2013 and 2012, and the related statements of operations (statutory basis), capital and surplus (statutory basis), and cash flows (statutory basis) 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 accordance with the accounting practices prescribed or permitted by the Texas Department of Insurance. Management is also responsible for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these statutory basis financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. 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 statutory basis financial statements.

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



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Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the admitted assets, liabilities and capital and surplus of MGA Insurance Company, Inc. (statutory basis) as of December 31, 2013 and 2012, and the results of its operations (statutory basis) and changes in its surplus and its cash flows (statutory basis) for the years then ended, in accordance with accounting practices prescribed or permitted by the Texas Department of Insurance as described in Note 1.

Basis of Accounting

We draw attention to Note 1 of the financial statements, which describes the basis of accounting. As described in Note 1 to the financial statements, the financial statements were prepared on the basis of the accounting practices prescribed or permitted by the Texas Department of Insurance, which is a basis of accounting other than accounting principles generally accepted in the United States of America. Our opinion is not modified with respect to this matter.

Other Matters

Our audits of the financial statements were conducted for the purpose of forming an opinion on those statements as a whole. The accompanying supplementary information presented on Schedules I, II and III of this report is presented to comply with the National Association of Insurance Commissioners' Accounting Practices and Procedures Manual and is 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 audits of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information is fairly stated in all material respects in relation to the financial statements as a whole.

Restriction of Use

This report is intended solely for the information and use of the Board of Directors and management of MGA Insurance Company, Inc. and for filing with the Texas Department of Insurance, and is not intended to be and should not be used by anyone other than these specific parties.

BDO USA, LLP

Dallas, Texas
May 30, 2014

MGA INSURANCE COMPANY, INC.

Statutory Statements of Admitted Assets,
Liabilities and Capital and Surplus

December 31, 2013 and 2012

(Amounts in thousands, except share amounts)

	<u>2013</u>	<u>2012</u>
<u>Admitted Assets</u>		
Invested Assets:		
Bonds, at amortized cost (fair value: \$145,812 – 2013, \$146,666 – 2012)	\$ 146,297	145,403
Bonds, at lower of amortized cost or fair value	8,143	7,193
Preferred stocks, at amortized cost (fair value: \$935 – 2013) \$1,014 – 2012)	1,000	1,000
Preferred stock, at lower of amortized cost or fair value	435	497
Certificates of deposit, at cost (which approximates fair value)	100	100
Investment in subsidiary	1	1
Other long-term investments, equity method at cost	7,515	2,692
Short-term investments, at cost (fair value: \$23,994 – 2013, \$32,066 – 2012)	24,002	32,068
Cash overdraft	<u>(4,168)</u>	<u>(9,016)</u>
Total invested assets	183,325	179,938
Accrued investment income	1,481	1,664
Premiums receivable	33,817	33,086
Property and equipment (net of accumulated depreciation and amortization: \$8,440 – 2013, \$7,781 – 2012)	1,800	2,082
Receivable from affiliates	562	1,883
Current federal income taxes receivable	-	18
Net deferred tax asset	6,474	3,072
Other assets	<u>23</u>	<u>119</u>
Total admitted assets	\$ <u><u>227,482</u></u>	<u><u>221,862</u></u>

(Continued)

MGA INSURANCE COMPANY, INC.

Statutory Statements of Admitted Assets,
Liabilities and Capital and Surplus

December 31, 2013 and 2012

(Amounts in thousands, except share amounts)

		<u>2013</u>	<u>2012</u>
<u>Liabilities and Capital and Surplus</u>			
Liabilities:			
Unpaid losses and loss adjustment expenses	\$	72,559	78,744
Unearned premiums		45,146	44,923
Accounts payable		3,824	2,657
Taxes, licenses and fees		1,126	1,067
Payable to affiliates		1,354	1,459
Commissions payable		324	429
Current federal income taxes payable		19	-
Other liabilities		<u>435</u>	<u>817</u>
Total liabilities		<u>124,787</u>	<u>130,096</u>
Commitments and contingencies (notes 4 and 13)			
Capital and Surplus:			
Common capital stock (\$1.00 par value, 12,000,000 shares authorized, 12,000,000 shares issued and 6,000,000 shares outstanding at December 31, 2013 and 2012)		12,000	12,000
Paid-in and contributed surplus		83,894	83,894
Unassigned surplus		12,801	1,872
Treasury stock, at cost (6,000,000 shares at December 31, 2013 and 2012)		<u>(6,000)</u>	<u>(6,000)</u>
Total capital and surplus		<u>102,695</u>	<u>91,766</u>
Total liabilities and capital and surplus	\$	<u>227,482</u>	<u>221,862</u>

See accompanying notes to statutory-basis financial statements.

MGA INSURANCE COMPANY, INC.

Statutory Statements of Operations

Years ended December 31, 2013 and 2012

(Amounts in thousands)

	<u>2013</u>	<u>2012</u>
Underwriting gain (loss):		
Net premiums written	\$ 191,291	187,797
Change in unearned premiums	<u>(223)</u>	<u>(1,881)</u>
Premiums earned	<u>191,068</u>	<u>185,916</u>
Net losses and loss adjustment expenses incurred	140,935	145,876
Commissions and other underwriting expenses incurred	<u>48,518</u>	<u>46,192</u>
Expenses incurred	<u>189,453</u>	<u>192,068</u>
Underwriting gain (loss)	<u>1,615</u>	<u>(6,152)</u>
Investment income:		
Net investment income earned	4,228	4,775
Net realized capital gains on investments	<u>614</u>	<u>1,902</u>
Net investment income	<u>4,842</u>	<u>6,677</u>
Other income (expense):		
Miscellaneous income (expense)	<u>19</u>	<u>(27)</u>
Total other income (expense)	<u>19</u>	<u>(27)</u>
Income from operations before federal income taxes	6,476	498
Federal income tax expense (benefit)	<u>36</u>	<u>(18)</u>
Net income	\$ <u>6,440</u>	<u>516</u>

See accompanying notes to statutory-basis financial statements.

MGA INSURANCE COMPANY, INC.

Statutory Statements of Changes in Capital and Surplus

Years ended December 31, 2013 and 2012

(Amounts in thousands)

		<u>2013</u>	<u>2012</u>
Common capital stock:			
Balance at beginning and end of year	\$	<u>12,000</u>	<u>12,000</u>
 Paid-in and contributed surplus:			
Balance at beginning and end of year		<u>83,894</u>	<u>83,894</u>
 Special surplus from retroactive reinsurance:			
Balance at beginning of year		-	17
Change in special surplus from retroactive reinsurance		<u>-</u>	<u>(17)</u>
Balance at end of year		<u>-</u>	<u>-</u>
 Unassigned surplus:			
Balance at beginning of year		1,872	10,773
Net income		6,440	516
Change in non-admitted assets		406	15,937
Change in net deferred income tax		3,635	(16,042)
Dividends to stockholders		-	(10,068)
Change in net unrealized gains		454	739
Other		<u>(6)</u>	<u>17</u>
Balance at end of year		<u>12,801</u>	<u>1,872</u>
 Treasury stock:			
Balance at beginning and end of year		<u>(6,000)</u>	<u>(6,000)</u>
 Total capital and surplus at end of year	\$	<u>102,695</u>	<u>91,766</u>

See accompanying notes to statutory-basis financial statements.

MGA INSURANCE COMPANY, INC.

Statutory Statements of Cash Flow

Years ended December 31, 2013 and 2012

(Amounts in thousands)

		<u>2013</u>	<u>2012</u>
Cash from operations:			
Premiums collected net of reinsurance	\$	190,561	204,043
Net investment income		7,037	6,865
Miscellaneous income		<u>112</u>	<u>96</u>
Total		<u>197,710</u>	<u>211,004</u>
Benefit and loss related payments		(113,228)	(105,926)
Commissions, expenses paid and aggregate write-ins for deductions		(81,357)	(81,918)
Federal income taxes paid		<u>-</u>	<u>(45)</u>
Total		<u>(194,585)</u>	<u>(187,889)</u>
Net cash provided by operating activities		<u>3,125</u>	<u>23,115</u>
Cash from investments:			
Proceeds from investments sold, matured, or repaid:			
Bonds		57,386	90,631
Stocks		-	1,121
Other long-term investments		1,390	-
Net gains on short-term investments		5	12
Miscellaneous proceeds		<u>-</u>	<u>222</u>
Total investment proceeds		<u>58,781</u>	<u>91,986</u>
Cost of investments acquired:			
Bonds		(60,524)	(96,612)
Stocks		-	(1,500)
Other long-term investments		<u>(6,187)</u>	<u>(2,533)</u>
Total investments acquired		<u>(66,711)</u>	<u>(100,645)</u>
Net cash used for investing activities		<u>(7,930)</u>	<u>(8,659)</u>
Cash from financing and miscellaneous sources:			
Cash provided (applied)			
Dividends to stockholders		-	(10,068)
Other cash provided (applied)		<u>1,587</u>	<u>(4,048)</u>
Net cash provided by (used in) financing and miscellaneous sources		<u>1,587</u>	<u>(14,116)</u>
Net (decrease) increase in cash, certificates of deposit and short-term investments		(3,218)	340
Cash, certificates of deposit and short-term investments, beginning of year		<u>23,152</u>	<u>22,812</u>
Cash, certificates of deposit and short-term investments, end of year	\$	<u>19,934</u>	<u>23,152</u>

See accompanying notes to statutory-basis financial statements.

MGA INSURANCE COMPANY, INC.

Notes to Statutory-Basis Financial Statements

December 31, 2013 and 2012

(1) Background and Summary of Significant Accounting Policies

(a) *Basis of Presentation*

MGA Insurance Company, Inc. (the “Company”), an insurance company domiciled in the State of Texas, owns 100% of MGA Agency, Inc. (“MGAA”). The Company is wholly-owned by Gainsco, Inc. (“Parent Company” or “Gainsco”). Gainsco is a Texas incorporated public holding company.

The accompanying statutory financial statements have been prepared in conformity with accounting practices prescribed or permitted by the Texas Department of Insurance (“SAP”). The State of Texas requires that insurance companies domiciled in Texas prepare their statutory basis financial statements in accordance with the codified National Association of Insurance Commissioners’ (“NAIC”) Accounting Practices and Procedures Manual (“NAIC SAP”) subject to any deviations prescribed or permitted by the Texas Insurance Commissioner. There are no material differences between the accounting practices prescribed or permitted by SAP and NAIC SAP as of and for the years ended December 31, 2013 and 2012, except as disclosed in Note 5.

The preparation of these financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

SAP varies in some respects from accounting principles generally accepted in the United States (“GAAP”). The significant differences between SAP and GAAP are as follows:

Investment Securities

- Investments are not classified into held-to-maturity, trading or available-for-sale categories.
- Investments in debt securities are carried at amortized cost; for GAAP, held-to-maturity investments would be reported at amortized cost, and the remaining fixed maturity investments would be reported at fair value with unrealized holding gains and losses reported in operations for those designated as trading and as a separate component of shareholder’s equity for those designated as available-for-sale.
- Investment grade bonds not backed by other assets are stated at amortized cost. Non-investment grade bonds and asset backed securities with an NAIC designation of 3 through 6 are stated at the lower of amortized costs or fair value. Investment grade asset backed securities, excluding residential mortgage backed securities, are stated at amortized cost. Residential mortgage-backed securities are valued using a matrix of values provided by the NAIC, which are compared to amortized cost to determine the carrying value and NAIC designation.

MGA INSURANCE COMPANY, INC.

Notes to Statutory-Basis Financial Statements

December 31, 2013 and 2012

- Investment grade perpetual preferred stocks are stated at fair value. Non-investment grade preferred stocks are stated at the lower of amortized cost or fair value. Common stocks are stated at fair value.

Negative Cash Balances

- Negative cash balances are recorded as a reduction to assets and not as a liability.

Allowance for Doubtful Accounts

- No allowance for agents' or premium balances determined to be unrecoverable is required for statutory accounting practices, rather these amounts are charged off and expensed through the statements of operations upon determination of unrecoverability.

Deferred Policy Acquisition Costs

- The costs related to acquiring business such as commissions, premium taxes, and other items are charged to expense in the year incurred and are not amortized over the periods benefited, whereas the related premiums are taken into operations on a pro rata basis over the periods covered by the policies.
- Ceding commission is deferred and taken into income on a pro rata basis over the period covered by the policies only to the extent that the ceding commission exceeds the acquisition costs related to those policies.

Reinsurance Ceded Reserves

- Reinsurance ceded reserves are recorded as a reduction of reserves rather than as an asset.

Retroactive Reinsurance Gains

- Retroactive reinsurance gains are recognized into income immediately and segregated in surplus as Special surplus from retroactive reinsurance and not deferred, and amortized over the period that the reinsurance is recovered.

Deferred Income Taxes

- Deferred tax assets are admitted in an amount equal to the sum of (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 timeframe corresponding with Internal Revenue Service ("IRS") tax loss carryback provisions, not to exceed three years, plus (2) the lesser of the remaining gross deferred tax assets expected to be realized within three years of the balance sheet date or 15% of capital and surplus excluding any net deferred tax assets, plus (3) the amount of remaining gross deferred tax assets that can be offset against existing gross deferred tax liabilities. Any non-admitted deferred tax assets are recorded directly to surplus.

MGA INSURANCE COMPANY, INC.

Notes to Statutory-Basis Financial Statements

December 31, 2013 and 2012

Tax Contingency Reserves

- In determining the need for tax contingency reserves, consideration is given to whether it is probable that specific uncertain tax benefits will be realized. GAAP requires that a more-likely-than-not standard be used, and then subjects the tax benefits to an additional quantitative measurement step and qualitative analysis.

Admitted and Non-admitted Assets

- Admitted assets are those recognized and accepted by state insurance departments in measuring the solvency of an insurer for statutory accounting purposes. Non-admitted assets do not contribute to the insurer's solvency. The statutory financial statements only present admitted assets on the balance sheet. Non-admitted assets are recorded by a charge to surplus.

Policy Fees

- Policy fees can be recognized into income immediately as they are written and not deferred, while under GAAP they are earned on a pro rata basis over the period the Company is at risk under the related policy.

Statement of Comprehensive Income (Loss)

- The statement of comprehensive income (loss) is not required for statutory accounting practices.

Statement of Cash Flow

- The statement of cash flow is presented as prescribed by statutory accounting practices.

For further information on the differences between statutory reporting and GAAP reporting refer to Note 11 in tabular format for the reconciliation between statutory capital and surplus and GAAP shareholders' equity and statutory net income and GAAP net income (loss).

MGA INSURANCE COMPANY, INC.

Notes to Statutory-Basis Financial Statements

December 31, 2013 and 2012

(b) *Nature of Operations*

The Company's nonstandard personal auto products are primarily aligned with customers seeking to purchase basic coverage and limits of liability required by statutory requirements, or slightly higher. Our products include coverage for third party liability, for bodily injury and physical damage, as well as collision and comprehensive coverage for theft, physical damage and other perils for an insured's vehicle. Within this context, we offer our products to a wide range of customers who present varying degrees of potential risk to the Company, and we strive to price our product to reflect this range of risk accordingly, in order to earn an underwriting profit. Simultaneously, when actuarially prudent, we attempt to position our product price to be competitive with other companies offering similar products to optimize our likelihood of securing our targeted customers. We offer flexible premium down payment, installment payment, late payment, and policy reinstatement plans that we believe help us secure new customers and retain existing customers, while generating an additional source of income from fees that we charge for those services. We primarily write six-month policies in Arizona, Florida, Nevada, New Mexico, Texas and Virginia, with one year policies in California and both six month and one year policies in Georgia and South Carolina. The terms of policies we are permitted to offer varies in the states in which we operate.

(c) *Investments*

Investments are valued in accordance with the laws of the State of Texas and the valuations prescribed by the Securities Valuation Office ("SVO") of the NAIC. Investment grade bonds not backed by other assets are stated at amortized cost using the interest method. Non-investment grade bonds, asset-backed and loan-backed securities with NAIC designations of 3 through 6 are stated at the lower of amortized costs or fair value. Investment grade loan backed securities, excluding residential mortgage backed securities, are stated at amortized cost. The prospective adjustment method is used to value all such securities. In order to value residential mortgage-backed securities, the Company followed the procedures established by the NAIC Modeling Process, which involves utilizing a matrix of values provided by the NAIC, which are compared to amortized cost to determine the carrying value and NAIC designation. The Company does not own any mortgage loans or reverse mortgages. The Company owns no derivatives. Investment grade redeemable preferred stocks are stated at amortized cost. Non-investment grade preferred stocks are stated at the lower of amortized cost or fair value. Other long-term investments in partnerships or limited liability companies are recorded under the equity method of accounting at cost. Under the equity method, the investment, originally recorded at cost, is adjusted to recognize our share of the net earnings or losses as they occur. The Company has no investments in joint ventures. Short-term investments, including money market funds, are stated at cost. Other investments with remaining maturities of one year or less at the time of acquisition are stated at amortized cost. Premiums and discounts on loan-backed and asset-backed securities are amortized over a period based on estimated future principal payments, including prepayments. Prepayment assumptions are reviewed periodically and adjusted to reflect actual prepayments and changes in expectations. The most significant determinants of prepayments are the difference between interest rates on the underlying

MGA INSURANCE COMPANY, INC.

Notes to Statutory-Basis Financial Statements

December 31, 2013 and 2012

mortgages, or underlying securities, and the current mortgage loan rates and the structure of the security. Other factors affecting prepayments include the size, type and age of underlying mortgages, the geographic location of the mortgaged properties, the credit worthiness of the borrowers and current loan to value ratios. Variations from anticipated prepayments affect the life and yield of these securities.

Investment securities are exposed to a number of factors, including general economic and business environment, changes in the credit quality of the issuer of the fixed income securities, changes in market conditions or disruptions in particular markets, changes in interest rates, or regulatory changes. Fair values of securities fluctuate based on the magnitude of changing market conditions. Our securities are issued by domestic entities and are backed either by collateral or the credit of the underlying issuer. Factors such as an economic downturn, disruptions in the credit markets, a regulatory change pertaining to the issuer's industry, deterioration in the cash flows or the quality of assets of the issuer, or a change in the issuer's marketplace may adversely affect our ability to collect principal and interest from the issuer. Both equity and fixed income securities have been affected over the past several years, and may be affected in the future, by significant external events. Credit rating downgrades, defaults, and impairments may result in write-downs in the value of the investment securities held by the Company. The Company regularly monitors its portfolio for pricing changes, which might indicate potential impairments, and performs reviews of securities with unrealized losses. In such cases, changes in fair value are evaluated to determine the extent to which such changes are attributable to (i) fundamental factors specific to the issuer, such as financial conditions, business prospects or other factors, or (ii) market-related factors, such as interest rates.

For fixed maturity securities that are other-than-temporarily impaired, the Company assesses its intent to sell and the likelihood that we will be required to sell the security before recovery of its amortized cost. If a fixed maturity security is considered other-than-temporarily impaired, but the Company does not intend to and is not more than likely to be required to sell the security prior to its recovery to amortized cost, the amount of the impairment is separated into a credit loss component and the amount due to all other factors. The credit loss component of an impairment charge on a fixed maturity security is determined by the excess of the amortized cost over the present value of the expected cash flows. The present value is determined using the best estimate of cash flows discounted at (1) the effective interest rate implicit at the date of acquisition for non-structured securities or (2) the book yield for structured securities. The techniques and assumptions for determining the best estimate of cash flows varies depending on the type of security. The credit loss component of an impairment charge is recognized in net earnings.

MGA INSURANCE COMPANY, INC.

Notes to Statutory-Basis Financial Statements

December 31, 2013 and 2012

Accrued investment income is the interest earned on securities which has been recognized in the results of operations, but the cash has not been received from the various security issuers. This accrual is based on the terms of each of the various securities and uses the 'effective interest method' for amortizing the premium and accruing the discount. Realized gains (losses) on securities are computed based upon the "specific identification" method on trade date and include write downs on securities considered to have other than temporary declines in fair value. Dividends on preferred stock are recorded as investment income on the ex-dividend date with a corresponding receivable to be extinguished upon receipt of cash.

(d) *Premium Revenues and Premium Receivables*

Premiums are recognized as earned on a pro rata basis over the period the Company is at risk under the related policy. Unearned premiums represent the portion of premiums written which are applicable to the unexpired terms of policies in force. Policy fees are recognized into income immediately as they are written and not deferred. Premiums receivable consist of balances owed for coverages written with the Company.

(e) *Property and Equipment*

Property and equipment are stated at cost less accumulated depreciation and amortization. Depreciation is calculated using the straight-line method over the estimated useful lives of the respective assets (primarily three years for furniture and equipment). Computer software costs relating to programs for internal use are recorded in property and equipment and are amortized using the straight-line method over three years or the estimated useful life, whichever is longer.

Costs associated with software developed or purchased for internal use are capitalized based on Statements of Statutory Accounting and Principles ("SSAP") 16R and other related guidance. Capitalized costs include external direct costs of materials and services consumed in developing or obtaining internal-use software and payroll for employees directly associated with, and who devote time to, the development of the internal-use software. Costs incurred in development and enhancement of software that do not meet the capitalization criteria, such as costs of activities performed during the preliminary and post-implementation stages, are expensed as incurred. The critical estimate related to this process is the determination of the amount of time devoted by employees to specific stages of internal-use software development projects. The Company reviews any impairment of the capitalized costs on a periodic basis. The Company amortizes such costs over the estimated useful life of the software, which is three years once the software has been placed in service.

MGA INSURANCE COMPANY, INC.

Notes to Statutory-Basis Financial Statements

December 31, 2013 and 2012

(f) *Commissions*

Commission expenses and other acquisition costs are charged to expense as incurred.

(g) *Losses and Loss Adjustment Expenses*

An insurance company generally makes claim payments as a result of accidents involving the risks insured under the insurance policies it issues. Months and sometimes years may elapse between the occurrence of an accident, reporting of the accident to the insurer and payment of the claim. Insurers record a liability for estimates of claims that will be paid for accidents reported to them, which are referred to as “case reserves.” In addition, since accidents are not always reported promptly upon occurrence and because the assessment of existing known claims may change over time with the development of new facts, circumstances and conditions, insurers estimate liabilities for such items, which are referred to as incurred but not reported (“IBNR”) reserves.

We maintain reserves for the payment of losses and loss adjustment expenses (“L&LAE”) for both case and IBNR under policies written by the Company. These claims reserves are estimates, at a given point in time, of amounts that we expect to pay on incurred claims based on facts and circumstances then known. The amount of case claims reserves is primarily based upon a case-by-case evaluation of the type of claim involved, the circumstances surrounding the claim, and the policy provisions relating to the type of claim. The amount of IBNR claims reserves is estimated on the basis of historical information and anticipated future conditions by lines of insurance and actuarial review. Reserves for claim adjustment expenses are intended to cover the ultimate costs of settling claims, including investigation and defense of lawsuits resulting from such claims. Inflation is implicitly reflected in the reserving process through analysis of cost trends and review of historical reserve results.

The process of establishing claims reserves is imprecise and reflects significant judgmental factors. In many liability cases, significant periods of time, ranging up to several years or more, may elapse between the occurrence of an insured claim and the settlement of the claim. The actual emergence of L&LAE may vary, perhaps materially, from the Company's estimates thereof, because (a) estimates of liabilities are subject to large potential revisions, as the ultimate disposition of claims incurred prior to the financial statement date, whether reported or not, is subject to the outcome of events that have not yet occurred (e.g., jury decisions, court interpretations, legislative changes (even after coverage is written and reserves are initially set) that broaden liability and policy definitions and increase the severity of claims obligations, changes in the medical condition of claimants, public attitudes and social/economic conditions such as inflation), (b) estimates of claims do not make provision for extraordinary future emergence of new classes of claims or types of claims not sufficiently represented in the Company's historical data base or which are not yet quantifiable, and (c) estimates of future costs are subject to the inherent limitation on the ability to predict the aggregate course of future events.

MGA INSURANCE COMPANY, INC.

Notes to Statutory-Basis Financial Statements

December 31, 2013 and 2012

In determining our reserve estimates for nonstandard personal automobile insurance, for each financial reporting date we record our best estimate, which is a point estimate, of our overall unpaid L&LAE for both current and prior accident years. Because the underlying processes require the use of estimates and professional actuarial judgment, establishing claims reserves is an inherently uncertain process. As our experience develops and we learn new information, our quarterly reserving process may produce revisions to our previously reported claims reserves, which we refer to as “development” and such changes may be material. We recognize favorable development when we decrease our previous estimate of ultimate losses, which results in an increase in net income in the period recognized. We recognize unfavorable development when we increase our previous estimate of ultimate losses, which results in a decrease in net income in the period recognized. Accordingly, while we record our best estimate, our claims reserves are subject to potential variability.

(h) *Income Taxes*

The Company's Federal income tax return is consolidated with Gainsco, which includes the Company, Gainsco, Inc., MGAA, Gainsco Service Corp. (“GSC”), National Specialty Lines, Inc. (“NSL”), BSAG, Inc., BSAG Real Estate Holdings, Inc., Bob Stallings Nissan of Baytown, Inc., Stallings Auto Group, Inc., Bob Stallings Hyundai, Inc. and GAINSCO Auto Insurance Agency, Inc. The method of allocation among companies is subject to a written agreement, whereby allocation is made primarily on a separate return basis with current credit for any net operating losses (“NOL”) or other items utilized in the consolidated tax return. Gainsco has a policy whereby each subsidiary will pay to or recover from Gainsco the amount of Federal income taxes it would have incurred (or been entitled to recover) as if that entity were filing its own Federal income tax return. Intercompany tax recoverable or payable balances are settled as soon as is practicable after Gainsco, Inc. recovers from or pays taxes to the Internal Revenue Service.

Deferred income tax items are accounted for under the “asset and liability” method which provides for temporary differences between the reporting of earnings for financial statement purposes and for tax purposes, primarily the discount on unpaid L&LAE, NOL carryforwards and the nondeductible portion of the change in unearned premiums. The Company has elected to admit deferred tax assets in an amount equal to the sum of (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 timeframe corresponding with IRS tax loss carryback provisions, not to exceed three years, plus (2) the lesser of the remaining gross deferred tax assets expected to be realized within three years of the balance sheet date or 15% of capital and surplus excluding any net deferred tax assets, plus (3) the amount of remaining gross deferred tax assets that can be offset against existing gross deferred tax liabilities. The remaining deferred tax assets are non-admitted. Deferred taxes do not include amounts for state taxes. Deferred Federal income tax expense or benefit is recorded directly to surplus. The current period election does not differ from the prior reporting period.

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The Company recognized a current income tax expense (benefit) of \$36,000 and (\$18,000) during 2013 and 2012, respectively, for allocated federal alternative minimum tax on a consolidated basis. This tax can be recouped in future years.

(2) Investments

The following schedule summarizes the components of net investment income:

	Years ended December 31,	
	2013	2012
	(Amounts in thousands)	
Investment income on:		
Bonds, preferred stocks and certificates of deposit	\$ 4,234	4,887
Cash, cash equivalents and short-term investments	95	125
Other long-term investments	<u>121</u>	<u>(21)</u>
	4,450	4,991
Investment expenses	<u>(222)</u>	<u>(216)</u>
Net investment income	\$ <u>4,228</u>	<u>4,775</u>

The fair value of Bonds, Preferred stocks, Certificates of deposit and Short-term investments were obtained from published valuation guides. These fair values do not differ materially from the fair values prescribed by the NAIC. The fair value of total Bonds, Preferred stocks, Certificates of deposit, Other long-term investments and Short-term investments, as prescribed by the NAIC, approximately totaled \$187,084,000 and \$190,235,000 at December 31, 2013 and 2012, respectively. The difference between the fair values presented below and the fair values prescribed by the NAIC differ by the non-investment grade valuations. At December 31, 2013, twelve securities totaling \$931,000 were non-investment grade bonds, mortgage backed-securities and preferred stocks with NAIC designations of 3 through 6 and were stated at fair value. At December 31, 2012, twelve securities totaling \$1,598,000 were non-investment grade bonds, mortgage backed-securities and preferred stocks with NAIC designations of 3 through 6 and were stated at fair value.

MGA INSURANCE COMPANY, INC.

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SSAP No. 100 defines fair value as the exit price, which is the price that would be received to sell an asset or paid to transfer a liability in a transaction between market participants at the measurement date. The following schedule summarizes the amortized cost and fair values of investments in Bonds, Preferred stocks, Certificates of deposit securities, Other long-term investments and Short-term investments of which the carrying amounts differ from estimated fair value at December 31, 2013 and 2012:

	December 31, 2013			
	Amortized Cost	Gross Unrealized	Gross Unrealized	Fair Value
		Gains	Losses	
(Amounts in thousands)				
U.S. Treasury	\$ 8,856	148	(13)	8,991
U.S. Government agencies	3,589	14	(71)	3,532
Corporate bonds	128,061	752	(1,238)	127,575
Mortgage-backed	5,791	28	(105)	5,714
Preferred stocks	1,000	10	(75)	935
Certificates of deposit	100	-	-	100
Other long-term investments	7,515	-	-	7,515
Short-term investments	<u>24,002</u>	<u>1</u>	<u>(9)</u>	<u>23,994</u>
Total Bonds, Preferred stocks, Certificates of deposit and Short-term investments	<u>\$ 178,914</u>	<u>953</u>	<u>(1,511)</u>	<u>178,356</u>

	December 31, 2012			
	Amortized Cost	Gross Unrealized	Gross Unrealized	Fair Value
		Gains	Losses	
(Amounts in thousands)				
U.S. Treasury	\$ 6,350	284	-	6,634
U.S. Government agencies	4,466	64	-	4,530
Corporate bonds	124,259	1,400	(402)	125,257
Asset-backed	1,338	1	-	1,339
Mortgage-backed	8,990	57	(141)	8,906
Preferred stocks	1,000	14	-	1,014
Certificates of deposit	100	-	-	100
Other long-term investments	2,692	-	-	2,692
Short-term investments	<u>32,068</u>	<u>6</u>	<u>(8)</u>	<u>32,066</u>
Total Bonds, Preferred stocks, Certificates of deposit and Short-term investments	<u>\$ 181,263</u>	<u>1,826</u>	<u>(551)</u>	<u>182,538</u>

MGA INSURANCE COMPANY, INC.

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The following schedule summarizes the gross unrealized losses showing the length of time that investments have been continuously in an unrealized loss position as of December 31, 2013 and 2012:

		December 31, 2013					
		Less than 12 months		12 months or longer		Total	
		Fair	Unrealized	Fair	Unrealized	Fair	Unrealized
		Value	Losses	Value	Losses	Value	Losses
		(Amounts in thousands)					
U.S. Treasury	\$	6,484	13	-	-	6,484	13
U.S. Government agencies		2,926	71	-	-	2,926	71
Corporate bonds		39,961	817	20,966	421	60,927	1,238
Mortgage-backed		1,570	28	2,163	77	3,733	105
Preferred stocks		424	75	-	-	424	75
Short-term investments		<u>13,284</u>	<u>9</u>	<u>-</u>	<u>-</u>	<u>13,284</u>	<u>9</u>
Total investments	\$	<u>64,649</u>	<u>1,013</u>	<u>23,129</u>	<u>498</u>	<u>87,778</u>	<u>1,511</u>

		December 31, 2012					
		Less than 12 months		12 months or longer		Total	
		Fair	Unrealized	Fair	Unrealized	Fair	Unrealized
		Value	Losses	Value	Losses	Value	Losses
		(Amounts in thousands)					
Corporate bonds	\$	35,171	398	2,183	4	37,354	402
Asset-backed		744	-	-	-	744	-
Mortgage-backed		2,367	73	1,948	68	4,315	141
Short-term investments		<u>11,185</u>	<u>8</u>	<u>-</u>	<u>-</u>	<u>11,185</u>	<u>8</u>
Total investments	\$	<u>49,467</u>	<u>479</u>	<u>4,131</u>	<u>72</u>	<u>53,598</u>	<u>551</u>

The gross unrealized losses, shown in the above tables, totaling \$498,000 and \$72,000 as of December 31, 2013 and 2012, respectively, relate to 25 and 6 individual securities, respectively, which had been in an unrealized loss position for 12 months or more as of such dates. At December 31, 2013 and 2012, approximately 93% and 77% of the unrealized gross losses were with issuers with a NAIC designation of 1 and 2, respectively. The decline in the market value is primarily related to the disruption and lack of liquidity in the markets in which these securities trade, along with credit risk aversion by investors. Other important factors include (i) the slowing of prepayments in mortgage and asset backed securities and (ii) the significant decline in the 3 month London Interbank Offered Rate for U.S. dollar deposits (“LIBOR”) for securities with floating rate coupons since the purchase of these assets. At this time based upon information currently available, the Company has the ability and it is the Company’s intent to hold the security until it fully recovers the principal, which could require the Company to hold these securities until their maturity; therefore, the Company considers the impairment to be temporary.

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In order to determine whether it is appropriate in an accounting period to recognize other than temporary impairment (“OTTI”) with respect to a portfolio security which has experienced a decline in fair value and as to which the Company has the ability and intent to hold the security until it fully recovers the principal, the Company considers all available evidence and applies judgment. With corporate debt issues, firm specific performance, industry trends, legislative and regulatory changes, government initiatives, and the macroeconomic environment all play a role in the evaluation process. With respect to asset backed securities (including mortgage backed securities), the Company uses individual cash flow modeling in addition to other available information. In the case of securities as to which the Company has the ability and intent to fully recover principal, if all scheduled principal and interest is expected to be received on a timely basis using the current best estimates of material inputs, such as default frequencies, severities, and prepayment speeds, generally no OTTI would be recognized unless other factors suggest that it would be appropriate to do so. The principal factors that the Company considers in this analysis are the extent to which the fair value of the security has declined, the ratings given to the security by recognized rating agencies, trends in those ratings, and information available to the Company from securities analysts and other commentators, public reports and other credible information.

The Company currently has one security backed directly by subprime loans and it has a NAIC designation of 1FM. The book adjusted carrying and fair values of this security were \$503,000 at December 31, 2013 and \$370,000 at December 31, 2012, respectively. This security had a NAIC designation of 5FM at December 31, 2012.

Included in the Company’s fixed income portfolio, are hybrid securities with a carrying value of \$9,801,000 and fair value of \$9,950,000 at December 31, 2013, and carrying value of \$12,124,000 and fair value of \$12,200,000 at December 31, 2012. A hybrid security as used here is one where the issuer of the debt instrument can choose to defer payment of the regularly scheduled interest due for a contractually set maximum period of time, usually five to ten years, without being in technical default on the issue.

One security, with carrying value and fair value of \$841,000, at December 31, 2013, and a carrying and a fair value of \$847,000 at December 31, 2012, is dependent on the continued claims paying ability of its financial guarantor (MBIA) in order for the Company not to sustain any loss of principal or interest. MBIA has a NAIC designation of 5FM. We concluded that the probable outcome is that principal and interest will be paid in full and, accordingly, the impairment on that security is considered temporary.

Preferred stocks predominately consist of auction preferred instruments which are issued by a trust that holds the preferred stock of a corporation. These investments are exchange traded. The Company has the option at stated intervals to redeem the auction preferred shares for a pro rata share of the underlying collateral. As of December 31, 2013, we have not chosen this option as the structure of the trust provides a higher coupon rate on the auction preferred shares than on the underlying collateral shares; and therefore, are of greater economic value. As of December 31, 2013, we concluded that these underlying shares are not other-than-temporarily impaired based on the credit review of the issuers.

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Investments in partnerships or limited liability companies are stated under the equity method of accounting at cost. The Company has classified these investments as Other long-term investments.

When a security has an unrealized loss in fair value that is deemed to be other than temporary, the Company reduces the carrying value of the security to its current market value, recognizing the decline as a realized loss in the statement of operations. These determinations primarily reflect the market-related issues associated with the disruption in the mortgage and other credit markets, which created a significant deterioration in both the valuation of the securities as well as our view of future recoverability of the valuation decline.

Proceeds from the sale of securities for the years ended December 31, 2013 and 2012 are presented in the following table:

	Years ended December 31,	
	2013	2012
	(Amounts in thousands)	
Proceeds:		
Bonds, sales	\$ <u>27,715</u>	<u>46,558</u>
Bonds, principal pay downs	\$ <u>3,971</u>	<u>15,568</u>
Bonds, maturities	\$ <u>25,700</u>	<u>28,505</u>
Preferred stocks	\$ <u>-</u>	<u>1,122</u>

	Years ended December 31,	
	2013	2012
	(Amounts in thousands)	
Realized gains:		
Bonds	\$ 615	2,308
Preferred stocks	-	121
Other invested assets	47	-
Short-term investments	<u>4</u>	<u>12</u>
Total realized gains	<u>666</u>	<u>2,441</u>
Realized losses:		
Bonds	(18)	(254)
Other invested assets	<u>(20)</u>	<u>-</u>
Total realized losses	<u>(38)</u>	<u>(254)</u>
Other-than-temporary impairment losses	<u>(14)</u>	<u>(285)</u>
Total realized investment gains, net	\$ <u>614</u>	<u>1,902</u>

During 2013 and 2012, the Company wrote down \$14,000 and \$285,000 in securities that were determined to have had an other-than-temporary credit related impairment charge.

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The amortized cost and fair value of Bonds, Preferred stocks and Certificates of deposit at December 31, 2013 by maturity are shown below.

	2013	
	Amortized Cost	Fair Value
	(Amounts in thousands)	
Due in one year or less	\$ 19,278	19,345
Due after one year through five years	90,200	90,115
Due after five years through ten years	5,962	5,755
Due after ten year through twenty years	1,271	1,266
Beyond twenty years	23,895	23,717
Mortgage backed securities	<u>5,791</u>	<u>5,714</u>
Total Bonds, Preferred stocks and Certificates of deposit	\$ <u>146,397</u>	<u>145,912</u>

Maturities subject to early or unscheduled prepayments have been included based upon their contractual maturity dates. Actual maturity dates may differ from contractual maturities because borrowers have the right to call or prepay obligations with or without call or prepayment penalties.

Investments with a statement value of \$4,970,000 and \$4,960,000 as of December 31, 2013 and 2012, respectively, were on deposit with various regulatory bodies as required by law.

(3) Fair Value Measurements

Fair value is defined as the price that would be received from selling an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The Company's estimates of fair value for financial assets and financial liabilities are based on the framework established in SSAP No. 100. The framework is based on the inputs used in valuation, gives the highest priority to quoted prices in active markets and requires that observable inputs be used in the valuations when available. The disclosure of fair value estimates in the SSAP No. 100 hierarchy is based on whether the significant inputs into the valuation are observable. In determining the three-level hierarchy in which the estimate is disclosed, the highest priority is given to unadjusted quoted prices in active markets and the lowest priority to unobservable inputs that reflect the Company's significant market assumptions. The three levels of the hierarchy are as follows:

- Level 1 – Quoted prices in active markets for identical assets or liabilities.
- Level 2 – Quoted prices for similar assets or liabilities in active markets; quoted prices for identical or similar assets or liabilities in inactive markets; or valuations based on models where the significant inputs are observable (e.g., interest rates, yield curves, prepayment speeds, default rates, loss severities, etc.) or can be corroborated by observable market data.

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- Level 3 – Valuations based on models where significant inputs are not observable. The unobservable inputs reflect the Company's own estimates as to the assumptions that market participants would use.

Valuation of Investments

The Company receives pricing from independent pricing services, and these are compared to prices available from sources accessed through the Bloomberg Professional System. The number of available quotes varies depending on the security, generally we obtain one quote for Level 1 investments, one to three quotes for Level 2 investments and one to two quotes, if available, for Level 3 investments. If there is a material difference in the prices obtained, further evaluation is made. Market prices and valuations from sources such as the Bloomberg system, TRACE and dealer offerings are used as a check on the prices obtained from the independent pricing services. Should a material difference exist, then an internal valuation is made. For purposes of valuing these securities management produces expected cash flows for the security utilizing the standard mortgage security modeling capabilities available on the Bloomberg Professional System. The key inputs are the default rate, severity of default, and voluntary prepayment rate for the underlying mortgage collateral. These are generally based at the start on the actual historical values of these parameters for the prior three months. These cash flows are then discounted by a required yield derived from market based observations of broker inventory offerings, or in some cases Bloomberg Indices of like securities. Management uses this valuation model primarily with mortgage backed securities where the matrix pricing methodology used by the independent pricing service is too broad in its categorizations. This often involves differences in reasonable prepayment assumptions or significant differences in performance among issuers. In some cases, other external observable inputs such as credit default swap levels are used as input in the fair value analysis.

Fixed Maturities

For U. S. Treasury, U. S. government and corporate bonds, the independent pricing services obtain information on actual transactions from a large network of broker-dealers and determine a representative market price based on trading volume levels. For asset backed and mortgage backed instruments, the independent pricing services obtain information on actual transactions from a large network of broker-dealers and sorts the information into various components, such as asset type, rating, maturity, and spread to a benchmark such as the U.S. Treasury yield curve. These components are used to create a pricing matrix for similar instruments.

All broker-dealer quotations obtained are non-binding. For short-term investments classified as Level 1 and Level 2, the Company uses prices provided by independent pricing services.

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The Company uses the following hierarchy for each instrument in total invested assets:

1. The Company obtains a price from an independent pricing service.
2. If no price is available from an independent pricing service for the instrument, the Company obtains a market price from a broker-dealer or other reliable source, such as Bloomberg.
3. The Company then validates the price obtained by evaluating its reasonableness. The Company's review process includes quantitative analysis (i.e., credit spreads and interest rate and prepayment fluctuations) and initial and ongoing evaluations of methodologies used by outside parties to calculate fair value and comparing the fair value estimates to its knowledge of the current market. If a price provided by a pricing service is considered to be materially different from the other indications that are obtained, the Company will make a determination of the proper fair value of the instrument based on data inputs available.

In order to determine the proper SSAP No. 100 classification for each instrument, the Company obtains from its independent pricing service the pricing procedures and inputs used to price the instrument. The Company analyzes this information, taking into account asset type, rating and liquidity, to determine what inputs are observable and unobservable in order to determine the proper SSAP No. 100 level. For those valued internally, a determination is made as to whether all relevant inputs are observable or unobservable in order to classify correctly.

All of the Company's Level 1 and Level 2 invested assets held at December 31, 2013 and 2012 were priced using either independent pricing services or available market prices to determine fair value. The Company classifies such instruments in active markets as Level 1 and those not in active markets as Level 2. The residential mortgage backed securities which are valued in the manner described above are all classified as Level 3. Those for which the individual pricing service value is used are classified as Level 2.

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The quantitative disclosures about the fair value measurements for each major category of assets at December 31, 2013 and 2012 were as follows:

		<u>December 31,</u> <u>2013</u>	<u>Quoted</u> <u>Prices in</u> <u>Active</u> <u>Markets</u> <u>(Level 1)</u>	<u>Significant</u> <u>Other</u> <u>Observable</u> <u>Inputs</u> <u>(Level 2)</u>	<u>Significant</u> <u>Unobservable</u> <u>Inputs</u> <u>(Level 3)</u>
(Amounts in thousands)					
Assets:					
Corporate bonds	\$	4,645	-	4,645	-
Mortgage backed		<u>3,498</u>	-	<u>3,498</u>	-
Total available-for-sale securities		<u>8,143</u>	-	<u>8,143</u>	-
Preferred stocks		<u>435</u>	<u>435</u>	-	-
Total preferred stock securities		<u>435</u>	<u>435</u>	-	-
Total assets classified by SSAP No. 100(1)	\$	<u>8,578</u>	<u>435</u>	<u>8,143</u>	-
Percentage of total		<u>100%</u>	<u>5%</u>	<u>95%</u>	<u>0%</u>

(1) The investments classified as Bonds and Preferred stocks, at amortized cost, Certificates of deposit, Other long-term investments, and Short-term investments are outside the scope of SSAP No. 100 and, therefore, not disclosed in the table as invested assets classified by SSAP No. 100.

		<u>December 31,</u> <u>2012</u>	<u>Quoted</u> <u>Prices in</u> <u>Active</u> <u>Markets</u> <u>(Level 1)</u>	<u>Significant</u> <u>Other</u> <u>Observable</u> <u>Inputs</u> <u>(Level 2)</u>	<u>Significant</u> <u>Unobservable</u> <u>Inputs</u> <u>(Level 3)</u>
(Amounts in thousands)					
Assets:					
Corporate bonds	\$	4,372	1,151	3,221	-
Mortgage backed		<u>2,821</u>	-	<u>2,821</u>	-
Total available-for-sale securities		<u>7,193</u>	<u>1,151</u>	<u>6,042</u>	-
Preferred stocks		<u>497</u>	<u>497</u>	-	-
Total preferred stock securities		<u>497</u>	<u>497</u>	-	-
Total assets classified by SSAP No. 100(1)	\$	<u>7,690</u>	<u>1,648</u>	<u>6,042</u>	-
Percentage of total		<u>100%</u>	<u>21%</u>	<u>79%</u>	<u>0%</u>

(1) The investments classified as Bonds and Preferred stocks, at amortized cost, Certificates of deposit, Other long-term investments, and Short-term investments are outside the scope of SSAP No. 100 and, therefore, not disclosed in the table as invested assets classified by SSAP No. 100.

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Level 1 includes exchange-traded securities. Level 2 securities are comprised of securities whose fair value was determined using observable market inputs. Investments classified as Level 3 are comprised of certain mortgage backed securities that values provided by an independent pricing service or quoted market prices were not used, many of which are not publicly traded or are not actively traded.

The following table provides a summary of changes in fair value associated with the Level 3 assets for the years ended December 31, 2013 and 2012:

	Fair Value Measurements Using Significant Unobservable Inputs (Level 3)	
	December 31,	
	2013	2012
	(Amounts in thousands)	
Beginning balance	\$ -	5,581
Total gains or losses (realized/unrealized):		
Included in earnings (or changes in net assets)	-	-
Included in unassigned surplus	-	-
Purchases, issuances, and settlements	-	-
Transfers in and/or out of Level 3	-	(5,581)
Ending balance	\$ -	-

The above table of Level 3 assets begins with the prior period balance and adjusts the balance for the gains or losses (realized and unrealized) that occurred during the current period. Any new purchases that are identified as Level 3 securities are then added and any sales of securities which were previously identified as Level 3 are subtracted. Next, any securities which were previously identified as Level 1 or Level 2 securities and which are currently identified as Level 3 are added. Finally, securities which were previously identified as Level 3 and which are now designated as Level 1 or as Level 2 are subtracted. The ending balance of the Level 3 securities presented above represent our best estimates and may not be substantiated by comparisons to independent markets and, in many cases, could not be realized in immediate settlement of the instruments.

The Company wrote down Alt-A securities (Level 2) for the year ended December 31, 2013 and 2012 that were determined to have had an other-than-temporary credit related impairment charge.

Securities transferred out of Level 3 in 2012 represent mortgage-backed securities with the Company previously valued internally. At present, fair values derived from an independent pricing service are utilized. Therefore, these securities were all transferred to Level 2. There were no transfers between Levels 1 and 2 during the periods presented.

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(4) Reinsurance

(a) *Unsecured Reinsurance Recoverables*

The Company does not have an unsecured aggregate reinsurance recoverable for claims paid and unpaid, including incurred but not reported, loss adjustment expenses and unearned premium reserves that exceeds 3% of the Company's surplus as regards policyholders, as of December 31, 2013 or 2012.

(b) *Assumed*

The Company has, in the past, utilized reinsurance arrangements with various non-affiliated admitted insurance companies, whereby the Company underwrote the coverage and assumed the policies 100% from the companies. These arrangements required that the Company maintain escrow accounts to assure payment of the unearned premiums and unpaid L&LAE relating to risks insured through such arrangements and assumed by the Company. As of December 31, 2013 and 2012, the balance held in trust in conjunction with reinsurance agreements totaled \$1,938,000 and \$2,516,000, respectively.

For 2013 and 2012, the premiums earned by assumption were \$500,000 and \$781,000, respectively, and the assumed unpaid L&LAE were \$1,148,000 and \$1,548,000, respectively.

At December 31, 2013 and 2012, if all reinsurance were cancelled, there are no return commissions that would be due reinsurers with the return of the unearned premium reserve.

(c) *Ceded*

Runoff Lines

On February 7, 2002, the Company announced its decision to cease writing commercial, specialty and umbrella lines of insurance due to continued adverse claims development and unprofitable underwriting results, these lines became known as runoff lines. As of December 31, 2013 and 2012, the Company had ceded unpaid L&LAE of \$936,000 and \$900,000, respectively.

Nonstandard Personal Auto Lines

In 2012, the Company maintained catastrophe reinsurance on its physical damage coverage for property claims of \$14,000,000 in excess of \$1,000,000 for a single catastrophe, as well as for aggregate catastrophes. For 2013, the Company maintains catastrophe reinsurance on its physical damage coverage for property claims of \$6,500,000 in excess of \$1,000,000 for a single catastrophe, as well as \$13,000,000 for aggregate catastrophes.

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The amounts deducted in the financial statements for reinsurance ceded as of and for the years ended December 31, 2013 and 2012 were as follows:

	<u>2013</u>	<u>2012</u>
	(Amounts in thousands)	
Unpaid losses and loss adjustment expenses	\$ <u>20</u>	<u>19</u>
Premiums written and earned	\$ <u>656</u>	<u>1,031</u>
Losses and loss adjustment expenses incurred	\$ <u>25</u>	<u>3</u>

The Company remains directly liable to their policyholders for all policy obligations and the reinsuring companies are obligated to the Company to the extent of the reinsured portion of the risks.

At December 31, 2013 and 2012, there are no return commissions due reinsurers if all reinsurance were canceled with the return of the unearned premium reserve.

There were no write-offs of any uncollectible reinsurance balances during the years ended December 31, 2013 and 2012.

The Company does not have any reinsurance recoverables in dispute for L&LAE that exceed 5% of the Company's surplus as regards policyholders from an individual reinsurer or that exceed 10% of the Company's surplus as regards policyholders in the aggregate, as of December 31, 2013 or 2012.

(5) Property and Equipment

The following schedule summarizes the components of property and equipment:

	As of and for the years ended December 31	
	<u>2013</u>	<u>2012</u>
	(Amounts in thousands)	
Furniture	\$ 1,051	1,049
Equipment	2,786	2,707
Software	6,403	6,107
Accumulated depreciation and amortization	(8,440)	(7,781)
Property and equipment, net	\$ <u>1,800</u>	<u>2,082</u>
Depreciation expense	\$ <u>917</u>	<u>795</u>

Accounting practices prescribed or permitted by the Texas Department of Insurance allows furniture and equipment to be admitted whereas as NAIC SAP does not. The Company adopted this practice in 2012.

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(6) Unpaid Losses and Loss Adjustment Expenses

The following table sets forth the changes in unpaid L&LAE, net of reinsurance cessions, as shown in the Company's statutory financial statements for the periods indicated:

	As of and for the Years ended December 31,	
	2013	2012
	(Amounts in thousands)	
Net unpaid losses and loss adjustment expenses, beginning of period (net of reinsurance recoverables of \$9 at January 1, 2013 and 2012, respectively)	\$ <u>78,744</u>	<u>75,590</u>
Net losses and loss adjustment expenses incurred related to:		
Current period	130,444	136,342
Prior periods	<u>10,491</u>	<u>9,534</u>
Total net losses and loss adjustment expenses incurred	<u>140,935</u>	<u>145,876</u>
Net losses and loss adjustment expenses paid related to:		
Current period	79,250	85,848
Prior periods	<u>67,870</u>	<u>56,874</u>
Total net losses and loss adjustment expenses paid	<u>147,120</u>	<u>142,722</u>
Net unpaid loss and loss adjustment expenses, end of period (net of reinsurance recoverables of \$21 and \$9 as of December 31, 2013 and 2012, respectively)	\$ <u>72,559</u>	<u>78,744</u>

The unfavorable development in net L&LAE related to prior periods for 2013 was primarily attributable to the Florida personal injury protection litigation in prior years. The unfavorable development in net L&LAE related to prior periods for 2012 was primarily attributable to Florida personal injury protection litigation of \$13.5 million. As of December 31, 2013 and 2012, we believe that the unpaid losses and L&LAE and the reinsurance agreements in force are sufficient to support the future emergence of prior year losses and L&LAE in both our runoff lines and our nonstandard automobile line.

The following table presents the favorable (unfavorable) development in nonstandard personal auto for claims occurring in prior accident years for each region for the years ended December 31, 2013 and 2012:

	2013	2012
	(Amounts in thousands)	
<u>Region:</u>		
Southeast (Florida, Georgia, South Carolina and Virginia)	\$ (10,197)	\$ (12,486)
Southwest (Arizona, California, New Mexico, Nevada and Texas)	<u>(210)</u>	<u>3,038</u>
Net favorable (unfavorable) development	\$ <u>(10,407)</u>	\$ <u>(9,448)</u>

MGA INSURANCE COMPANY, INC.

Notes to Statutory-Basis Financial Statements

December 31, 2013 and 2012

Salvage and subrogation anticipated deducted from unpaid L&LAE at December 31, 2013 and 2012 was \$874,000 and \$1,009,000, respectively.

(7) Federal Income Taxes

The following table presents the components of the net deferred tax assets and deferred tax liabilities at December 31, 2013 and 2012 and the changes in these balances:

	December 31,					
	2013			2012		
	<u>Ordinary</u>	<u>Capital</u>	<u>Total</u>	<u>Ordinary</u>	<u>Capital</u>	<u>Total</u>
	(Amounts in thousands)					
Gross deferred tax assets	\$ 17,959	618	18,577	\$ 19,911	884	20,795
Statutory valuation allowance	(11,109)	(558)	(11,667)	(16,540)	(831)	(17,371)
Total gross deferred tax assets	6,850	60	6,910	3,371	53	3,424
Total gross deferred tax liabilities	(376)	(60)	(436)	(299)	(53)	(352)
Net deferred tax asset			6,474			3,072
Deferred tax assets non-admitted			-			-
Net admitted deferred tax asset			<u>6,474</u>			<u>3,072</u>
Decrease in non-admitted deferred tax asset	\$		-	\$		(16,394)

The Company has not recognized a deferred tax liability for the undistributed earnings of its wholly-owned subsidiary that arose in 2013 and prior years because the Company does not expect those undistributed earnings to reverse and become taxable to the Company in the foreseeable future. A deferred tax liability will be recognized when the Company expects that it will recover those undistributed earnings in a taxable manner, such as through receipt of dividends or sale of the investment.

The components of current income taxes are presented in the following table:

	Years ended December 31,	
	2013	2012
	(Amounts in thousands)	
Federal income taxes expense (benefit)	\$ <u>36</u>	(18)

Under SAP, deferred Federal income taxes are provided (through surplus) for temporary differences between the statutory accounting practices basis and tax basis of existing assets and liabilities with certain statutory limits on the amount of deferred tax assets that may be admitted. As a consequence, the portion of the tax expense, which is a result of the change in the deferred tax asset or liability, may not always be consistent with the income reported on the statutory statements of operations. The Company has evaluated its tax contingencies, and at December 31, 2013 and 2012, the Company does not have any uncertain tax positions.

MGA INSURANCE COMPANY, INC.

Notes to Statutory-Basis Financial Statements

December 31, 2013 and 2012

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities are as follows:

	December 31	
	2013	2012
	(Amounts in thousands)	
<u>Deferred Tax Assets:</u>		
Ordinary		
Net operating loss carryforward	\$ 13,285	14,330
Discounting of unearned premiums	3,070	3,055
Discounting of unpaid losses and loss adjustment expenses	835	1,303
Investments	618	884
Property and equipment	51	566
Non-admitted assets	356	546
AMT carryforward	<u>362</u>	<u>111</u>
Total deferred tax assets	18,577	20,795
Statutory valuation allowance	(11,667)	(17,371)
Non-admitted deferred tax assets	-	-
Admitted deferred tax assets	<u>6,910</u>	<u>3,424</u>
<u>Deferred Tax Liabilities:</u>		
Accretion of bond discount	431	345
Discounting of anticipated salvage and subrogation	<u>5</u>	<u>7</u>
Total deferred tax liabilities	<u>436</u>	<u>352</u>
Net admitted deferred tax assets	\$ <u>6,474</u>	<u>3,072</u>

The change in net deferred income taxes reported in surplus before consideration of non-admitted assets is comprised of the following components:

	December 31,		
	2013	2012	Change
	(Amounts in thousands)		
Total gross deferred tax assets	\$ 6,910	3,424	3,486
Total gross deferred tax liabilities	<u>(436)</u>	<u>(352)</u>	<u>(84)</u>
Net deferred tax asset	6,474	3,072	3,402
Deferred tax change in net unrealized losses			<u>233</u>
Change in net deferred income tax			\$ <u>3,635</u>

MGA INSURANCE COMPANY, INC.

Notes to Statutory-Basis Financial Statements

December 31, 2013 and 2012

The provision for federal income taxes is different from that which would be obtained by applying the statutory Federal income tax rate to income before income taxes. The significant items giving rise to this difference are as follows:

		<u>Years ended December 31,</u>	
		<u>2013</u>	<u>2012</u>
(Amounts in thousands)			
Provision computed at statutory rate of 34%	\$	2,202	169
Change in statutory valuation allowance		(5,704)	17,371
Other, net		<u>(97)</u>	<u>(1,516)</u>
Total statutory income tax expense (benefit)	\$	<u>(3,599)</u>	<u>16,024</u>
Federal income taxes incurred	\$	36	(18)
Change in net deferred income tax		<u>(3,635)</u>	<u>16,042</u>
Total statutory income tax expense (benefit)	\$	<u>(3,599)</u>	<u>16,024</u>

As a result of losses in prior years, as of December 31, 2013, the Company has NOL carryforwards for tax purposes aggregating \$39,073,000. These NOL carryforwards of \$19,092,000, \$9,369,000, \$130,000 and \$10,482,000, if not utilized, will expire in 2021, 2022, 2023 and 2027, respectively. As of December 31, 2013, the tax benefit of the NOL carryforwards was \$13,285,000, which is calculated by applying the Federal statutory income tax rate of 34% against the NOL carryforwards of \$39,073,000. The Company incurred no Federal income taxes that are available for recoupment in the event of future net losses but did incur Federal Alternative Minimum Tax (“AMT”) which will be recoverable in future taxable years of \$362,000.

(8) Capital and Surplus

Authorized capital stock consisted of 12,000,000 shares of \$1.00 par value common stock authorized and issued, of which 6,000,000 shares were outstanding and 6,000,000 shares were in treasury as of December 31, 2013 and 2012.

Statutes in Texas restrict the payment of dividends by MGA for any 12 month period to the greater of net income for the preceding year or 10% of surplus as regards policyholders as of the preceding December 31. This amount cannot be greater than unassigned surplus as of the preceding December 31. At December 31, 2013, \$10,269,000 is available for dividend payments. Dividends cannot be paid without regulatory notification of no objection from the Texas Department of Insurance.

MGA INSURANCE COMPANY, INC.

Notes to Statutory-Basis Financial Statements

December 31, 2013 and 2012

(9) Non-admitted Assets

The following table presents the components of non-admitted assets:

		<u>December 31,</u>	
		<u>2013</u>	<u>2012</u>
		(Amounts in thousands)	
Prepaid expenses	\$	1,048	1,396
Furniture and equipment		<u>151</u>	<u>209</u>
Total non-admitted assets	\$	<u>1,199</u>	<u>1,605</u>

(10) Reconciliation with Statutory Annual Statements

The following schedules reconcile these financial statements with the Annual Statement filed with the State of Texas:

		<u>December 31,</u>	
		<u>2013</u>	<u>2012</u>
		(Amounts in thousands)	
Statutory admitted assets as reported in the Annual Statement	\$	227,482	221,864
Add:			
Decrease in current federal taxes receivable		-	(2)
Statutory admitted assets as reported in audited statutory financial statements	\$	<u>227,482</u>	<u>221,862</u>

		<u>December 31,</u>	
		<u>2013</u>	<u>2012</u>
		(Amounts in thousands)	
Statutory liabilities as reported in the Annual Statement	\$	124,787	129,617
Add:			
Increase in taxes, licenses and fees		-	500
Decrease in payable to affiliates		-	(21)
Statutory liabilities as reported in audited statutory financial statements	\$	<u>124,787</u>	<u>130,096</u>

		<u>December 31,</u>	
		<u>2013</u>	<u>2012</u>
		(Amounts in thousands)	
Statutory capital and surplus as reported in the Annual Statement	\$	102,695	92,247
Add:			
Increase in other underwriting expenses incurred		-	(479)
Increase in federal taxes expense		-	(2)
Statutory capital and surplus as reported in audited statutory financial statements	\$	<u>102,695</u>	<u>91,766</u>

MGA INSURANCE COMPANY, INC.

Notes to Statutory-Basis Financial Statements

December 31, 2013 and 2012

		<u>Year ended December 31,</u>	
		<u>2013</u>	<u>2012</u>
		(Amounts in thousands)	
Statutory net income as reported in the Annual Statement	\$	5,959	997
Add:			
Decrease (increase) in other underwriting expenses incurred		479	(479)
Decrease (increase) in federal taxes expense		<u>2</u>	<u>(2)</u>
Statutory net income as reported in audited statutory financial statements	\$	<u>6,440</u>	<u>516</u>

		<u>Year ended December 31,</u>	
		<u>2013</u>	<u>2012</u>
		(Amounts in thousands)	
Net cash provided by operations as reported in the Annual Statement	\$	3,146	23,094
Add (deduct):			
(Increase) decrease in payable to affiliates		<u>(21)</u>	<u>21</u>
Net cash provided by operations as reported in audited statutory financial statements	\$	<u>3,125</u>	<u>23,115</u>

		<u>Year ended December 31,</u>	
		<u>2013</u>	<u>2012</u>
		(Amounts in thousands)	
Net cash provided by (used in) financing and miscellaneous sources as reported in the Annual Statement	\$	1,566	(14,095)
Add (deduct):			
Increase (decrease) in payable to affiliates		<u>21</u>	<u>(21)</u>
Net cash provided by (used in) financing and miscellaneous sources as reported in audited statutory financial statements	\$	<u>1,587</u>	<u>(14,116)</u>

Subsequent to the filing of the 2012 Annual Statement, but before finalizing the 2012 audited statutory financial statements, the Company made a change to the amount recorded for premium tax expense. While an amount had been previously recorded in the Annual Statement, this amount did not appropriately reflect the 2012 expense or the full amount of the accrual for premium tax expense. Neither of which were considered material to capital and surplus. The amounts indicated in these audited statutory financial statements properly reflect the accrual for premium tax expense in its respective period by virtue of an adjustment to beginning unassigned surplus in the Statutory Statement of Admitted Assets, Liabilities and Capital and Surplus, as well as an adjustment to the expense noted in the current year Statutory Statement of Operations.

MGA INSURANCE COMPANY, INC.

Notes to Statutory-Basis Financial Statements

December 31, 2013 and 2012

(11) Reconciliation with GAAP Financial Statements

The following schedules reconcile statutory capital and surplus and statutory net income with shareholders' equity and net income on the basis of GAAP as of and for the years ended December 31, 2013 and 2012:

	2013	2012
	(Amounts in thousands)	
Statutory capital and surplus	\$ 102,695	91,766
(Deduct) add :		
Deferred Federal income tax	(285)	(711)
Non-admitted assets	1,199	1,605
Deferred policy acquisition costs	6,795	6,761
Unearned policy fees	(2,540)	(2,510)
Net unrealized (losses) gains on investments, gross of tax	(314)	1,419
Allowance for doubtful accounts	(421)	(320)
GAAP shareholders' equity	\$ 107,129	98,010
Statutory net income	\$ 6,440	516
Add (deduct):		
Deferred Federal income tax expense (benefit)	3,828	(394)
Increase (decrease) in deferred policy acquisition costs	34	(134)
Decrease in allowance for doubtful accounts	(107)	(193)
Increase in unearned policy fees	(30)	(204)
Other	-	2
GAAP net (loss) income	\$ 10,165	(407)

(12) Related Party Transactions

The following table reflects intercompany balances which were generated under various service contracts and cost sharing arrangements as of December 31, 2013 and 2012:

	2013	2012
	(Amounts in thousands)	
Receivable from affiliates:		
GAINSCO	\$ 24	-
NSL	538	1,635
MGAA	-	248
Total receivable from affiliates	\$ 562	1,883
Payable to affiliates:		
GSC	\$ 791	1,459
MGAA	563	-
Total payable to affiliates	\$ 1,354	1,459

MGA INSURANCE COMPANY, INC.

Notes to Statutory-Basis Financial Statements

December 31, 2013 and 2012

At December 31, 2013, the amount receivable from affiliates relates to allocated corporate general and administrative expenses based on cost sharing arrangements. For the year ended December 31, 2013, the Company paid and expensed \$104,000 and \$80,000, respectively, to Gainsco resulting in a receivable over funding of the settlement of the allocated expenses with Gainsco. For the year ended December 31, 2013, the Company had paid and expensed \$325,000 and \$862,000, respectively, to NSL resulting in a receivable due from NSL of the allocated expenses with NSL. At December 31, 2013, the amount payable to affiliates relates to underwriting expenses incurred based on service contracts and cost sharing arrangements. For the year ended December 31, 2013, the Company paid and expensed \$1,447,000 and \$2,238,000, respectively, to GSC resulting in a payable with GSC. For the year ended December 31, 2013, the Company paid and expensed \$4,512,000 and \$5,075,000, respectively, to MGAA. The terms of the arrangements require that the balances be settled within thirty days to forty-five days.

For the year ended December 31, 2012, the Company had paid and expensed \$514,000 and \$762,000, respectively, to MGAA resulting in a receivable over funding of the settlement of the allocated expenses with MGAA. For the year ended December 31, 2012, the Company had paid and expensed \$1,379,000 and \$3,013,000, respectively, to NSL resulting in a receivable over funding of the settlement of the allocated expenses with NSL. At December 31, 2012, the amount payable to affiliates relates to underwriting expenses incurred based on service contracts and cost sharing arrangements. For the year ended December 31, 2012, the Company paid and expensed \$1,379,000 and \$3,013,000, respectively, to GSC. The terms of the arrangements require that the balances be settled within thirty days to forty-five days.

The only other material related party transactions are described in notes 4 and 13.

(13) Commitments and Contingencies

Assessments

The Company is not aware of any assessments that could have a material effect on the Company's financial position or results of operations. The Company has not accrued any liability for assessments.

Claims Related to Alleged Extra Contractual Obligations and Alleged Bad Faith Losses Stemming from Lawsuits

The Company paid \$11,050,000 in 2013 to settle claims related to alleged extra contractual obligations or to alleged bad faith claims stemming from lawsuits. The number of claims where amounts were paid to settle claims related to alleged extra contractual obligations or to alleged bad faith claims stemming from lawsuits was in the 0 to 25 range during the reporting period. The claim count information is provided on a per claimant basis.

MGA INSURANCE COMPANY, INC.

Notes to Statutory-Basis Financial Statements

December 31, 2013 and 2012

Legal Proceedings

In the normal course of its operations, the Company is named as defendant in various legal actions seeking monetary damages, including cases involving business disputes and those involving allegations that the Company wrongfully denied insurance claims and is liable for damages. Some cases involving insurance claims seek amounts significantly in excess of our policy limits. In the opinion of the Company's management, based on the information currently available, the ultimate liability, if any, resulting from the disposition of such litigation will not have a material adverse effect on the Company's consolidated financial position or results of operations. However, in view of the uncertainties inherent in such litigation, it is possible that the ultimate cost to the Company might exceed the reserves we have established by amounts that could have a material adverse effect on the Company's future results of operations, financial condition and cash flows in a particular reporting period.

In November 2010, a claim for recovery of damages of less than \$500 in a Personal Injury Protection ("PIP") in Dade County, Florida (Feijoo v. MGA Insurance Company, Inc.) was amended, with the plaintiff seeking to convert the case to a putative class action representing all persons similarly situated with respect to PIP claims in Florida against MGA. The Amended Complaint seeks damages of an unspecified amount and equitable and other relief. In August 2012, the Court dismissed the class action claims with prejudice, and the individual PIP case was subsequently transferred to County Court. Dismissal of the class action claims is subject to possible appeal by the named Plaintiff at the conclusion of the individual case. While such litigation is inherently unpredictable, the Company believes that the complaint is without merit and intends to defend itself vigorously. As a result, the Company is unable to reasonably estimate a possible range of losses, if any, arising from the litigation.

In April 2011, a putative class action was filed in Dade County, Florida, against MGA (Advanced Chiropractic Center Company, D/B/A Accident & Wellness Centers, as Assignee v. MGA Insurance Company, Inc.). This lawsuit, purportedly brought on behalf of all persons similarly situated with respect to PIP claims in Florida, asserts that the defendant has failed to comply with requirements of the Florida Personal Injury Protection ("PIP") law by improperly calculating the amounts charged against PIP deductibles and seeks damages of an unspecified amount and equitable and other relief. While such litigation is inherently unpredictable, the Company believes that the complaint is without merit and intends to defend itself vigorously. As a result, the Company is unable to reasonably estimate a possible range of losses, if any, arising from the litigation.

In November 2011, a complaint was filed against MGA in the Circuit Court of the Seventeenth Judicial Circuit in and for Broward County, Florida (Pericles v. MGA Insurance Company, Inc.). The complaint arises out of an automobile accident that occurred in 2007. MGA denied coverage under a policy that had expired on the date of the accident. The plaintiff obtained a judgment against the named insured and the driver and is now seeking to enforce the judgment against MGA based on allegations of bad faith. A summary judgment in favor of MGA was granted by the Court in June 2013. The plaintiff has appealed the grant of summary judgment.

MGA INSURANCE COMPANY, INC.

Notes to Statutory-Basis Financial Statements

December 31, 2013 and 2012

In February 2014, a complaint was filed in United States District Court for the Middle District of Florida by 20 automobile body shops, naming as defendants approximately 40 insurance companies, including MGA (A & E Auto Body, Inc. et al. v. 21st Century Centennial Insurance Company d/b/a Farmers Insurance Group, et al.). The complaint alleges various anticompetitive practices used by the defendants to control and depress automobile damage repair costs in Florida. While such litigation is inherently unpredictable, the Company believes that the complaint is without merit and intends to defend the case vigorously. As a result, the Company is unable to reasonably estimate a possible range of losses, if any, arising from the litigation.

Off-balance-sheet-risk

The Company does not have any financial instruments where there is off-balance-sheet-risk of accounting loss due to credit or market risk. There is credit risk in the premiums receivable and reinsurance balances receivable of the Company. At December 31, 2013 and 2012, the Company did not have any claims receivables by individual reinsurers that were material with regard to capital and surplus.

The following table sets forth significant receivable balances at December 31, 2013 and 2012:

	2013		2012	
	<u>Balance</u>	<u>% of Policyholder Surplus</u>	<u>Balance</u>	<u>% of Policyholder Surplus</u>
	(Dollar amounts in thousands)			
<u>Premiums receivable from:</u>				
NSL	\$ 17,056	16.6%	18,284	19.9%
MGAA	16,108	15.7%	14,059	15.3%
Old American County Mutual	582	0.6%	637	0.7%

(14) Leases

The Company entered into an eleven-year lease agreement for the Florida office in May of 2010 that includes rentable office space of 22,480 square feet. Under the terms of this lease, the Company has the option of renewing for two additional five year periods through the year 2031. The Company also has the option of terminating the lease agreement during the sixth year of the term subject to payment of a penalty. The lease contains an annual rent escalation of 2.25%. During 2013 and 2012, the Company recorded lease expense on a straight line basis of \$507,000, respectively.

MGA INSURANCE COMPANY, INC.

Notes to Statutory-Basis Financial Statements

December 31, 2013 and 2012

The future minimum rental payments are as follows (amounts in thousands):

<u>Year</u>	<u>Amount</u>
2014	\$ 1,815
2015	1,567
2016	560
2017	573
2018	586
Thereafter	<u>1,418</u>
Total	\$ <u>6,519</u>

The Company has not entered into any sale and leaseback arrangements.

(15) Geographical Distribution

The following table sets forth the direct premium written by Managing General Agents/Third Party Administrators that exceeds 5% of policyholder surplus for the year ended December 31, 2013:

<u>Name</u>	<u>Type of business written</u>	<u>Direct Written Premium</u>
		(Amounts in thousands)
NSL	Property and Casualty	\$ 101,621
MGAA	Property and Casualty	\$ 89,649

Both MGAA and NSL are affiliates of the Company. NSL is wholly-owned by GAINSCO.

The Company makes available nonstandard personal auto lines of business to U.S. residents in several states. The following table sets forth the Company's total yearly direct premiums written by geographic area for the years indicated.

<u>Area</u>	<u>2013</u>	<u>2012</u>
Florida	42.9%	48.7%
Texas	32.8	28.0
Arizona	8.0	8.9
South Carolina	5.8	4.9
New Mexico	4.9	4.6
Georgia	3.4	3.6
Oklahoma	1.2	0.2
California	0.1	1.1
Virginia	0.9	0.0

(16) Risk-Based Capital

The Company's statutory capital exceeds the benchmark capital level under the Risk Based Capital ("RBC") formula for its insurance companies. RBC is a method for establishing the minimum amount of capital appropriate for an insurance company to support its overall business operations in consideration of its size and risk profile. As of December 31, 2013, the Company's RBC authorized control level was \$13,473,000 and the total adjusted capital was \$102,695,000.

MGA INSURANCE COMPANY, INC.

Notes to Statutory-Basis Financial Statements

December 31, 2013 and 2012

(17) Subsequent Events

On March 14, 2014, the Company paid a dividend to GAINSCO of \$5,000,000, which reduced MGA's statutory policyholders' surplus.

The Company has evaluated subsequent events from the balance sheet date through May 30, 2014, the date at which the consolidated financial statements were available to be issued, and determined that there are no other items to disclose.

MGA INSURANCE COMPANY, INC.

Summary Investment Schedule

December 31, 2013

(Dollar amounts in thousands)

	<u>Gross investment holdings</u>		<u>Admitted assets as reported in the Annual Statement</u>	
	<u>Amount</u>	<u>Percentage</u>	<u>Amount</u>	<u>Percentage</u>
Bonds:				
U.S. Treasury	\$ 8,856	4.83%	\$ 8,856	4.83%
U.S. Government agencies	3,589	1.96	3,589	1.96
Mortgage-backed	9,289	5.07	9,289	5.07
Other debt and other fixed income securities – unaffiliated domestic securities	<u>132,706</u>	<u>72.39</u>	<u>132,706</u>	<u>72.39</u>
Total bonds	154,440	84.25	154,440	84.25
Preferred stocks	1,435	0.78	1,435	0.78
Cash overdraft and certificates of deposit	(4,068)	(2.22)	(4,068)	(2.22)
Common stock of subsidiary	1	-	1	-
Other long-term investments	7,515	4.10	7,515	4.10
Short-term investments	<u>24,002</u>	<u>13.09</u>	<u>24,002</u>	<u>13.09</u>
Total invested assets	\$ <u>183,325</u>	<u>100.00%</u>	\$ <u>183,325</u>	<u>100.00%</u>

See accompanying independent auditor's report.

MGA INSURANCE COMPANY, INC.

Investment Risk Interrogatories

December 31, 2013

(Dollar amounts in thousands)

1. Total admitted assets as reported on the statement of admitted assets, liabilities, and capital and surplus \$ 227,482

2. The ten largest exposures to a single insurer/borrower/investment, excluding 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, property occupied by the Company, and policy loans.

Investment Category	Amortized Cost	Percentage of total admitted assets
<u>Issuer:</u>		
Bounty Minerals LLC	\$ 3,226	1.418%
KKR Capital Markets LLC	\$ 2,110	0.928%
Prudential Financial, Inc.	\$ 2,097	0.922%
Progressive Corp	\$ 1,501	0.660%
Lincoln National Corp.	\$ 1,433	0.630%
Fortress Worldwide Transportation	\$ 1,431	0.629%
Ingersoll-Rand Co. UNNT	\$ 1,271	0.559%
Dominion Resources, Inc.	\$ 1,254	0.551%
International Paper Co.	\$ 1,244	0.547%
Nucor Corp	\$ 1,187	0.522%

3. Total admitted assets held in bonds and preferred stocks by NAIC rating.

Bonds with an NAIC rating of 1	\$ 50,816	22.338%
Bonds with an NAIC rating of 2	\$ 118,736	52.196%
Preferred Stocks with an NAIC rating of 2	\$ 1,000	0.440%
Bonds with an NAIC rating of 3	\$ 7,078	3.111%
Preferred Stocks with an NAIC rating of 3	\$ 435	0.191%
Bonds with an NAIC rating of 4	\$ 971	0.427%
Bonds with an NAIC rating of 5	\$ 841	0.370%

The answers to each of the remaining interrogatories of the reporting entity's aggregate holdings are not applicable.

See accompanying independent auditor's report.

MGA INSURANCE COMPANY, INC.

Schedule of Supplemental Reinsurance Risk Interrogatories

December 31, 2013

The following represent Annual Statement interrogatories, which are required to be included with the annual audit report beginning with audit reports on financial statements as of and for the year ended December 31, 2013 for reinsurance contracts entered into, renewed or amended on or after January 1, 1994 and any other reinsurance contracts that are in force on January 1, 1995 and cover insurable events on the underlying insurance policies that occur on or after that date.

- | | | |
|-----|--|-----------------------------|
| 7.1 | Has the reporting entity reinsured any risk with any other entity under a quota share reinsurance contract that includes a provision 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 any similar provisions)? | YES [] NO [X] |
| 7.2 | If yes, indicate the number of reinsurance contracts containing such provisions. | <u> </u> |
| 7.3 | If yes, does the amount of reinsurance credit taken reflect the reduction in quota share coverage caused by any applicable limiting provision(s)? | YES [] NO [X] |
| 8.1 | Has this reporting entity reinsured any risk with any other entity and agreed to release such entity from liability, in whole or in part, from any loss that may occur on this risk, or portion thereof, reinsured? | YES [] NO [X] |
| 8.2 | If yes, give full information. | Not Applicable |
| 9.1 | Has the reporting entity 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: (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(s) contain one or more of the following features or other features that would have similar results: | YES [] NO [X] |
| | (a) A contract term longer than two years and the contract is noncancellable 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 schedule, accumulating retentions form multiple years or any features inherently designed to delay timing of the reimbursement to the ceding entity. | |

MGA INSURANCE COMPANY, INC.

Schedule of Supplemental Reinsurance Risk Interrogatories

December 31, 2013

- 9.2 Has the reporting entity during the period covered by the statement ceded any risk under any reinsurance contract (or under multiple contracts with the same reinsurer or its affiliates), 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 where:
- (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.
- 9.3 If yes to 9.1 or 9.2, please provide the following information in the Reinsurance Summary Supplemental Schedule for Interrogatory 9:
- (a) The aggregate financial statement impact gross of all such ceded reinsurance contracts on the balance sheet and statement of income;
- (b) A summary of the reinsurance contract terms and indicate whether it applies to the contracts meeting the criteria in 9.1 or 9.2; and
- (c) A brief discussion of management's principal objectives in entering into the reinsurance contract including the economic purpose to be achieved.
- 9.4 Except for transactions meeting the requirements of paragraph 30 of SSAP No. 62, Property and Casualty Reinsurance, has the reporting entity ceded any risk under any reinsurance contract (or multiple contracts with the same reinsurer or its affiliates) during the period covered by the financial statement, and either:
- (a) Accounted for that contract as reinsurance (either positive or retroactive) under statutory accounting principles ("SAP") and a deposit under generally accepted accounting principles ("GAAP"); or
- (b) Accounted for that contract as reinsurance under GAAP and as a deposit under SAP?
- 9.5 If yes to 9.4, explain in the Reinsurance Summary Supplemental Schedule for Interrogatory 9 (Section D) why the contract(s) is treated differently for GAAP and SAP.

See accompanying independent auditor's report.