MGA INSURANCE COMPANY, INC.

Statutory Financial Statements and Supplemental Schedules

December 31, 2018 and 2017

(With Independent Auditor’s Report Thereon)

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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 statutory basis financial statements of MGA Insurance Company, Inc., which comprise the statutory basis statements of admitted assets, liabilities and capital and surplus as of December 31, 2018 and 2017, and the related statutory basis statements of operations, changes in capital and surplus, and cash flows for the years then ended, and the related notes to the statutory basis financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these statutory basis 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 audits 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.

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

As described in Note 1, the statutory basis financial statements are prepared in accordance with 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.

The effects on the accompanying financial statements of the variances between such practices and accounting principles generally accepted in the United States of America are presumed to be material.

Adverse Opinion on U.S. Generally Accepted Accounting Principles

In our opinion, because of the significance of the matters described in the "Basis for Adverse Opinion on U.S. Generally Accepted Accounting Principles" paragraph, the statutory basis financial statements referred to above do not present fairly, in accordance with accounting principles generally accepted in the United States of America, the financial position of MGA Insurance Company, Inc. as of December 31, 2018 and 2017, and the results of its operations and its cash flows for the years then ended.

Opinion on Regulatory Basis of Accounting

In our opinion, the statutory basis financial statements referred to above present fairly, in all material respects, the admitted assets, liabilities and capital and surplus of MGA Insurance Company, Inc. as of December 31, 2018 and 2017, and the results of its operations and its cash flows for the years then ended, in accordance with accounting practices prescribed or permitted by the Texas Department of Insurance as described in Note 1.

Supplementary Information

Our audits of the statutory basis 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 statutory basis financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the statutory basis financial statements. The information has been subjected to the auditing procedures applied in the audits of the statutory basis financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the statutory basis financial statements or to the statutory basis financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the supplemental information is fairly stated in all material respects in relation to the statutory basis 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 2, 2019

MGA INSURANCE COMPANY, INC.

Statutory Statements of Admitted Assets,
Liabilities and Capital and Surplus

December 31, 2018 and 2017

(Amounts in thousands, except share amounts)

		2018	2017
Admitted Assets			
Invested Assets:			
Bonds, at amortized cost (fair value: $208,330 – 2018, $173,883 – 2017)	$	212,390	174,605
Bonds, at lower of amortized cost or fair value		4,046	3,428
Preferred stocks, at amortized cost (fair value: $0 – 2018, $778 – 2017)		-	777
Preferred stocks, at lower of amortized cost or fair value		4,844	1,558
Common stocks, at lower of amortized cost or fair value		6,938	7,759
Certificates of deposit, at cost (which approximates fair value)		-	100
Investment in subsidiary		-	1
Other long-term investments, equity method at cost		12,521	16,084
Short-term investments, at cost (fair value: $19,721 – 2018, $35,369 – 2017)		19,732	35,389
Cash overdraft		(3,679)	(3,034)
Total invested assets		256,792	236,667
Accrued investment income		2,023	1,716
Premiums receivable		64,191	54,872
Property and equipment (net of accumulated depreciation and amortization: $12,383 – 2018, $11,361 – 2017)		2,814	1,804
Receivable from affiliates		441	34
Net deferred tax asset		6,318	4,143
Other assets		17	184
Total admitted assets	$	332,596	299,420

(Continued)

MGA INSURANCE COMPANY, INC.

Statutory Statements of Admitted Assets,
Liabilities and Capital and Surplus

December 31, 2018 and 2017

(Amounts in thousands, except share amounts)

		2018	2017
Liabilities and Capital and Surplus			
Liabilities:			
Unpaid losses and loss adjustment expenses	$	110,008	94,430
Unearned premiums		86,021	74,430
Accounts payable		14,237	12,414
Taxes, licenses and fees		4,328	3,396
Payable to affiliates		5,139	3,502
Commissions payable		304	255
Unclaimed property		1,799	1,642
Current federal income taxes payable		1,586	1,941
Other liabilities		13	72
Total liabilities		223,435	192,082
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, 2018 and 2017)		12,000	12,000
Paid-in and contributed surplus		83,894	83,894
Unassigned surplus		19,267	17,444
Treasury stock, at cost (6,000,000 shares at December 31, 2018 and 2017)		(6,000)	(6,000)
Total capital and surplus		109,161	107,338
Total liabilities and capital and surplus	$	332,596	299,420

See accompanying notes to statutory-basis financial statements.

MGA INSURANCE COMPANY, INC.

Statutory Statements of Operations

Years ended December 31, 2018 and 2017

(Amounts in thousands)

		2018	2017
Underwriting gain:			
Net premiums written	$	337,603	287,225
Change in unearned premiums		(11,591)	(12.720)
Premiums earned		326,012	274,505
Net losses and loss adjustment expenses incurred		209,573	179,181
Commissions and other underwriting expenses incurred		94,785	78,823
Expenses incurred		304,358	258,004
Underwriting gain		21,654	16,501
Investment income:			
Net investment income earned		7,225	6,083
Net realized capital gains on investments		941	454
Net investment income		8,166	6,537
Other expense:			
Miscellaneous expense		(71)	(305)
Total other expense		(71)	(305)
Income from operations before federal income taxes		29,749	22,733
Federal income tax expense		5,921	4,656
Net income	$	23,828	18,077

See accompanying notes to statutory-basis financial statements.

MGA INSURANCE COMPANY, INC.

Statutory Statements of Changes in Capital and Surplus

Years ended December 31, 2018 and 2017

(Amounts in thousands)

		2018	2017
Common capital stock:			
Balance at beginning and end of year	$	12,000	12,000
Paid-in and contributed surplus:			
Balance at beginning and end of year		83,894	83,894
Unassigned surplus:			
Balance at beginning of year		17,444	13,411
Net income		23,828	18,077
Change in non-admitted assets		(1,457)	(875)
Change in net deferred income tax		1,199	(4,330)
Dividends to stockholders		(18,077)	(12,933)
Change in net unrealized losses		(3,670)	4,094
Balance at end of year		19,267	17,444
Treasury stock:			
Balance at beginning and end of year		(6,000)	(6,000)
Total capital and surplus at end of year	$	109,161	107,338

See accompanying notes to statutory-basis financial statements.

MGA INSURANCE COMPANY, INC.

Statutory Statements of Cash Flow

Years ended December 31, 2018 and 2017

(Amounts in thousands)

		2018	2017
Cash from operations:			
Premiums collected net of reinsurance	$	327,926	278,200
Net investment income		8,425	7,697
Miscellaneous income		(71)	(305)
Total		336,280	285,592
Benefit and loss related payments		(154,849)	(134,762)
Commissions, expenses paid and aggregate write-ins for deductions		(131,002)	(107,445)
Federal income taxes paid		(6,276)	(4,350)
Total		(292,127)	(246,557)
Net cash provided by operating activities		44,153	39,035
Cash from investments:			
Proceeds from investments sold, matured, or repaid:			
Bonds		34,144	39,419
Stocks		342	341
Other long-term investments		4,062	1,346
Net gains on short-term investments		(15)	(12)
Total investment proceeds		38,533	41,094
Cost of investments acquired:			
Bonds		(75,187)	(60,327)
Stocks		(5,075)	(2,900)
Other long-term investments		(11)	-
Total investments acquired		(80,273)	(63,227)
Net cash used in investing activities		(41,740)	(22,133)
Cash from financing and miscellaneous sources:			
Cash (applied) provided			
Dividends to stockholders		(18,077)	(12,933)
Other cash provided		(738)	1,084
Net cash used in financing and miscellaneous sources		(18,815)	(11,849)
Net increase in cash, certificates of deposit and short-term investments		(16,402)	5,053
Cash, certificates of deposit and short-term investments, beginning of year		32,455	27,402
Cash, certificates of deposit and short-term investments, end of year	$	16,053	32,455

See accompanying notes to statutory-basis financial statements.

(1) Background and Summary of Significant Accounting Policies

(a) Basis of Presentation

MGA Insurance Company, Inc. (the "Company," "our," "us" or "we"), 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, 2018 and 2017, 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:

<u>Investment Securities</u>

- 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.

- 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.

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 nonadmitted deferred tax assets are recorded directly to surplus.

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 Nonadmitted Assets

- Admitted assets are those recognized and accepted by state insurance departments in measuring the solvency of an insurer for statutory accounting purposes. Nonadmitted assets do not contribute to the insurer's solvency. The statutory financial statements only present admitted assets on the balance sheet. Nonadmitted 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 NAIC SAP reporting and GAAP reporting refer to Note 11 in tabular format for the reconciliation between NAIC SAP capital and surplus and GAAP shareholders' equity and NAIC SAP net income and GAAP net income.

(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 property 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 products to reflect this range of risk accordingly, in order to earn an underwriting profit. Simultaneously, when actuarially prudent, we attempt to position our product pricing 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, New Mexico, Oklahoma Utah and Texas, with both six month and one year policies in Florida, Georgia, South Carolina, Tennessee and Virginia. 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 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. The Company's 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 the Company's 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 of being 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.

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 includes write-downs on securities considered to have other than temporary declines in fair value. Dividends on preferred and common stocks 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. 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 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.

(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. 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.

The Company maintains 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.

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, MGAA, Gainsco Service Corp. ("GSC"), National Specialty Lines, Inc. ("NSL"), GAINSCO/Bob Stallings Racing, Inc., Gainsco Automotive Holdings Corp., Stallings Auto Group, Inc., Bob Stallings Hyundai, Inc., BSAG, Inc., Bob Stallings Car Rental, Inc., (formerly BSAG Real Estate Holdings, Inc.), First Win Automotive, Inc., Red Dragon Properties I, 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 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 recovers from or pays taxes to the IRS.

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 and the nondeductible portion of the change in unearned premiums. In 2016, the Company 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 carryforwards for existing temporary differences that reverse during a timeframe corresponding with IRS tax loss carryforward 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. In 2017, all loss carryforwards were fully utilized.

The Company recognized a current income tax expense of $5,921,000 and $4,656,000 during 2018 and 2017, respectively, for allocated Federal income tax on a consolidated basis and intercompany tax expense. This tax can be recouped in future years.

(2) Investments

The following schedule summarizes the components of net investment income:

		Years ended December 31,	
		2018	2017
		(Amounts in thousands)	
Investment income on:			
Bonds, common stock, preferred stocks and certificates of deposit	$	6,688	5,815
Cash, cash equivalents and short-term investments		458	361
Other long-term investments		341	203
		7,487	6,379
Investment expenses		(262)	(296)
Net investment income	$	7,225	6,083

The fair value of Bonds, Preferred stocks, Certificates of deposit and Short-term investments were obtained from commercially available valuation services. 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 $256,399,000 and $221,462,000 at December 31, 2018 and 2017, 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, 2018, seventeen securities totaling $2,113,000 were non-investment grade bonds and common stock with NAIC designations of 3 through 6 and were stated at fair value. At December 31, 2017, seven securities totaling $1,140,000 were non-investment grade bonds and common stock with NAIC designations of 3 through 6 and were stated at fair value.

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, 2018 and 2017:

	December 31, 2018			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(Amounts in thousands)			
U.S. Treasury	$ 6,475	-	(134)	6,341
U.S. Government agencies	2,000	1	(16)	1,985
Corporate bonds	202,543	221	(4,119)	198,645
Asset-backed	891	-	(2)	889
Mortgage-backed	481	1	(12)	470
Other long-term investments	12,521	-	-	12,521
Short-term investments	19,732	6	(17)	19,721
Total Bonds, Preferred stocks, Certificates of deposit and Short-term investments	$ 244,643	229	(4,300)	240,572

	December 31, 2017			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(Amounts in thousands)			
U.S. Treasury	$ 6,467	-	(92)	6,375
U.S. Government agencies	3,000	-	(25)	2,975
Corporate bonds	160,949	826	(1,405)	160,370
Asset-backed	1,557	-	(2)	1,555
Mortgage-backed	2,632	1	(25)	2,608
Preferred stocks	777	1	-	778
Certificates of deposit	100	-	-	100
Other long-term investments	16,084	-	-	16,084
Short-term investments	35,389	-	(20)	35,369
Total Bonds, Preferred stocks, Certificates of deposit and Short-term investments	$ 226,955	828	(1,569)	226,214

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, 2018 and 2017:

		December 31, 2018					
		Less than 12 months		12 months or longer		Total	
		Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
		(Amounts in thousands)					
U.S. Treasury	$	-	-	6,341	134	6,341	134
U.S. Government agencies		-	-	984	16	984	16
Corporate bonds		77,474	845	94,556	3,274	172,030	4,119
Asset-backed		-	-	889	2	889	2
Mortgage-backed		-	-	418	12	418	12
Short-term investments		8,556	17	-	-	8,556	17
Total investments	$	86,030	862	103,188	3,438	189,218	4,300

		December 31, 2017					
		Less than 12 months		12 months or longer		Total	
		Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
		(Amounts in thousands)					
U.S. Treasury	$	4,923	44	1,452	48	6,375	92
U.S. Government agencies		-	-	2,975	25	2,975	25
Corporate bonds		61,502	421	54,875	984	116,377	1,405
Asset-backed		1,556	2	-	-	1,556	2
Mortgage-backed		-	-	2,547	25	2,547	25
Short-term investments		15,515	20	-	-	15,515	20
Total investments	$	83,496	487	61,849	1,082	145,345	1,569

The gross unrealized losses, shown in the above tables, totaling $3,438,000 and $1,082,000 as of December 31, 2018 and 2017, respectively, relate to 116 and 63 individual securities, respectively, which had been in an unrealized loss position for 12 months or more as of such dates. At December 31, 2018 and 2017, approximately 93% and 94% of the unrealized gross losses were with issuers with a NAIC designation of 1 and 2, respectively. The decline in market value is primarily related to an increase in market interest rates since purchasing related to policy actions by the Federal Reserve. Another contributing factor has been the persistent low levels of short term interest rates, such as the 3 month London Interbank Offered Rate for U.S. dollar deposits, and the related fall in the forward expectations for these short term yields since the time of acquisition of floating rate and “fixed to floating” coupon rate securities. At this time based upon information currently available, the Company has the ability and the intent to hold the securities 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.

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 amortized cost, based upon the present value of the principal and interest expected to be received 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.

Included in the Company's fixed income portfolio are hybrid securities with a carrying value of \$17,429,000 and fair value of \$16,190,000 at December 31, 2018, respectively, and carrying value of \$20,992,000 and fair value of \$21,005,000 at December 31, 2017, respectively. 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.

Preferred stocks consist of exchanged traded and over-the-counter issues of public companies. As of December 31, 2018, we concluded that these underlying shares were not other-than-temporarily impaired based on the credit review of the issuer.

Common stock consists primarily of shares of an exchange traded limited liability company, which invests in transportation and infrastructure related assets. This position resulted from the exchange of the Company's ownership in a private limited partnership, previously categorized as Other long-term investments, for these common shares in conjunction with the partnership going public through an initial public offering in 2016. As of December 31, 2018, management does not believe that any common shares are other-than-temporarily impaired based on the credit review of the issuer.

Investments in private partnerships or limited liability companies are stated under the equity method of accounting or 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 can reflect the market-related issues associated with a disruption in the credit markets, which can create a significant deterioration in both the valuation of the securities, as well as the Company's view of future recoverability of the valuation decline. Also, if determined that a security is not likely to be held until the full recovery of amortized cost, the carrying value is reduced to the fair value.

Proceeds from the sale of securities for the years ended December 31, 2018 and 2017 are presented in the following table:

		Years ended December 31,	
		2018	2017
		(Amounts in thousands)	
Proceeds:			
Bonds, sales	$	14,191	20,665
Bonds, principal pay downs	$	885	218
Bonds, maturities	$	19,068	18,536
Preferred stocks	$	342	341
Other invested assets	$	4,062	1,346

Realized gains and losses on investments for the years ended December 31, 2018 and 2017 are presented in the following table:

		Years ended December 31,	
		2018	2017
		(Amounts in thousands)	
Realized gains:			
Bonds	$	3	140
Other invested assets		2,161	771
Short-term investments		-	-
Total realized gains		2,164	911
Realized losses:			
Bonds		(195)	(426)
Preferred stock		-	(19)
Common stock		(158)	-
Short-term investments		(11)	(12)
Total realized losses		(364)	(457)
Other-than-temporary impairment losses		(859)	-
Total realized investment gains, net	$	941	454

During 2018, the Company wrote down $859,000 in (Level 2) securities that were determined to have had an other-than-temporary credit related impairment charge. No charges were determined for 2017.

The amortized cost and fair value of Bonds and Certificates of deposit at December 31, 2018 by maturity are shown below.

		2018	
		Amortized Cost	Fair Value
		(Amounts in thousands)	
Due in one year or less	$	28,305	28,098
Due after one year through five years		159,889	157,620
Due after five years through ten years		3,223	3,244
Due after ten year through twenty years		1,900	1,770
Beyond twenty years		17,701	16,239
Asset-backed securities		891	889
Mortgage-backed securities		481	470
Total Bonds and Certificates of deposit	$	212,390	208,330

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 $4,453,000 and $4,545,000 as of December 31, 2018 and 2017, 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.

- 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 management obtains 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 security modeling capabilities available on the Bloomberg Professional System. The key inputs for mortgage securities 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 six 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.

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, 2018 and 2017 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. Any 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.

The quantitative disclosures about the fair value measurements for each major category of assets, at the lower of amortized cost or fair value, at December 31, 2018 and 2017 were as follows:

		December 31, 2018	Quoted Prices in Active Markets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
		(Amounts in thousands)			
Assets:					
Corporate bonds	$	4,046	-	4,046	-
Total available-for-sale securities		4,046	-	4,046	-
Preferred stock		4,844	3,966	878	-
Common stock		6,938	6,938	-	-
Total assets classified by SSAP No. 100(1)	$	15,828	10,904	4,924	-
Percentage of total		100%	69%	31%	0%

(1) The investments classified as Bonds and Preferred stock, carried 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.

		December 31, 2017	Quoted Prices in Active Markets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
		(Amounts in thousands)			
Assets:					
Corporate bonds	$	3,428	-	3,428	-
Total available-for-sale securities		3,428	-	3,428	-
Preferred stock		1,558	1,558	-	-
Common stock		7,759	7,759	-	-
Total assets classified by SSAP No. 100(1)	$	12,745	9,317	3,428	-
Percentage of total		100%	73%	27%	0%

(1) The investments classified as Bonds and Preferred stock, carried 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.

Level 1 includes exchange-traded securities. Level 2 securities are comprised of securities whose fair value was determined using observable market inputs.

The Company had no securities associated with the Level 3 assets for the years ended December 31, 2018 and 2017.

There were no security transfers between Levels 1, 2 and 3 during the periods presented. At present, fair values derived from an independent pricing service are utilized.

(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, 2018 or 2017.

(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, 2018 and 2017, the balance held in trust in conjunction with reinsurance agreements totaled $141,000 and $139,000, respectively.

For 2018 and 2017, the premiums earned by assumption were $157,000 and $181,000, respectively, and the assumed unpaid L&LAE were $145,000 and $150,000, respectively.

At December 31, 2018 and 2017, 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

For 2018 and 2017, the Company maintained 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 $19,500,000 for aggregate catastrophes.

The amounts deducted in the financial statements for reinsurance ceded as of and for the years ended December 31, 2018 and 2017 were as follows:

		2018	2017
		(Amounts in thousands)	
Premiums written and earned	$	545	788
Losses and loss adjustment expenses incurred	$	-	-

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, 2018 and 2017, 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, 2018 and 2017.

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, 2018 or 2017.

(5) Property and Equipment

The following schedule summarizes the components of property and equipment:

		As of and for the years ended December 31	
		2018	2017
		(Amounts in thousands)	
Furniture	$	1,653	1,175
Equipment		4,087	3,563
Software		9,457	8,427
Accumulated depreciation and amortization		(12,383)	(11,361)
Property and equipment, net	$	2,814	1,804
Depreciation expense	$	1,968	1,519

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.

(6) Unpaid Loss 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,	
		2018	2017
		(Amounts in thousands)	
Net unpaid losses and loss adjustment expenses, beginning of period	$	94,430	83,575
Net losses and loss adjustment expenses incurred related to:			
Current period		212,069	178,080
Prior periods		(2,496)	1,101
Total net losses and loss adjustment expenses incurred	$	209,573	179,181
Net losses and loss adjustment expenses paid related to:			
Current period		131,500	108,984
Prior periods		62,495	59,342
Total net losses and loss adjustment expenses paid		193,995	168,326
Net unpaid loss and loss adjustment expenses, end of period	$	110,008	94,430

The (favorable) unfavorable developments in net loss and loss adjustment expenses incurred, in the aforementioned table, was primarily attributable to the difference in actual and expected claims frequency and severity associated with the various coverages underwritten. As of December 31, 2018, management believes the balance sheet carried reserves made a reasonable provision for all unpaid loss and loss adjustment expense obligations of the Company under the terms of its contracts and reinsurance agreements.

The following table presents the favorable (unfavorable) development for claims occurring in prior accident years for each region for the years ended December 31, 2018 and 2017:

		2018	2017
		(Amounts in thousands)	
Region:			
Southeast (Florida, Georgia, South Carolina, Tennessee and Virginia)	$	1,736	(279)
Southwest (Arizona, California, New Mexico, Nevada, Utah and Texas)		735	(846)
Other		25	24
Net favorable (unfavorable) development	$	2,496	(1,101)

Salvage and subrogation anticipated deducted from unpaid L&LAE at December 31, 2018 and 2017 was $2,176,000 and $2,022,000, respectively.

(7) Federal Income Taxes

The following table presents the components of the net deferred tax assets and deferred tax liabilities at December 31, 2018 and 2017 and the changes in these balances:

		December 31,					
		2018			2017		
		(Amounts in thousands)					
		Ordinary	Capital	Total	Ordinary	Capital	Total
Gross deferred tax assets	$	6,536	566	7,102	5,435	130	5,565
Statutory valuation allowance		-	-	-	-	-	-
Total gross deferred tax assets		6,536	566	7,102	5,435	130	5,565
Total gross deferred tax liabilities		(355)	(429)	(784)	(272)	(1,150)	(1,422)
Net deferred tax asset				6,318			4,143
Deferred tax assets nonadmitted				-			-
Net admitted deferred tax asset				6,318			4,143
Decrease in nonadmitted deferred tax asset	$			-			-

The Company has not recognized a deferred tax liability for the undistributed earnings of its wholly-owned subsidiary that arose in 2018 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,	
		2018	2017
		(Amounts in thousands)	
Federal income taxes expense	$	5,921	4,656

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 has no material uncertain tax positions at December 31, 2018 and 2017.

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	
		2018	2017
		(Amounts in thousands)	
Deferred Tax Assets:			
Ordinary			
Discounting of unearned premiums	$	3,613	3,126
Discounting of unpaid loss and loss adjustment expenses		676	462
Investments		565	130
Property and equipment		782	650
Compensation and benefits accrual		1,022	865
Nonadmitted assets		444	332
Total deferred tax assets		7,102	5,565
Statutory valuation allowance		-	-
Admitted deferred tax assets		7,102	5,565
Deferred Tax Liabilities:			
Accretion of bond discount		776	1,418
Discounting of anticipated salvage and subrogation		8	4
Total deferred tax liabilities		784	1,422
Net admitted deferred tax assets	$	6,318	4,143

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

		December 31,			
		2018	2017		Change
		(Amounts in thousands)			
Total gross deferred tax assets	$	7,102	5,565		1,537
Total gross deferred tax liabilities		(784)	(1,422)		638
Net deferred tax asset		6,318	4,143		2,175
Deferred tax change in net unrealized losses					(976)
Change in net deferred income tax				$	(1,199)

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:

		Years ended December 31,	
		2018	2017
		(Amounts in thousands)	
Provision computed at statutory rate of 21%	$	6,247	7,729
Intercompany tax settlements		(394)	(980)
Change in enacted tax rates		-	2,564
Net temporary differences		(1,043)	(154)
Other, net		(88)	(173)
Total statutory income tax benefit	$	4,722	8,986
Federal income taxes incurred	$	5,921	4,656
Change in net deferred income tax		(1,199)	4,330
Total statutory income tax benefit	$	4,722	8,986

The Company fully utilized the NOL carryforwards that were set to expire in 2027. In accordance with SSAP No. 101 the impact of the change in the enacted tax rate in December 2017 was recorded in Net deferred tax assets at December 31, 2017. For the Company, the rate decreased from 34% to 21% and amounted to a $2,564,000 reduction in the Net deferred tax assets and Unassigned funds (surplus).

(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, 2018 and 2017.

During 2018, the Company paid ordinary dividends to its Parent Company of $12,844,000 in March and $5,233,000 in December totaling $18,077,000. During 2017, the Company paid ordinary dividends to its Parent Company of $7,700,000 in March and $5,233,000 in December totaling $12,933,000.

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 funds (surplus) as of the preceding December 31. At December 31, 2018, $18,595,000 is available for dividend payments next March or later, and the Company can pay an additional $5,233,000 in December 2019. Dividends can be paid with regulatory notification of no objection from the Texas Department of Insurance.

(9) Nonadmitted Assets

The following table presents the components of nonadmitted assets:

		December 31,	
		2018	2017
		(Amounts in thousands)	
Leasehold improvements and automobiles	$	3,724	3.093
Prepaid expenses		2,077	1,545
Premium receivables		440	147
Other		39	38
Total nonadmitted assets	$	6,280	4,823

(10) Reconciliation with Statutory Annual Statements

The Company had no reconciling differences between these financial statements and the Annual Statement filed with the State of Texas as of and for the years ended December 31, 2018 and 2017.

(11) Reconciliation with GAAP Financial Statements

The following schedules reconcile NAIC SAP capital and surplus and NAIC SAP net income with shareholders' equity and net income on the basis of GAAP as of and for the years ended December 31, 2018 and 2017:

		2018	2017
		(Amounts in thousands)	
Statutory capital and surplus	$	109,161	107,338
(Deduct) add :			
Deferred Federal income tax expense		(3,748)	(1,601)
Nonadmitted assets		6,280	4,823
Deferred policy acquisition costs		14,670	12,012
Unearned policy fees		(3,580)	(3,187)
Net unrealized losses on investments, gross of tax		(4,871)	(4,541)
Allowance for doubtful accounts		(850)	(598)
GAAP shareholders' equity	$	117,062	114,246
Statutory net income	$	23,828	18,077
(Deduct) add:			
Deferred Federal income tax expense		28	(3,438)
Increase in deferred policy acquisition costs		2,658	2,515
Decrease in allowance for doubtful accounts		(252)	(55)
Decrease (increase) in unearned policy fees		(393)	(464)
GAAP net income	$	25,869	16,635

(12) Related Party Balances

The following table reflects intercompany balances which were generated under various service contracts and cost sharing arrangements as of December 31, 2018 and 2017:

		2018	2017
		(Amounts in thousands)	
Receivable from affiliates:			
GAINSCO	$	441	34
NSL		-	-
Total receivable from affiliates	$	441	34
Payable to affiliates:			
GSC	$	4,141	2,913
NSL		567	111
MGAA		431	478
Total payable to affiliates	$	5,139	3,502

At December 31, 2018, the amount receivable from affiliates relates to allocated expenses based on cost sharing arrangements. For the year ended December 31, 2018, Gainsco owed the Company $441,000 as a result of funding to Gainsco of $700,000 less payments from Gainsco of $259,000. At December 31, 2018, the amount payable to affiliates relates to expenses incurred based on cost sharing arrangements. For the year ended December 31, 2018, the Company owed GSC $4,141,000 as a result of funding to the Company of $4,563,000 less payments from the Company of $422,000. For the year ended December 31, 2018, the Company owed NSL $568,000 as a result of funding to the Company of $1,000,000 less payments from the Company of $432,000. For the year ended December 31, 2018, the Company owed MGAA $431,000 as a result of funding to the Company of $886,000 less payments from the Company of $455,000. The terms of the arrangements require that the balances be settled within thirty days to forty-five days.

At December 31, 2017, the amount receivable from affiliates relates to allocated expenses based on cost sharing arrangements. For the year ended December 31, 2017, Gainsco owed the Company $34,000 as a result of funding to Gainsco of $889,000 less payments from Gainsco of $855,000. At December 31, 2017, the amount payable to affiliates relates to expenses incurred based on cost sharing arrangements. For the year ended December 31, 2017, the Company owed GSC $2,913,000 as a result of funding to the Company of $4,339,000 less payments from the Company of $1,426,000. For the year ended December 31, 2017, the Company owed NSL $111,000 as a result of funding to the Company of $664,000 less payments from the Company of $775,000. For the year ended December 31, 2017, the Company owed MGAA $478,000 as a result of funding to the Company of $935,000 less payments from the Company of $456,000. 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.

The Company has evaluated transactions with related parties from the balance sheet date through May 1, 2019, the date at which the statutory basis financial statements were available to be issued, and determined that there are no other items to disclose.

(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 $1,333,000 in 2018 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 and to alleged bad faith claims stemming from lawsuits during the reporting period were between 0-25. The claim count information is provided on a per claimant basis. The majority of the alleged extra contractual obligations are related to a Florida Court-Induced Personal Injury Protection ("PIP") fee schedule litigation problem that severely impacted the entire industry.

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 the 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 management has 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 August 2012, a policyholder of the Company was involved in an auto accident in Georgia resulting in medical treatment for the claimant, Ms. Yolanda Castano-Castano. Following the accident, the Company offered to settle the matter with the claimant for its policyholder's available limits of liability, $25,000. The Company retained defense counsel to oversee conclusion of the settlement after the Company reached an oral agreement to settle with the claimant's counsel. The defense firm apparently failed to finalize the settlement within the time period required by claimant's written demand. As a result, the Company's tender of policy limits was rejected by the claimant's counsel. The claimant then filed suit against the policyholder. In March 2017, the case was tried, and the plaintiff received a jury verdict against the Company's insured in the amount of $700,000. The Company appealed the judgment on behalf of its insured. In May 2018, the Georgia Court of Appeals partially ruled in favor of the Company's insured, vacating the verdict and remanding the case for a new trial. The Company appealed to the Georgia Supreme Court with regard to two additional points of appeal. In February 2019 the

Georgia Supreme Court declined to hear the appeal of the other two arguments and remanded the case to the trial court. No claim has ever been brought against the Company with respect to this matter. The Company intends to pursue a claim against its initial defense firm if the Company ultimately pays any amount in excess of its underlying policy limits. While such litigation is inherently unpredictable, the Company believes that the claim is without merit and intends to continue to defend its insured vigorously. As a result, the Company is unable to reasonably estimate a possible range of losses, if any, arising from the litigation.

In May 2011, a policyholder of the Company was involved in an auto accident in New Mexico resulting in medical treatment for the claimant, Ms. Amanda Jones-Worthington. Following the accident, the Company requested medical records from the claimant, but received only some of them. Upon finally receiving sufficient medical information, the Company offered to settle the matter with the claimant for its policyholder’s limits of liability, $25,000. Settlement of the claim was complicated by the insured being criminally charged for driving under the influence. The Company’s policy limits tender was rejected by the claimant, and the claimant filed a lawsuit against the policyholder. In January 2014, the case was tried and the plaintiff received a jury verdict against the Company’s insured in the amount of $760,000 ($360,000 in compensatory damages and $400,000 in punitive damages). The Company’s auto insurance policies specifically exclude liability for punitive damages. In March 2017, the Company’s insured partially assigned to the plaintiff his interest in a claim against the Company and his defense counsel. The plaintiff then filed suit in New Mexico state court against the Company and the defense counsel alleging legal malpractice and insurance bad faith, among other claims. The Company reported this claim to its errors and omissions carrier, and the carrier has accepted the defense of the claim. The Company’s errors and omissions insurance policy provides for a $1,000,000 retention. Court-ordered mediation of this case occurred in early May 2018 and was unsuccessful; another mediation occurred in March 2019 and was also unsuccessful. It is anticipated that the case will be tried in the fall of 2019 if the parties are unable to settle it before then. While such litigation is inherently unpredictable, the Company believes that the complaint against it is without merit and intends to continue 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.

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, 2018 the Company did not have any claims receivables by individual reinsurers that were material with regard to shareholders' equity.

The following table sets forth significant receivable balances at December 31, 2018 and 2017:

		2018		2017	
		Balance	% of Policyholder Surplus	Balance	% of Policyholder Surplus
		(Dollar amounts in thousands)			
Premiums receivable from:					
NSL	$	37,895	34.7%	31,620	29.5%
MGAA		26,213	24.0%	23,165	21.6%
Old American County Mutual		44	0.1%	52	0.1%

(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 2018 and 2017, the Company recorded rent expense of $638,000 and $623,000, respectively.

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

Year		Amount
2019	$	599
2020		612
2021		206
2022		-
2023 and thereafter		-
Total	$	1,417

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

(15) Geographical Distribution

There were no unaffiliated Managing General Agents/Third Party Administrators producing direct written premium equal to or greater than 5% of policyholder surplus for the year ended December 31, 2018.

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.

Area	2018	2017
Texas	29.8%	31.4%
South Carolina	24.8	19.4
Florida	16.1	21.2
Georgia	12.4	11.2
Arizona	6.7	7.2
New Mexico	3.5	4.1
Virginia	2.2	2.7
Utah	2.2	0.1
Tennessee	1.2	1.4
Oklahoma	1.1	1.3

(16) Risk-Based Capital

The Company's statutory capital exceeds the benchmark capital level under the Risk Based Capital ("RBC") formula for the insurance company. 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, 2018, the Company's RBC authorized control level was $22,093,000 and the total adjusted capital was $109,161,000.

(17) Subsequent Events

On March 21, 2019, the Company paid a dividend to Gainsco of $10,000,000, which reduced MGA's statutory policyholders' surplus.

The Company has evaluated subsequent events from the balance sheet date through May 2, 2019, 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, 2018

(Dollar amounts in thousands)

	Gross investment holdings		Admitted assets as reported in the Annual Statement	
	Amount	Percentage	Amount	Percentage
Bonds:				
U.S. Treasury	$ 6,475	2.52%	$ 6,475	2.52%
U.S. Government agencies	2,000	0.78	2,000	0.78
Asset-backed	891	0.35	891	0.35
Mortgage-backed	481	0.19	481	0.19
Other debt and other fixed income securities – unaffiliated domestic securities	206,589	80.45	206,589	80.45
Total bonds	$ 216,436	84.29	$ 216,436	84.29
Preferred stocks	S 4,844	1.89	S 4,844	1.89
Common stock	6,938	2.70	6,938	2.70
Cash overdraft	(3,679)	(1.43)	(3,679)	(1.43)
Other long-term investments	12,521	4.87	12,521	4.87
Short-term investments	19,732	7.68	19,732	7.68
Total invested assets	$ 256,792	100.00%	$ 256,792	100.00%

See accompanying independent auditor’s report.

MGA INSURANCE COMPANY, INC.

Investment Risk Interrogatories

December 31, 2018

(Dollar amounts in thousands)

1. Total admitted assets as reported on the statement of admitted assets, liabilities, and capital and surplus $ 332,596

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
Issuer:			
Bounty Minerals LLC	$	7,169	2.156%
Fortress Worldwide Transportation and Infrastructure Investors LLC	$	5,814	1.748%
Infinity Property and Casualty Corporation	$	3,105	0.933%
KKR Capital Markets LLC	$	2,418	0.727%
International Business Machines Corporation	$	2,101	0.632%
Prudential Financial, Inc.	$	2,043	0.614%
WRK Co Inc.	$	2,039	0.613%
Wells Fargo & Company	$	2,011	0.605%
National Rural Utilities Cooperative Finance Corporation	$	1,997	0.600%
U.S. Bancorp	$	1,982	0.596%

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

Bonds with an NAIC rating of 1	$	78,128	23,491%
Bonds with an NAIC rating of 2	$	144,821	43.543%
Preferred Stock with an NAIC rating of 2	$	3,205	0.964%
Bonds with an NAIC rating of 3	$	1,873	0.563%
Preferred Stock with an NAIC rating of 3	$	878	0.264%
Bonds with an NAIC rating of 4	$	2,396	0.720%
Preferred Stock with an NAIC rating of 4	$	761	0.229%
Bonds with an NAIC rating of 6	$	823	0.247%

13. Equity interest less than 2.5% of total admitted assets.

Issuer:			
Bounty Minerals LLC	$	7,169	2.156%
Fortress Worldwide Transportation and Infrastructure Investors LLC	$	5,313	1.597%
KKR Capital Markets LLC	$	2,418	0.727%
Contango Oil & Gas Company	$	1,625	0.489%
Fitness Capital Partners	$	1,549	0.466%
Capital Springs Lending Partners	$	1,384	0.416%
U.S. Bancorp		990	0.298
MetLife, Inc.	$	960	0.289%
SunTrust Banks, Inc.	$	878	0.264%
General Electric Company	$	765	0.230%

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, 2018

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, 2017 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.	____________
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:	
	(a) A contract term longer than two years and the contract is noncancellable by the reporting entity during the contract term;	YES [ ] NO [X]
	(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, 2018

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	YES [ ] NO [X]
	(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;	Not Applicable
	(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	YES [ ] NO [X]
	(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.	Not Applicable

See accompanying independent auditor’s report.