THE WESTAIM CORPORATION

SUPPLEMENTAL FINANCIAL INFORMATION RELATED TO HOUSTON INTERNATIONAL INSURANCE GROUP, LTD.

MARCH 20, 2014

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HOUSTON INTERNATIONAL INSURANCE GROUP, LTD. (“HIIG”)

Safe Harbour Statement

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Certain statements contained herein are "forward-looking statements". Any statements that express or involve discussions with respect to predictions, expectations, beliefs, plans, projections, objectives, assumptions or future events or performance (often, but not always using words or phrases such as "expects", "does not expect", "is expected", "seek", "endeavour", "anticipates", "does not anticipate", "plans", "estimates", "believes", "does not believe" or "intends", "does not intend" or stating that certain actions, events or results may, could, would, might or will occur or be taken, or achieved) are not statements of historical fact and may be "forward-looking statements". Forward-looking statements are based on expectations, estimates and projections at the time the statements are made that involve a number of risks and uncertainties which would cause actual results or events to differ materially from those presently anticipated. These include but are not limited to: (i) risks related to commercial, strategic, operational, regulatory, compliance and human resources risks; (ii) general economic and financial conditions which may affect the ability to raise new capital; (iii) general industry and market conditions and growth rates; (iv) matters identified in the risk factors and/or forward-looking statements contained in public documents filed by the Corporation with applicable Canadian securities regulators; (vi) other risks and uncertainties that have not been identified at this time; (vii) management's response to these factors; (viii) the inability on the part of the Corporation to complete any portion of the proposed acquisition to which this supplemental financial information relates (the "Acquisition") on the terms contemplated or at all; (ix) the failure to receive final regulatory and/or other approvals; (x) future unforeseen liabilities; and (xi) other factors. Except as required by law, the Corporation does not have any obligation to advise any person if it becomes aware of any inaccuracy in or omission from any forward-looking statement or to update such forward-looking statement.

All amounts herein are in United States dollars unless otherwise noted.

Non-GAAP Measures

Non-GAAP Measures – Houston International Insurance Group, Ltd. (“HIIG”)

HIIG uses both United States generally accepted accounting principles (“GAAP”) and non-GAAP measures to assess performance and certain non-GAAP measures are disclosed herein. The Company cautions readers about non-GAAP measures that do not have a standardized meaning under GAAP and are unlikely to be comparable to similar measures used by other companies.

HIIG uses both GAAP and non-GAAP measures to assess performance. While the non-GAAP measures disclosed herein have been derived from HIIG's financial statements for the years ended December 31, 2011 (audited), 2012 (audited) and 2013 (unaudited), the Corporation cautions readers that non-GAAP measures do not have a standardized meaning under GAAP and are unlikely to be comparable to similar measures used by other companies. A reconciliation between GAAP and all non-GAAP measures used herein can be found in the following pages.

Management of the Corporation and HIIG believe that such information will better enable investors to understand HIIG’s core business lines and will facilitate comparison of the Corporation’s future performance to HIIG’s historical results. The Corporation cautions, however, that the financial performance and trends illustrated herein may not be representative of actual future results.

Several adjustments have been made to HIIG’s historical results in preparing this supplemental financial information to exclude results from operations of certain lines of business no longer written by HIIG and certain non-recurring expenses. While the adjustments and assumptions used herein are believed by management to be a reasonable presentation of HIIG’s financial performance relating to the continuing business lines, no assurance can be given that the adjusted historical non-GAAP information contained herein provides an accurate reflection of the results that would have been achieved and may not be representative of actual future results.

Certain totals, subtotals and percentages may not reconcile exactly due to rounding.

EXHIBIT I

Houston International Insurance Group, Ltd. ("HIIG")

Consolidated Statement of Operations for the years ended December 31, 2011, 2012 and 2013

(in US$ 000s)	Historical		Unaudited
Dec 31, Fiscal Year End	**2011** (1)	**2012** (1)	**2013** (1)
Gross Written Premiums	$ 98,799	$ 181,831	$ 383,584
Net Written Premiums	54,496	125,328	275,072
Net Earned Premiums	38,356	84,841	207,833
Losses Incurred & LAE	26,340	54,252	127,077
Net Acquisition Costs	4,400	10,250	34,455
Operating Expenses	23,079	35,629	38,858
Total Underwriting Expenses	53,819	100,131	200,391
Underwriting Income (Loss)	**(15,464)**	**(15,290)**	**7,443**
Total Invesment Income	6,239	13,531	10,405
Other Income, net of expenses	261	2,282	3,198
Operating Income (Loss)	**(8,963)**	**524**	**21,045**
Interest Expense	6,185	4,435	4,308
Pre-tax Income	**(15,148)**	**(3,911)**	**16,737**
Tax expense (benefit)	(3,061)	(2,670)	5,858
Net Income (Loss) (1)	**$ (12,088)**	**$ (1,241)**	**$ 10,879**
Non-Continuing Operations, net of taxes	(14,549)	(12,446)	(15,700)
Non-recurring items, net of taxes	(4,122)	(16,233)	-
Net Income (Loss) Reported	**$ (30,759)**	**$ (29,920)**	**$ (4,821)**
Loss Ratio	68.7%	63.9%	61.1%
Acquisition Ratio	11.5%	12.1%	16.6%
Operating Expense Ratio	60.2%	42.0%	18.7%
Combined Ratio (Continuing Operations)	**140.3%**	**118.0%**	**96.4%**

(1) The statement of operations of HIIG for the years ended December 31, 2011, 2012 and 2013 have been presented on a non-GAAP basis to exclude income and expenses related to non-continuing operations, and certain other one-time non-recurring items. In the view of HIIG management, this non-GAAP presentation may provide investors with useful information regarding its historical results. Please see the cautionary statements and disclaimers related to the use of non-GAAP measures, and a reconciliation between GAAP and non-GAAP measures for the fiscal years ended December 31, 2011, 2012 and 2013 provided in this supplemental financial information.

EXHIBIT II

Houston International Insurance Group, Ltd. ("HIIG")

Preliminary Adjusted Balance Sheet as at December 31, 2013

Unaudited and Preliminary Adjusted Balance Sheet (in US$ 000s)			
Assets		**Liabilities**	
Fixed Income Securities, at fair value	$ 401,716	Loss and Loss Adjustment Expense Reserves	$ 376,489
Equity Securities	13,309	Unearned Premium	197,265
Investment in Partnership	3,792	Deferred Ceding Commissions	3,175
Investment in Affiliates	10,128	Premium Balances Payable	24,632
Land and Real Estate	358	Commissions Payable to Agents	1,370
Cash and Cash Equivalents	77,184	Surplus Lines Taxes Payable	46
Restricted Cash and Short Term Investments	15,051	Accrued Expenses and Accounts Payable	33,511
Short Term Investments	42,079	Loan Payable	40,000
Receivable (Payable) for Unsettled Trades	771	Trust Preferred Note Payable	59,794
Total Invested Assets	**564,387**	**Total Liabilities**	**736,282**
Premium Receivables, Net	49,356	**Stockholders' Equity**	
Reinsurance Recoverable, Net	139,023	Common Stock, Net of Treasury Stock	312
Reinsurance Receivable, Net	14,274	Additional Paid In Capital	376,199
Ceded Unearned Premiums	58,773	Unrealized Gains/(Losses), Net	(3,248)
Deferred Policy Acquisition Costs	24,960	Retained Earnings	(174,981)
Property and Equipment, Net	11,086	**Total Stockholders' Equity**	**198,281**
Federal Tax Recoverable	169		
Deferred Tax Asset	17,046		
Goodwill	22,557		
Intangible Assets	24,566		
Other Assets	8,366		
Total Assets	**$ 934,564**	**Total Liabilities and Stockholders' Equity**	**$ 934,564**

Note: This Preliminary Adjusted Balance Sheet consists of HIIG's (unaudited) preliminary balance sheet as at December 31, 2013 adjusted for (i) the Treasury Purchase as part of the Initial Acquisition, as such terms are defined in Westaim's press release dated March 12, 2014 relating to the Acquisition (the "Press Release"), (ii) an agreed upon adjustment to the deferred tax asset, and (iii) other minor adjustments, all as defined in the Initial Secondary Purchase Agreement and Second Acquisition Purchase Agreement, as applicable, as such terms are defined in the Press Release. This balance sheet is unaudited and subject to change.

EXHIBIT III

Houston International Insurance Group, Ltd. ("HIIG")

Consolidated Statement of Operations

(in US$ 000s)	Audited Dec 31, 2011	Adjustments Non-Continuing	Adjustments Reclassification	Adjustments Non-Recurring	Adjustments Total	Non-GAAP Dec 31, 2011
		(1)	(2)	(3)		
Gross Premiums Written	218,211	(119,412)	-	-	(119,412)	98,799
Less: Ceded Written	87,387	(43,084)	-	-	(43,084)	44,303
Net Written Premiums	130,824	(76,328)	-	-	(76,328)	54,496
Revenues						
Net premiums earned	192,257	(153,901)	-	-	(153,901)	38,356
Net commission & fee income	7,500	(6,644)	-	-	(6,644)	856
Other income	-	-	2,205	-	2,205	2,205
Net investment income	11,483	(3,076)	-	-	(3,076)	8,407
Net realized gain (losses)	6,148	(2,482)	(5,834)	-	(8,316)	(2,168)
Other than temporary impairment loss	(5,834)	-	5,834	-	5,834	-
Total revenues	211,554	(166,103)	2,205	-	(163,898)	47,656
Expenses						
Net Losses and loss adjustment expenses	159,251	(132,911)	-	-	(132,911)	26,340
Policy acquisition costs	34,909	(32,714)	2,205	-	(30,509)	4,400
Operating expenses	48,433	(22,521)	(1,000)	(1,832)	(25,354)	23,079
Interest expense	6,185	-	-	-	-	6,185
Non-operating expenses	1,800	-	1,000	-	1,000	2,800
Total expenses	250,578	(188,146)	2,205	(1,832)	(187,774)	62,804
Income (loss) before federal income tax expense	(39,024)	22,043	-	1,832	23,876	(15,148)
Federal income tax expense (benefit)	(10,864)	7,162	-	641	7,803	(3,061)
Net income (loss) from continuing	**(28,160)**	**14,881**	**-**	**1,191**	**16,072**	**(12,088)**
Net loss from discontinued operations, net of taxes	(2,599)	(11,950)	-	-	(11,950)	(14,549)
Non-recurring items, net of taxes	-	(2,931)	-	(1,191)	(4,122)	(4,122)
Net income (loss) reported	**(30,759)**	**-**	**-**	**-**	**-**	**(30,759)**

Notes:

(1) Non-Continuing Operations represents the financial results of certain business written by HIIG in the applicable fiscal year that was cancelled by HIIG management in the years ended December 31, 2011, 2012 and 2013. It was deemed by HIIG management that eliminating these results would better reflect the results of operations of HIIG as they exist on December 31, 2013 for the fiscal year ended December 31, 2011.

(2) Reclassification represents amounts reclassified from presentation in the audited financial statements to, in the view of HIIG's management, better reflect the results of HIIG for the fiscal year ended December 31, 2011.

(3) Non-Recurring Items represents income and costs related to events that have been deemed by HIIG management to be either one time or non-recurring in nature. It was considered by HIIG management that eliminating these results would better reflect the results of operations of the Continuing Operations of HIIG for the fiscal year ended December 31, 2011.

Houston International Insurance Group, Ltd. ("HIIG")

Consolidated Statement of Operations

(in US$ 000s)	Audited Dec 31, 2012	Adjustments Non-Continuing (1)	Reclassification (2)	Non-Recurring (3)	Total	Non-GAAP Dec 31, 2012
Gross Premiums Written	241,614	(59,783)	-	-	(59,783)	181,831
Less: Ceded Written	104,131	(47,628)	-	-	(47,628)	56,503
Net Written Premiums	137,483	(12,155)	-	-	(12,155)	125,328
Revenues						
Net premiums earned	116,711	(31,870)	-	-	(31,870)	84,841
Net commission & fee income	443	(9)	-	-	(9)	434
Other income	422	(179)	3,555	-	3,376	3,798
Net investment income	8,259	-	-	900	900	9,159
Net realized gain (losses)	(7,198)	12,454	(884)	-	11,570	4,372
Other than temporary impairment loss	(884)	-	884	-	884	-
Total revenues	117,753	(19,604)	3,555	900	(15,149)	102,604
Expenses						
Net Losses and loss adjustment expenses	93,036	(38,784)	-	-	(38,784)	54,252
Policy acquisition costs	14,813	(8,118)	3,555	-	(4,563)	10,250
Operating expenses	37,233	296	(1,000)	(900)	(1,604)	35,629
Interest expense	4,435	-	-	-	-	4,435
Non-operating expenses	950	-	1,000	-	1,000	1,950
Total expenses	150,467	(46,606)	3,555	(900)	(43,951)	106,516
Income (loss) before federal income tax expense	(32,714)	27,003	-	1,800	28,803	(3,911)
Federal income tax expense (benefit)	(4,606)	2,606	-	(670)	1,936	(2,670)
Net income (loss) from continuing	**(28,108)**	**24,397**	**-**	**2,470**	**26,867**	**(1,241)**
Net loss from discontinued operations, net of taxes	(1,812)	(10,634)	-	-	(10,634)	(12,446)
Non-recurring items, net of taxes	-	(13,763)	-	(2,470)	(16,233)	(16,233)
Net income (loss) reported	**(29,920)**	**-**	**-**	**-**	**-**	**(29,920)**

Notes:

(1) Non-Continuing Operations represents the financial results of certain business written by HIIG in the applicable fiscal year that was cancelled by HIIG management in the years ended December 31, 2011, 2012 and 2013. It was deemed by HIIG management that eliminating these results would better reflect the results of operations of HIIG as they exist on December 31, 2013 for the fiscal year ended December 31, 2012.

(2) Reclassification represents amounts reclassified from presentation in the audited financial statements to, in the view of HIIG's management, better reflect the results of HIIG for the fiscal year ended December 31, 2012.

(3) Non-Recurring Items represents income and costs related to events that have been deemed by HIIG management to be either one time or non-recurring in nature. It was considered by HIIG management that eliminating these results would better reflect the results of operations of the Continuing Operations of HIIG for the fiscal year ended December 31, 2012.

Houston International Insurance Group, Ltd. ("HIIG")

Consolidated Statement of Operations

(in US$ 000s)	Preliminary Unaudited Dec 31, 2013	Adjustments Non-Continuing	Reclassification	Non-Recurring	Total	Preliminary Non-GAAP Dec 31, 2013
		(1)	(2)	(3)		
Gross Premiums Written	400,701	(17,117)	-	-	(17,117)	383,584
Less: Ceded Written	115,521	(7,009)	-	-	(7,009)	108,512
Net Written Premiums	285,180	(10,108)	-	-	(10,108)	275,072
Revenues						
Net premiums earned	221,219	(13,386)	-	-	(13,386)	207,833
Net commission & fee income	1,859	3	-	-	3	1,861
Other income	633	(632)	3,749	-	3,117	3,749
Net investment income	5,589	-	-	-	-	5,589
Net realized gain (losses)	7,007	-	(2,191)	-	(2,191)	4,816
Other than temporary impairment loss	(2,191)	-	2,191	-	2,191	-
Total revenues	234,115	(14,015)	3,749	-	(10,266)	223,849
Expenses						
Net Losses and loss adjustment expenses	160,828	(33,750)	-	-	(33,750)	127,077
Policy acquisition costs	33,626	(2,920)	3,749	-	829	34,455
Operating expenses	42,033	(2,174)	(1,000)	-	(3,174)	38,858
Interest expense	4,308	-	-	-	-	4,308
Non-operating expenses	1,413	-	1,000	-	1,000	2,413
Total expenses	242,207	(38,844)	3,749	-	(35,095)	207,112
Income (loss) before federal income tax expense	(8,092)	24,829	-	-	24,829	16,737
Federal income tax expense (benefit)	(3,271)	9,129	-	-	9,129	5,858
Net income (loss) from continuing	**(4,821)**	**15,700**	**-**	**-**	**15,700**	**10,879**
Net loss from discontinued operations, net of taxes	-	(15,700)	-	-	(15,700)	(15,700)
Non-recurring items, net of taxes	-	-	-	-	-	-
Net income (loss) reported	**(4,821)**	**-**	**-**	**-**	**-**	**(4,821)**

Notes:

(1) Non-Continuing Operations represents the financial results of certain business written by HIIG in the applicable fiscal year that was cancelled by HIIG management in the years ended December 31, 2011, 2012 and 2013. It was deemed by HIIG management that eliminating these results would better reflect the results of operations of HIIG as they exist on December 31, 2013 for the fiscal year ended December 31, 2013.

(2) Reclassification represents amounts reclassified from presentation in the unaudited financial statements to, in the view of HIIG's management, better reflect the results of HIIG for the fiscal year ended December 31, 2013.

(3) Non-Recurring Items represents income and costs related to events that have been deemed by HIIG management to be either one time or non-recurring in nature. It was considered by HIIG management that eliminating these results would better reflect the results of operations of the Continuing Operations of HIIG for the fiscal year ended December 31, 2013.

EXHIBIT IV

HOUSTON INTERNATIONAL INSURANCE GROUP, LTD. AND SUBSIDIARIES

CONSOLIDATED FINANCIAL STATEMENTS
WITH REPORT OF INDEPENDENT ACCOUNTANTS
FOR THE YEARS ENDED DECEMBER 31, 2012 AND 2011

HLB
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Report of Independent Accountants

The Board of Directors
Houston International Insurance Group, Ltd.

Report on the Financial Statements

We have audited the accompanying consolidated balance sheets of Houston International Insurance Group, Ltd. (the "Company") as of December 31, 2012 and 2011, and the related consolidated statements of operations and comprehensive income(loss), stockholders' equity and cash flows 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 accounting principles generally accepted in the United States of America; this includes 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 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 Company'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 Company's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

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

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Company as of December 31, 2012 and 2011, and the results of its operations and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

Ham, Langston & Brezina, LLP

Houston, Texas
June 3, 2013

HOUSTON INTERNATIONAL INSURANCE GROUP, LTD.

Consolidated Balance Sheets

December 31, 2012 and 2011

	2012	2011
	(In Thousands, Except Share and Per Share Amounts)	
Assets		
Fixed maturity securities, at fair value (amortized cost $271,011 $283,426, respectively)	$ 274,473	$ 282,720
Equity securities, at fair value (cost $97,050 and $153,670, respectively)	98,743	152,404
Notes receivable from related parties, net of allowance of $0 and $1,200, respectively	3,000	14,290
Real estate	358	1,951
Investment in affiliate	5,829	6,052
Investment in partnership	2,154	-
Short-term investments, at cost, which approximates fair value	28,046	5,834
Total investments	412,603	463,251
Cash and cash equivalents	31,083	60,026
Restricted cash	47,798	19,180
Premiums receivable, net of allowance of $205 in each year	38,895	48,106
Reinsurance recoverables	181,267	196,920
Ceded unearned premium	35,744	32,272
Deferred policy acquisition costs	16,490	15,201
Federal income taxes receivable	5,572	5,094
Deferred federal income taxes	42,237	40,526
Intangible assets, net	24,839	28,521
Goodwill	22,557	12,197
Other assets	15,387	17,190
Total assets	$ 874,472	$ 938,484

The accompanying notes are an integral part of the financial statements.

HOUSTON INTERNATIONAL INSURANCE GROUP, LTD.

Consolidated Balance Sheets, Continued

December 31, 2012 and 2011

	2012	2011
	(In Thousands, Except Share and Per Share Amounts)	
Liabilities and Stockholders' Equity		
Liabilities:		
Losses and loss adjustment expenses	$ 389,154	$ 463,828
Unearned premiums	110,275	85,898
Deferred ceding commission	4,454	6,200
Reinsurance payables	27,311	24,205
Premium payables	555	8,900
Payable for securities	-	1,878
Accounts payable and accrued liabilities	50,042	44,893
Funds held on reinsurance treaties	-	6,684
Notes payable	47,500	33,000
Trust debenture securities	59,794	59,794
Total liabilities	689,085	735,280
Commitments and contingencies		
Stockholders' Equity:		
Common stock, par value $0.01 per share; 68,000,000 shares authorized; 34,211,973 and 33,102,976 shares issued, and 34,211,973 and 32,995,276 shares outstanding as of December 31, 2012 and 2011, respectively	342	330
Treasury stock, at cost, 0 and 107,700 shares as of December 31, 2012 and 2011, respectively	-	(1)
Additional paid-in capital	321,774	314,498
Stock subscriptions receivable	(2,098)	(1,820)
Deficit	(138,583)	(108,663)
Accumulated other comprehensive income (loss)	3,952	(1,140)
Total stockholders' equity	185,387	203,204
Total liabilities and stockholders' equity	$ 874,472	$ 938,484

The accompanying notes are an integral part of the financial statements.

HOUSTON INTERNATIONAL INSURANCE GROUP, LTD.

Consolidated Statements of Operations and Comprehensive Income (Loss)

for the years ended December 31, 2012 and 2011

	2012	2011
	(In Thousands)	
Revenues:		
Premiums earned, net	$ 116,711	$ 192,257
Commission and fee income	443	7,500
Other income	422	-
Net investment income	8,259	11,483
Net realized gains (losses)	(7,198)	6,148
Other than temporary impairment losses	(884)	(5,834)
Total revenues	117,753	211,554
Expenses:		
Losses and loss adjustment expenses, net	93,036	159,251
Policy acquisition costs	14,813	34,909
Other operating expense	37,233	48,433
Interest expense	4,435	6,185
Amortization expense	950	1,800
Total expenses	150,467	250,578
Loss before federal income tax benefit	(32,714)	(39,024)
Federal income tax benefit	(4,606)	(10,864)
Net loss from continuing operations	(28,108)	(28,160)
Net loss from discontinued operations	(1,812)	(2,599)
Net loss	$ (29,920)	$ (30,759)
Other comprehensive income (loss):		
Unrealized gains and losses on investments:		
Net change in unrealized gains and losses on investments, net of tax	1,607	(2,732)
Less reclassification adjustment for losses on securities no longer held, net of tax	3,485	1,138
Total other comprehensive income (loss)	5,092	(1,594)
Net loss	(29,920)	(30,759)
Comprehensive income (loss)	$ (24,828)	$ (32,353)

The accompanying notes are an integral part of the financial statements.

HOUSTON INTERNATIONAL INSURANCE GROUP, LTD.

Consolidated Statements of Changes in Stockholders' Equity

for the years ended December 31, 2012 and 2011

(In Thousands, Except Share Amounts)

	Common Stock	Treasury Stock	Additional Paid-In Capital	Stock Subscription Receivable	Deficit	Accumulated Other Comprehensive Income (Loss)	Total
Balance at December 31, 2010	$ 324	$ -	$ 309,747	$ (945)	$ (77,904)	$ 454	$ 231,676
Employee share purchase	2	-	1,523	(875)	-	-	650
Stock-based compensation	-	2	979	-	-	-	981
Stock issuance from acquisition	4	-	3,996	-	-	-	4,000
Treasury stock purchase, 313,623 shares	-	(3)	(1,747)	-	-	-	(1,750)
Net loss	-	-	-	-	(30,759)	-	(30,759)
Other comprehensive loss, net of tax	-	-	-	-	-	(1,594)	(1,594)
Balance at December 31, 2011	330	(1)	314,498	(1,820)	(108,663)	(1,140)	203,204
Employee share purchase	6	1	3,720	(278)	-	-	3,449
Stock-based compensation	6	-	3,556	-	-	-	3,562
Net loss	-	-	-	-	(29,920)	-	(29,920)
Other comprehensive income, net of tax	-	-	-	-	-	5,092	5,092
Balance at December 31, 2012	$ 342	$ -	$ 321,774	$ (2,098)	$ (138,583)	$ 3,952	$ 185,387

The accompanying notes are an integral part of the financial statements.

HOUSTON INTERNATIONAL INSURANCE GROUP, LTD.

Consolidated Statements of Cash Flows

for the years ended December 31, 2012 and 2011

	2012	2011
	(In Thousands)	
Cash flows from operating activities		
Net loss	$ (29,920)	$ (30,759)
Adjustments to reconcile net loss to cash used in operating activities:		
Amortization expenses	950	1,800
Amortization of premium, net	2,017	1,445
Depreciation expense	1,046	1,189
Stock-based compensation	3,562	981
Impairment of securities	884	7,429
Realized investment (gains) losses	6,975	(6,713)
Equity in earnings of investments	223	(1,052)
Deferred income taxes	(4,417)	(9,415)
Decrease (increase) in assets:		
Premiums receivable, net	9,199	40,202
Reinsurance recoverable	15,653	(15,983)
Ceded unearned premiums	(3,472)	(3,569)
Change in restricted cash	-	5,088
Deferred policy acquisition costs amortization	(1,289)	18,925
Federal income taxes receivable	(478)	932
Other assets	6,165	(1,723)
Increase (decrease) in liabilities:		
Losses and loss adjustment expenses	(72,990)	(21,540)
Unearned premiums	24,391	(57,864)
Reinsurance payables	1,360	13,946
Accounts payable and accrued liabilities	(22,009)	8,177
Funds held on reinsurance treaties	(6,588)	(316)
Net cash used in operating activities	(68,738)	(48,820)
Cash flows from investing activities:		
Purchases of investment securities	(334,884)	(472,332)
Proceeds from sale of investment securities	401,807	394,382
Net cash paid in acquisitions	(3,000)	(6,524)
Proceeds from sale of business	10,847	10,950
Advance on note receivable from related party	-	(11,300)
Payment received on note receivable from related party	11,290	2,617
Purchase of property, plant and equipment	(5,380)	(2,262)
Net change in short-term investments	(30,216)	114,041
Increase in restricted cash	(28,618)	(19,180)
Net cash provided by investing activities	21,846	10,392

The accompanying notes are an integral part of the financial statements.

HOUSTON INTERNATIONAL INSURANCE GROUP, LTD.
Consolidated Statements of Cash Flows, Continued
for the years ended December 31, 2012 and 2011

	2012	2011
	(In Thousands)	
Cash flows from financing activities		
Proceeds from note payable and line of credit	14,500	-
Employee share purchases	3,449	650
Treasury stock purchase	-	(1,750)
Other	-	(158)
Net cash provided by financing activities	17,949	(1,258)
Net Increase (decrease) in cash and cash equivalents	(28,943)	(39,686)
Cash and cash equivalents at beginning of year	60,026	99,712
Cash and cash equivalents at end of year	$ 31,083	$ 60,026
Cash paid for interest and income taxes		
Interest	$ 4,435	$ 6,329
Income taxes	$ -	$ 5,815
Non-cash investing and financing activities		
Business acquired with directly related liability	$ 7,500	$ 2,000
Business acquired with common stock	$ -	$ 4,000

The accompanying notes are an integral part of the financial statements.

1. Nature of Operations

Houston International Insurance Group, Ltd., (the “Company” or “HIIG”), a Delaware holding company, was organized on January 3, 2006 and is the parent company of Houston Specialty Insurance Company (“HSIC”), Oklahoma Specialty Insurance Company (“OSIC”), Imperium Insurance Company (“IIC”) , Great Midwest Insurance Company (“GMIC”) and Bunker Hill Underwriting Agency, Inc. (“BHUA”).

HSIC is a Texas-domiciled insurance company that writes risks primarily related to workers’ compensation, commercial auto, commercial property, international aviation and general liability as a non-admitted carrier in 49 states and on an admitted basis in Texas.

OSIC is an Oklahoma-domiciled insurance company covering risks primarily related to commercial auto, commercial property and general liability as a non-admitted carrier in Texas and on an admitted basis in Oklahoma. OSIC was formed in 2011.

IIC is a Texas-domiciled insurance company that primarily writes direct insurance business covering risks primarily related to workers’ compensation, commercial auto, commercial property, international aviation and general liability through general agents and managing general agents in the United States. IIC is licensed to write direct insurance and reinsurance in 49 states plus the District of Columbia.

GMIC is a Texas-domiciled insurance company that primarily covers workers' compensation, auto, property, general and professional liability. GMIC is licensed to write direct insurance in 45 states.

BHUA, a Texas Corporation, is a managing general insurance agent for property and casualty risks in specialty niche markets. BHUA underwrote primarily on behalf of the HIIG insurance company subsidiaries. Beginning January 1, 2013, the insurance company subsidiaries began writing all of their business directly. BHUA will only actively underwrite business in the future that is placed outside of the HIIG group of companies.

2. Summary of Significant Accounting Policies

Basis of Presentation

The accompanying consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”), and include the accounts of the Company and its subsidiaries for the years ended December 31, 2012 and 2011. All inter-company transactions and balances have been eliminated in consolidation.

The results of operations of National Health Insurance Company (“NHIC”) and the loss on its disposal, in October 2012 are recorded as discontinued operations for the year ended December 31, 2012. The comparative results for 2011 have been restated accordingly.

2. Summary of Significant Accounting Policies (continued)

Use of Estimates

The preparation of the consolidated financial statements in conformity with GAAP 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 consolidated financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from these estimates.

Cash and Cash Equivalents

Cash and cash equivalents include cash on hand and highly liquid short-term investments. The Company considers all short-term investments purchased with an original maturity of three months or less to be cash equivalents.

Restricted Cash

As an insurance agent, BHUA collects premiums from its clients, and after deducting their commissions and any applicable fees, remits these premiums to insurance companies. Unremitted insurance premiums are held in a fiduciary capacity as restricted cash with the related liability reported as premium payable. The Company earns interest on these unremitted funds which is reported as investment income.

The Company also is required by state regulations to maintain assets on deposit with certain states. Cash in a depository account which is restricted by a State is recorded as restricted cash.

Investments

The Company's investments in fixed maturity securities and equity securities are classified as available for sale and are reported at fair value based on quoted market prices or dealer quotes with unrealized gains and losses excluded from earnings and reported as a separate component of stockholders' equity, net of taxes, as a component of accumulated other comprehensive income. If quoted market prices or dealer quotes are not available, fair value is estimated based on recent trading. Premiums and discounts on mortgage-backed securities are amortized using the retroactive method adjusted for anticipated prepayments and the estimated economic life of the securities. Adjustments related to changes in prepayment assumptions are included as part of investment income.

Investment income consists primarily of interest and dividends. Interest is recognized on the accrual basis, and dividends are recorded as earned at the ex-dividend date. Interest income on mortgage-backed and asset-backed securities is determined using the effective-yield method based on estimated principal repayments.

2. Summary of Significant Accounting Policies (continued)

Investments, continued

Realized gains and losses on investments are recognized in income based upon the specific identification method. The amortized cost of debt securities is adjusted for amortization of premiums and accretion of discounts.

Declines in the market value of invested assets below cost are evaluated for other-than-temporary impairment losses on a quarterly basis. Impairment losses for declines in the value of fixed income and equity securities below cost attributable to issuer-specific events are based on all relevant facts and circumstances for each investment and are recognized when appropriate. For fixed income and equity securities with unrealized losses due to market conditions or industry-related events where the Company does not have the intent to sell the security and has the ability to hold the investment for a period of time sufficient to allow a market recovery or to maturity, declines in value below cost are not assumed to be other-than-temporary. When impairment of the value of an investment is considered other than temporary, the decrease in value is reported in earnings as a realized investment loss and a new cost basis is established.

The Company's investment in affiliate represents an investment in ClearView Holdings, LLC ("CVR"), which was acquired on December 27, 2010. The Company's initial investment of $5.0 million represents approximately 15% ownership of CVR. The Company also has material intra-entity transactions with CVR. Accordingly, the Company uses the equity method to account for the investment in affiliate. In applying the equity method, the investment in affiliate was initially recorded at cost and is subsequently adjusted based on the Company's proportionate share of the net income or loss of CVR. Changes in the carrying value of the investment in affiliate are recorded in net investment income in the statements of operations.

In 2012, the Company invested $2.2 million in Dowling Capital Partners I, a limited partnership ("DCP"), as part of a total investment commitment of $10.0 million. The Company's investment represents approximately 9.3% interest in DCP. The Company uses the equity method to account for the investment. Under the equity method, the initial investment is recorded at cost and is subsequently adjusted based on the Company's proportionate share of the net income or loss of DCP. No income or loss was recorded for the year ended December 31, 2012.

The Company's short-term investments have maturities of greater than three months and less than twelve months when purchased and are carried at cost, which approximate fair value.

Reinsurance

In the ordinary course of business, the Company purchases facultative, excess of loss, catastrophe and quota share reinsurance. Under a reinsurance contract the assuming reinsurer is liable to the ceding company to the extent of the reinsurance. Reinsurance does not, however, discharge the Company from its primary liability to its policyholders in the event the reinsurer is unable to meet its obligations under its reinsurance agreement with the Company.

2. Summary of Significant Accounting Policies (continued)

Reinsurance, continued

Management has evaluated its reinsurance arrangements and determined that insurance risk is transferred to the reinsurers and therefore the arrangements qualify for reinsurance accounting. The costs of reinsurance agreements that have been determined to be short-duration prospective contracts are recognized over the life of the contract in a manner consistent with the earning of premiums on the underlying policies subject to the reinsurance contract.

Premiums earned and losses and loss adjustment expenses ("LAE") incurred are stated in the accompanying consolidated statements of operations after deduction of amounts ceded to reinsurers. Reinsurance recoverables include balances due from reinsurers on paid and unpaid losses. Balances due from reinsurers on unpaid losses, including an estimate of such recoverables related to reserves for incurred but not reported losses, are reported as assets and are included in reinsurance recoverables even though amounts due on unpaid losses and LAE are not recoverable from the reinsurer until such losses are paid. As of December 31, 2012, the Company has $42.4 million of collateral for additional security to collect claim recoverables from various reinsurers.

Ceded premiums, losses and LAE are accounted for on a basis consistent with that used in accounting for the original policies issued and with the terms of the reinsurance agreements.

Management believes that reinsurance recoverables on unpaid losses and LAE as recorded in the consolidated balance sheets represent its best estimate of reinsurance recoverables on unpaid losses and LAE; however, as changes in the estimated ultimate liability for losses and LAE are determined, the estimated ultimate amount recoverable from the reinsurer will also change. Accordingly, the ultimate recoverable could be significantly more or less than the amount indicated in the consolidated financial statements. As adjustments to these estimates become necessary, such adjustments are reflected in current operations.

In preparing consolidated financial statements, management estimates the amounts recoverable from reinsurers to be uncollectible based on an assessment of factors, including the creditworthiness of the reinsurers and the adequacy of collateral obtained, where applicable. Significant uncertainties are inherent in the assessment of the creditworthiness of reinsurers and estimates of any uncollectible amounts due from reinsurers. Any change in the ability of the Company's reinsurers to meet their contractual obligations could have a significant impact on the consolidated financial statements and the Company's ability to meet its regulatory capital and surplus requirements. There was no allowance for uncollectible reinsurance at December 31, 2012 and 2011.

2. Summary of Significant Accounting Policies (continued)

Deferred Policy Acquisition Costs

Policy acquisition costs consist of commissions and premium taxes that vary with and are primarily related to the production of new or renewal business. Policy acquisition costs and related ceding commissions are deferred and charged or credited to earnings in proportion with the premium earned.

A premium deficiency is recognized if the sum of expected claims, claims adjustment expenses, unamortized acquisition costs and policy maintenance costs exceed the related unearned premiums. A premium deficiency would first be recognized by charging any unamortized acquisition costs to expense to the extent required to eliminate the deficiency. If the premium deficiency was greater than unamortized acquisition costs, a liability would be accrued for the excess deficiency. The Company considers anticipated investment income in the determination of premium deficiencies. There was $0 million and $1 million of premium deficiencies recorded during the years ended December 31, 2012, and 2011, respectively.

Intangible Assets

Goodwill represents the excess of the purchase price of the subsidiaries over the fair value of the assets acquired and liabilities assumed. Identifiable intangible assets with a finite useful life are amortized over the period that the asset is expected to contribute directly or indirectly to the future cash flows of the Company. Indefinite lived intangible assets are not amortized. Goodwill and identifiable intangible assets are tested for recoverability whenever events or changes in circumstances indicate that a carrying amount may not be recoverable and are subject to annual impairment testing. An impairment loss is recognized if the carrying value of an intangible asset is not recoverable and its carrying amount exceeds its fair value. There was $0.3 million and $0 million of impairment losses for trademarks recorded during the years ended December 31, 2012 and 2011, respectively.

Management reviews long-lived assets including intangible assets, by first assessing qualitative factors to determine whether it is more likely than not that an indefinite-lived intangible asset is impaired. If the more-likely-than-not threshold is met, the Company performs a quantitative impairment test by comparing the fair value with the carrying amount. The impairment test is based on a comparison of the fair value as determined by estimating the future undiscounted cash flows associated with the asset as compared to the asset's carrying value amount to determine if an impairment of such asset and its carrying value exists. The effect of any impairment would be to expense the difference between the fair value of such assets and its carrying value.

2. Summary of Significant Accounting Policies (continued)

Property and Equipment

Property and equipment, which is included in other assets, are recorded at cost, less accumulated depreciation. Furniture and equipment are depreciated under the straight-line method over the estimated useful lives of the respective assets, which is five to seven years. Electronic data processing equipment and software, including certain costs incurred to develop or obtain software for internal use, are capitalized and depreciated under the straight-line method over the estimated useful lives of the respective assets, which range from three to ten years. Leasehold improvements are amortized using the straight-line method over the shorter of the estimated useful life of the asset or the remaining original lease term, excluding options or renewal periods. Leasehold improvements are generally depreciated over approximately ten years. Expenditures for major renewals and improvements that extend the useful life of the assets are capitalized. The cost and accumulated depreciation of assets sold or otherwise disposed of are removed from the accounts and any resulting gain or loss is reflected in earnings.

Depreciation expense for the years ended December 31, 2012 and 2011 was $1.1 million for each year.

Losses and Loss Adjustment Expenses

Losses and LAE reserves represent management's best estimate of the ultimate net cost of all reported and unreported losses that are unpaid as of the balance sheet dates. The estimated reserves for losses and LAE include the accumulation of estimates for claims reported and unpaid prior to the balance sheet dates, estimates (based on projections of relevant historical data) of claims incurred but not reported, and estimates of expenses for investigating and adjusting all incurred and unpaid claims. The reserves are estimated on an undiscounted basis, using individual case-basis valuations, statistical analyses, and various actuarial procedures. The projection of future claim payments and reporting is based on an analysis of the Company's historical experience, supplemented by analyses of industry loss data.

Amounts reported are necessarily subject to uncertainty from various sources, including changes in reporting patterns, claims settlement patterns, judicial decisions, legislation, and economic conditions and, therefore, actual loss experience may not conform to the assumptions used in determining the estimated amounts for such liability at the balance sheet dates. Management believes that, subject to the inherent variability in any such estimate, the reserves are within a reasonable and acceptable range of adequacy. Reserves are continually monitored and reviewed, and as settlements are made or reserves adjusted, the differences are reported in current operations.

Because of the nature of the business historically written, the Company's management believes that the Company has limited exposure to environmental and other toxic tort type claim liabilities.

Salvage and subrogation recoverables are estimated using the case-basis method for large recoverables and historical statistics for smaller recoverables.

2. Summary of Significant Accounting Policies (continued)

Premiums

Premiums are earned pro rata over the terms of the policies. Premiums receivable include deferred premiums, which represent installment payments due to the Company from insureds under the payment terms of their policies. Premiums receivable are also reported net of commissions payable in the amount of approximately $3.1 and $5.6 million at December 31, 2012 and 2011, respectively.

Unearned premiums represent the portion of premiums written which is applicable to the unexpired terms of insurance policies or reinsurance contracts in force. These unearned premiums are calculated on a pro rata basis over the terms of the policies for direct and ceded amounts.

The Company establishes an allowance for bad debts ("allowance") on its premiums receivable through a charge to other expenses in the accompanying consolidated statements of operations. This allowance is determined based on estimates and assumptions to project future experience. After all collection efforts have been exhausted, the Company reduces the allowance for bad debts for premiums receivable that have been deemed uncollectible. The Company periodically reviews the adequacy of the allowance and makes adjustments as necessary. Future additions to the allowance may be necessary based on changes in the general economic conditions and the policyholders' financial condition. As of December 31, 2012 and 2011, the Company has accrued an allowance related to premiums receivable of approximately $0.2 million in both years.

Fee and Commission Income

Commissions are recognized generally on the effective date of the policies or the billing date, whichever is later. In situations where the Company bills a policy or an installment prior to the effective date, deferred commission is recorded as a liability. Any subsequent premium adjustments, including policy cancellations, are recognized upon notification from the insurance carriers, or insured, as applicable. The Company records an allowance for estimated return commissions and fees that may be required to be repaid based on early termination of policies. After review, the Company determined that no allowance was required as of December 31, 2012 and 2011.

When the underwriting agency within the Company utilizes an insurance company subsidiary as the policy issuing company, the Company eliminates in consolidation the fee and commission income against the insurance company subsidiary's policy acquisition costs and defers the policy acquisition costs of the related agency.

Federal Income Taxes

Income taxes are provided for the tax effects of transactions reported in the financial statements and consist of taxes currently due plus deferred taxes resulting from temporary differences between financial statement and income tax reporting purposes. A valuation allowance is established for any deferred tax asset not expected to be realized. As of December 31, 2012, and 2011, the Company has a valuation allowance of $4.8 million and $0, respectively.

2. Summary of Significant Accounting Policies (continued)

Federal Income Taxes, continued

Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

The Company records a liability for uncertain tax positions where it is more likely than not that the tax position will not be sustained upon examination by the appropriate tax authority. Changes in the liability for uncertain tax positions are reflected in income tax expense in the period when a new uncertain tax position arises, judgment changes about the likelihood of uncertainty, the tax issue is settled or the statute of limitation expires. Any potential net interest income or expense and penalties related to uncertain tax positions are recorded in the statements of operations.

The Company, excluding NHIC, files a consolidated federal income tax return in the United States and certain other state tax returns. NHIC files a separate tax return as a life and health insurance company. The Company's admitted insurance subsidiaries pay premium taxes on gross premiums written in lieu of most state income or franchise taxes.

Stock Based Compensation

Compensation costs for share-based payments to employees, former employees and non-employee directors are recognized based on the grant date fair value of the award and are amortized over the grantees' vesting period. The Company uses the Black-Scholes-Merton valuation model to value employee stock options. All outstanding options expired unexercised in 2012.

Restricted stock is valued at the fair value of the common stock on the date issued. Restricted stock was issued in 2012 and 2011 and the fair value of the stock was determined based on the December 31, 2012 and 2011 book value. The expense is being recognized over the vesting period.

Preferred Stock

The Company has 2,000,000 of authorized Series A and Series B preferred stock. The preferred stock contains a provision that holders receive an annual 8% paid in kind dividend. All outstanding preferred stock was converted to common stock at a 1:1 ratio in 2010.

2. Summary of Significant Accounting Policies (continued)

Derivative Financial Instruments

The Company utilizes derivative instruments, primarily interest rate swaps, to modify interest rate characteristics of certain liabilities to reduce its exposure to interest rate fluctuations, reducing the effects these fluctuations might have on associated cash flows. Derivative instruments are recorded in the accompanying balance sheet at fair value. Derivatives meeting certain specific requirements may be designated as hedges and hedge accounting would then be applied. The Company has not designated its derivative instruments as hedges, and accordingly, unrealized gains and losses are recognized currently in income. Cash flows from derivative financial instruments are classified as operating activities in the statement of cash flows.

Concentrations of Credit Risk

Financial instruments that potentially subject the Company to concentrations of credit risk are primarily cash and cash equivalents, investments, premiums receivable and reinsurance balances.

Cash equivalents and short-term investments include investments in money market funds and securities backed by the U.S. government. Investments are diversified throughout many industries and geographic regions. The Company limits the amount of credit exposure with any one financial institution and believes that no significant concentration of credit risk exists with respect to cash and investments. At December 31, 2012 and 2011, the outstanding premiums receivable are generally diversified due to the large number of entities comprising the Company's customer base and their dispersion across many different lines of business and geographic regions. Failure by general agents to remit premiums could result in premium write-offs and a corresponding loss of income by the Company. The Company also has receivables from its reinsurers. Reinsurance contracts do not relieve the Company from its obligations to claimants or policyholders. Failure of reinsurers to honor their obligations could result in losses to the Company. The Company evaluates the financial condition of its reinsurers and may obtain collateral to minimize its exposure to significant losses from reinsurer insolvencies. The Company reinsures with highly rated companies and, as such, limits its credit risk.

Reclassification

Certain 2011 amounts have been reclassified to conform to the 2012 presentation. Such reclassifications had no effect on the Company's financial position, net loss or cash flows.

Recent Accounting Pronouncements

October 2010, the FASB issued an accounting update that amends *Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts*. The amendment clarifies the definition of acquisition costs incurred by an insurance company and limits capitalization to such costs directly related to renewing or acquiring new insurance contracts. All costs incurred for unsuccessful marketing or underwriting efforts, along with indirect costs, are to be expensed as incurred. This guidance must be adopted by January 1, 2012, either prospectively or retrospectively. The Company adopted this guidance on January 1, 2012 and it did not have a significant effect on its financial results.

2. Summary of Significant Accounting Policies (continued)

Recent Accounting Pronouncements, continued

In May 2011, the FASB issued amendments to "Fair Value Measurement" (Topic 820). The amendments were to achieve common fair value measurement and disclosure requirements in GAAP and International Financial Reporting Standards. Some of the amendments clarify the FASB's intent about the application of existing fair value measurement requirements. Other amendments change a particular principle or requirement for measuring fair value or for disclosing information about fair value measurements. There are changes to how premiums and discounts (including blockage factors) are applied. There are clarifications made to principal market determination. The amendments also clarify that the highest and best use and valuation premise concepts are not applicable to financial instruments. There are amendments that indicate how a company should determine the fair value of its own equity instruments and the fair value of liabilities. New disclosures, with a particular focus on Level 3 measurement, are required. All transfers between Level 1 and Level 2 will now be required to be disclosed. Information about when the current use of a non-financial asset measured at fair value differs from its highest and best use is to be disclosed. The amendments in this update are to be applied prospectively. The amendments are effective during interim and annual periods beginning after December 15, 2011. The adoption of this amendment did not have a material impact on the Company's financial results and disclosures.

In September 2011, the FASB issued an accounting update to simplify how entities test goodwill for impairment. The update permits an entity to first assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount as a basis for determining whether it is necessary to perform the two-step goodwill impairment test described in Topic 350, "Intangibles-Goodwill and Other." The more-likely-than-not threshold is defined as having a likelihood of more than 50 percent. Previous guidance required an entity to test goodwill for impairment on at least an annual basis by comparing the fair value of a reporting unit with its carrying amount, including goodwill (step one). If the fair value of a reporting unit is less than its carrying amount, then the second step of the test must be performed to measure the amount of the impairment loss, if any. Under the update, an entity is not required to calculate the fair value of a reporting unit unless the entity determines that it is more likely than not that its fair value is less than its carrying amount. The update is effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011. Early adoption was permitted, including for annual and interim goodwill impairment tests performed as of a date before September 15, 2011, if an entity's financial statements for the most recent annual or interim period had not yet been issued or, for nonpublic entities, had not yet been made available for issuance. The adoption of this update did not have an impact on the Company's financial results and disclosures.

In December 2011, with further clarification issued in January 2013, the FASB issued an accounting update requiring disclosures about offsetting and related arrangements to enable users of financial statements to understand the effect of those arrangements on an entities financial position. Entities are required to disclose both gross information and net information about both instruments and transactions eligible for offset in the statement of financial position and instruments and transactions subject to an agreement similar to a master netting arrangement. This update is applicable to derivatives including

2. Summary of Significant Accounting Policies (continued)

Recent Accounting Pronouncements, continued

bifurcated embedded derivatives, repurchase agreements and reverse repurchase agreements and securities borrowing and securities lending arrangements. The update is effective for annual reporting periods beginning on or after January 1, 2013, and interim periods within those annual periods. The disclosures required by this update should be provided retrospectively for all comparative periods presented. The Company does not anticipate that this update will have an impact on the financial results and disclosures.

In July 2012, the FASB issued an accounting update that allows an entity the option to first assess qualitative factors to determine whether it is more likely than not that an indefinite-lived intangible asset is impaired. The more-likely-than-not threshold is defined as having a likelihood of more than 50 percent. If the more-likely-than-not threshold is met, an entity is required to determine the fair value of the indefinite-lived intangible asset and perform the quantitative impairment test by comparing the fair value with the carrying amount in accordance with accounting guidance. The update is effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012. Early adoption is permitted, including for annual and interim impairment tests performed as of a date before July 27, 2012, if an entity's financial statements for the most recent annual or interim period have not yet been issued or, for nonpublic entities, have not yet been made available for issuance. The adoption of this update did not have an impact on the Company's financial results and disclosures.

In February 2013, the FASB issued an accounting update to improve the reporting of reclassifications out of accumulated other comprehensive income. An entity is required to report the effect of significant reclassifications, by component, out of accumulated other comprehensive income on the respective line items in net income if the item is required under GAAP to be reclassified in its entirety in the same reporting period. The required disclosures of the update are allowed either in the Statement of Operations or in the notes. The amendments in the update are effective for reporting periods beginning after December 15, 2012. The adoption of this update did not have an impact on the Company's financial results.

3. Goodwill

The changes in the carrying amount of goodwill for the years ended December 31, 2012 and 2011, are as follows:

	2012	2011
Balance as of January 1		
Goodwill	$ 12,197	$ 6,882
Accumulated impairment losses	-	-
	12,197	6,882
Goodwill acquired during the year	10,360	9,831
Goodwill written off related to sale of business	-	(4,516)
Balance as of December 31		
Goodwill	22,557	12,197
Accumulated impairment losses	-	-
	$ 22,557	$ 12,197

4. Intangible Assets

The following details the Company's acquired identifiable intangible assets as of December 31, 2012 and 2011 (in thousands):

	2012		2011	
	Gross Value Assigned	Accumulated Amortization	Gross Value Assigned	Accumulated Amortization
Amortizing intangible assets:				
Policy renewals on insurance in force	$ 1,987	$ (1,987)	$ 2,438	$ (1,934)
Managing general agents' relationships	12,583	(3,973)	12,583	(3,336)
Noncompete/exclusivity agreements	3,933	(2,512)	3,794	(2,351)
Favorable lease	567	(456)	567	(369)
Total amortizing intangible assets	19,070	$ (8,928)	19,382	$ (7,990)
Non-amortizing intangible assets:				
Trademarks	678		995	
Regulatory insurance licenses	14,019		16,134	
Total non-amortizing intangible assets	14,697		17,129	
Total gross intangible assets	$ 33,767		$ 36,511	

The intangible assets related to policy renewals on insurance in-force, MGA relationships and noncompete/exclusivity agreements, have a weighted average useful life of ten years. The portion of intangible assets related to the favorable lease agreement has a weighted average useful life of seven years.

4. Intangible Assets, continued

Amortization expense for the year ended December 31, 2012 and 2011 was approximately $1.0 and $1.8 million, respectively.

Estimated future net amortization expense for the next five years is as follows (in thousands):

Year		
2013	$	900
2014		822
2015		805
2016		805
2017		805

5. Investments

The amortized cost and the fair value of the Company's investments are summarized as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
		(In Thousands)		
December 31, 2012				
Fixed maturity securities:				
U.S. government securities	$ 12,990	$ 95	$ (1)	$ 13,084
Federal Agency securities	70,804	510	(2)	71,312
Corporate securities and miscellaneous	76,494	1,178	(25)	77,647
Municipal securities	34,420	839	(27)	35,232
Residential mortgage-backed securities	59,089	614	(46)	59,657
Commercial mortgage-backed securities	9,321	278	-	9,599
Asset-backed securities	7,893	50	(1)	7,942
Total fixed maturity securities	$ 271,011	$ 3,564	$ (102)	$ 274,473
Equity securities:				
Common stock	$ 24,371	$ 2,826	$ (1,103)	$ 26,094
Mutual funds	72,679	593	(623)	72,649
Total equity securities	$ 97,050	$ 3,419	$ (1,726)	$ 98,743

5. Investments (continued)

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(In Thousands)			
December 31, 2011				
Fixed maturity securities:				
U.S. government securities	$ 64,891	$ 165	$ -	$ 65,056
Federal Agency securities	76,664	516	(24)	77,156
Corporate securities and miscellaneous	79,052	517	(2,088)	77,481
Municipal securities	9,889	102	-	9,991
Residential mortgage-backed securities	48,266	139	-	48,405
Commercial mortgage-backed securities	2,301	28	(40)	2,289
Asset-backed securities	2,363	3	(24)	2,342
Total fixed maturity securities	$ 283,426	$ 1,470	$ (2,176)	$ 282,720
Equity securities:				
Common stock	$ 28,990	$ 1,384	$ (2,711)	$ 27,663
Mutual funds	124,680	670	(609)	124,741
Total equity securities	$ 153,670	$ 2,054	$ (3,320)	$ 152,404

The amortized cost and estimated fair value of fixed maturity investments at December 31, 2012 by contractual maturity, are shown below. Expected maturities may differ from contractual maturities because borrowers have the right to call or prepay obligations with or without call or prepayment penalties. Also, changing interest rates, tax considerations or other factors may result in portfolio sales prior to maturity.

	Amortized Cost	Estimated Fair Value
	(In Thousands)	
Due after one year through five years	$ 134,432	$ 135,825
Due after five years through ten years	48,320	49,005
Due after ten years	11,956	12,445
Residential mortgage-backed securities	59,089	59,657
Commercial mortgage-backed securities	9,321	9,599
Asset-backed securities	7,893	7,942
Total	$ 271,011	$ 274,473

5. Investments, continued

When the fair value of an investment is lower than its cost, an assessment is made to determine whether the decline is temporary or other than temporary. The assessment of other-than-temporary impairment (OTTI) of fixed maturities and equity securities is based on both quantitative criteria and qualitative information and also considers a number of other factors including, but not limited to, the length of time and the extent to which the fair value has been less than the cost, the financial condition and near term prospects of the issuer, whether the issuer is current on contractually obligated interest and principal payments, general market conditions and industry or sector specific factors.

For fixed maturity investments, the Company is required to recognize an other than temporary impairment loss when it concludes it has the intent to sell or it is more likely than not it will be required to sell an impaired fixed maturity before the security recovers to its amortized cost value or it is likely it will not recover the entire amortized cost value of an impaired debt security. If the Company has the intent to sell or it is more likely than not that the Company will be required to sell an impaired fixed maturity before the security recovers to its amortized cost value, the security is written down to fair value and the entire amount of the writedown is included in net income as a realized investment loss. For all other impaired fixed maturities, the impairment loss is separated into the amount representing the credit loss and the amount representing the loss related to all other factors. The amount of the impairment loss that represents the credit loss is included in net income as a realized investment loss and the amount of the impairment loss that relates to all other factors is included in other comprehensive income.

For equity securities, the Company considers its intent and ability to hold a security for a period of time sufficient to allow for the recovery of cost. If the decline in the fair value of an equity security is deemed to be other than temporary, the security is written down to fair value and the amount of the write down is included in net income as an other than temporary impairment loss. Approximately a $0.9 million and $5.8 million OTTI adjustment was made on equity securities considered impaired and recorded as realized losses for the years ended December 31, 2012 and 2011, respectively.

For fixed maturities, the split between the amount of other-than-temporary impairment losses that represents credit losses and the amount that relates to all other factors is principally based on assumptions regarding the amount and timing of projected cash flows. For fixed maturities other than mortgage-backed securities, cash flow estimates are based on assumptions regarding the probability of default and estimates regarding the timing and amount of recoveries associated with a default. For mortgage-backed securities, cash flow estimates are based on assumptions regarding future prepayment rates, default rates, loss severity and timing of recoveries. The Company has developed the estimates of projected cash flows using information based on historical market data, industry analyst reports and forecasts and other data relevant to the collectability of a security.

5. Investments, continued

The following tables summarize gross unrealized losses and the corresponding fair values of investments, aggregated by length of time that individual securities have been in a continuous unrealized loss position.

	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
			(In Thousands)			
December 31, 2012						
U.S. government securities	5,367	(1)	-	-	5,367	(1)
Federal Agency securities	23,182	(2)	-		23,182	(2)
Corporate securities and miscellaneous	3,850	(25)	-		3,850	(25)
Residential mortgage-backed securities	12,976	(45)	-	-	12,976	(45)
Commercial mortgage-backed securities	-	-	-		-	-
Municipal securities	6,791	(28)	-	-	6,791	(28)
Asset-backed securities	2,807	(1)	-		2,807	(1)
Common stocks	3,807	(338)	2,540	(765)	6,347	(1,103)
Mutual funds	28,785	(526)	7,903	(97)	36,688	(623)
Total temporarily impaired securities	$ 87,565	$ (966)	$ 10,443	$ (862)	$ 98,008	$ (1,828)

	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
			(In Thousands)			
December 31, 2011						
Federal Agency securities	$ 20,472	$ (24)	$ -	$ -	$ 20,472	$ (24)
Corporate securities and miscellaneous	26,320	(638)	9,677	(1,450)	35,997	(2,088)
Commercial mortgage-backed securities	301	(1)	583	(39)	884	(40)
Asset-backed securities	-	-	1,642	(24)	1,642	(24)
Common stocks	9,803	(2,182)	2,509	(529)	12,312	(2,711)
Mutual funds	64,962	(609)	-	-	64,962	(609)
Total temporarily impaired securities	$ 121,858	$ (3,454)	$ 14,411	$ (2,042)	$ 136,269	$ (5,496)

At December 31, 2012, 70 individual fixed maturity and equity securities were in a gross unrealized loss position, of which 36 were fixed maturities. The Company does not have the intent to sell and it is not more likely than not that the Company will be required to sell these fixed maturities before the securities recover to their amortized cost value. In addition, the Company believes that none of the declines in the fair values of these fixed maturities relate to credit losses. The Company has the intent and ability to hold the equity securities in an unrealized loss position for a period of time sufficient to allow for the recovery of cost. The Company believes that none of the declines in the fair value of these fixed maturities and equity securities were other than temporary at December 31, 2012.

5. Investments, continued

The components of net realized gains (losses) for the year ended December 31, 2012 and 2011 are as follows (in thousands):

	2012	2011
Gross realized gains		
Fixed maturity securities	$ 3,081	$ 243
Equity securities	3,854	6,420
Sale of business	0	859
Total	6,935	7,522
Gross realized losses		
Fixed maturity securities	(923)	(86)
Equity securities	(738)	(1,288)
Sale of business – indemnification claim	(12,250)	-
Other	(222)	-
Total	(14,133)	(1,374)
Net realized gains (losses)	$ (7,198)	$ 6,148

Proceeds from sales of fixed maturity securities and equity securities for the year ended December 31, 2012 were approximately $249.5 million and $152.3 million, respectively. Proceeds from sales of fixed maturity securities and equity securities for the year ended December 31, 2011 were approximately $155.2 million and $239.2 million, respectively.

The Company's net investment income for the year ended December 31, 2012 and 2011 is summarized as follows (in thousands):

	2012	2011
Income:		
Fixed maturity securities	$ 5,248	$ 3,692
Equity securities	3,590	6,621
Investment in affiliate	(222)	1,731
Short-term investments and cash	776	957
Total investment income	9,392	13,001
Investment expenses	(1,133)	(1,518)
Net investment income	$ 8,259	$ 11,483

5. Investments (continued)

The change in net unrealized gains (losses) on investments, net of deferred income taxes, for the years ended December 31, 2012 and 2011 is as follows (in thousands):

	2012	2011
Fixed maturity securities	$ 4,280	$ 1,362
Equity securities	2,636	(3,706)
Deferred income taxes	(1,824)	750
Total	$ 5,092	$ (1,594)

The Company is required by various state regulations to maintain cash, securities or letters of credit on deposit with the states in a depository account. At December 31, 2012, and 2011, cash and securities having a fair value of approximately $128.3 million and $179.3 million, respectively, were on deposit.

6. Real Estate

In 2010, NHIC purchased land and buildings in Temple, Texas for $1.5 million. NHIC leased this facility to two businesses owned by a stockholder of the Company for $180,000 per year. The leases were non-cancellable and expired in 2025. During 2012 and 2011, $0 and $0.4 million of improvements were capitalized related to this property. This property was sold on October 31, 2012, as part of the sale of NHIC (see Note 24).

7. Investment in Affiliate

As a result of the sale of SWR, the Company reinvested $5.0 million or approximately 15% ownership of ClearView Holdings, LLC ("CVR"), which is included in investment in affiliates in the consolidated balance sheet as of December 31, 2012 and 2011. During the years ended December 31, 2012 and 2011, the Company recorded its equity pick up of approximately $(0.2) million and $1.05 million, respectively, from its investment in CVR which represented approximately 15% of CVR's net income (loss) for the years ended December 31, 2012 and 2011.

8. Notes Receivable from Related Parties

The Company has a $3 million note receivable due from a company owned by a stockholder. The note bears interest at a variable interest rate with a floor of 1.7% per annum and a ceiling of 50% of any distributions received by the affiliated company from the company in which these funds were ultimately invested. All principal and outstanding interest is due on December 31, 2019. Included in other assets is accrued interest receivable related to this note of $0.66 million at December 31, 2012, and $0.45 million at December 31, 2012 and 2011, respectively.

8. Notes Receivable from Related Parties, continued

In 2011, IIC entered into a note agreement with a company owned by a shareholder of the Company. IIC extended a line of credit in the amount of $15 million. The note bore interest at a rate of 8% per year. Interest was due quarterly and all principal was due May 2018. The note was collateralized by all assets of the affiliated company. The principal balance of the note was $11.3 million at December 31, 2011. The note was paid in full in July 2012.

9. Trust Debenture Securities

On August 2, 2006, Delos Capital Trust (the Trust), a Delaware statutory trust, issued $58.0 million of fixed/floating rate capital securities guaranteed by the Company. The Trust issued $1.8 million of common stock to the Company.

The sole asset of the Trust consists of Fixed/Floating Rate Junior Subordinated Deferrable Interest Debentures (the Debentures) with a principal amount of $59.8 million issued by the Company. The Debentures are redeemable on or after September 15, 2011 and have a maturity date of September 15, 2036. The Debentures are unsecured obligations of the Company. Interest on the Debentures is payable quarterly at an annual rate of 8.825% through June 30, 2011. Beginning in July 2011, the interest on the Debentures converted to three month LIBOR plus 3.4%, which was 3.71% at December 31, 2012.

The Company has not consolidated the Trust, which issued the capital securities, as it did not meet the consolidation requirements under guidance issued by FASB. The Company reflected the debt related to the trust debenture securities in the December 31, 2012 and 2011 consolidated balance sheet.

10. Notes Payable

Term Loan Note

During 2008, the Company entered into a $33 million term loan (Tranche A) with a financial institution. This term loan was amended in 2011. The amended agreement added a new term loan tranche of $7 million. (Tranche B). Interest on Tranche A is calculated on the outstanding principal based on the Eurodollar Rate, which is defined by the loan agreement as the one-month London Interbank Offer Rate (“LIBOR”) (.209% at December 31, 2012), plus the Eurodollar Margin, which is defined as 1.75%, or Highest Lawful Rate, whichever is less. Highest Lawful Rate is defined as maximum rate of interest under applicable law. Interest on Tranche B is calculated on the outstanding principal based on the Eurodollar rate plus the Eurodollar margin, which is defined as 2.50% or the Highest Lawful Rate, whichever is less. The Company, at its option and no more than once per month, may elect whether all of the term loan’s interest will accrue at either the Eurodollar Rate or Prime Rate. Prime rate is defined as a per annum rate of interest as published in the “Money Rates” column of The Wall Street Journal or if not available, the rate established by the financial institution as its prime rate. Interest only payments

10. Notes Payable (continued)

Term Loan Note, continued

are due and payable on a quarterly basis beginning October 1, 2008 and continuing regularly thereafter until December 30, 2016 at which time all outstanding principal and interest is due. The term loan is collateralized by a perfected first priority security interest in all of the assets of HIIG and BHUA and the outstanding capital stock of HSIC.

In conjunction with the original term loan (Tranche A), the Company entered into two interest rate swap agreements to exchange one-month LIBOR plus 1.75% (total 1.96% at December 31, 2012) for a 5.15% fixed rate on a notional amount of $13 million and a 5.43% fixed rate on a notional amount of $20 million. The interest rate swap agreements mature on September 30, 2013. The Company is exposed to credit loss in the event of nonperformance by the counterparty to the interest rate swap agreement. However, the Company does not anticipate nonperformance by the counterparty.

The Company has not elected hedge accounting for cash flow hedges. Accordingly, an interest rate swap liability of $0.3 million and $0.2 million is included in accrued expenses and accounts payable at December 31, 2012 and 2011, respectively.

Revolving Promissory Note

In December 2011, the Company entered into a new agreement for a two-year $20 million revolving promissory note with a financial institution. This note replaced a $5 million revolving promissory note which expired December 31, 2011. Interest is calculated on the outstanding principal based on the Eurodollar Rate, which is defined by the loan agreement as LIBOR (0.209% at December 31, 2012), plus the Eurodollar Margin, which is defined as 2.50%, or the Highest Lawful Rate, whichever is less. Interest only payments are due and payable on a quarterly basis on any outstanding principal balance beginning January 1, 2012 and continuing regularly thereafter until December 30, 2013 at which time all outstanding principal and interest is due. The Company is also liable for a .25% per annum usage fee multiplied by the $20 million revolving commitment less the outstanding balance of the revolving promissory note. The revolving promissory note is collateralized by a perfected first priority security interest in all of the assets and outstanding capital stock of the Company's subsidiaries. The outstanding balance on the revolving promissory note was $7.5 million and $0 as of December 31, 2012, and 2011, respectively.

The credit agreement, as amended, to the term loan note and revolving promissory note contains numerous restrictive financial covenants, including financial ratios and limitations on stock and debt issuance. As of December 31, 2012, the Company was not in compliance with certain of the financial covenants. The Company has received a waiver from the financial institution for these violations along with amended financial covenants which include minimum graduated net income amounts and consolidated net worth requirements of $185 million through December 30, 2013 and $225 million thereafter.

11. Funds at Lloyds

The Company has $4.6 million of Funds at Lloyds that it uses to guarantee performance on a 2012 reinsurance contract. The reinsurance contract expires 2014.

12. Income Taxes

The Federal income tax benefit consists of the following for the year ended December 31, 2012 and 2011 (in thousands):

	2012	2011
Current tax benefit	$ (188)	$ (3,278)
Deferred tax benefit	(4,418)	(7,586)
Total income tax benefit	$ (4,606)	$ (10,864)

The Company's effective federal income tax rates in 2012 and 2011 were 11.4% and 29%, respectively. The rate for 2012 and 2011 is less than the statutory Federal income tax rate of 35% due primarily to the valuation allowance in 2012 and the difference in the gain for book and tax related to the sale of assets in 2012 and 2011.

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

	2012	2011
	(In Thousands)	
Deferred tax assets:		
Net operating losses	$ 30,813	$ 16,844
Losses and loss adjustment expenses	9,170	11,675
Unearned premiums	5,217	3,753
Goodwill	1,495	5,443
Stock options/awards	53	1,395
Securities write downs	3,021	2,807
AMT credits	685	857
Allowance for bad debts	75	495
Severance accrual	-	82
Impairments	2,441	-
Indemnity settlement	4,435	-
Unrealized losses on investments	-	686
Other	4,302	5,101
Total deferred tax assets before valuation allowance	61,707	49,138
Valuation allowance	(4,778)	-
Total deferred tax assets	56,929	49,138

12. Income Taxes (continued)

Deferred tax liabilities:				
Deferred policy acquisition costs	$	4,253	$	2,229
Intangibles		3,064		3,033
Discount on fixed maturity securities		69		61
Depreciation		958		866
Unrealized gains on investments		1,804		-
Other		4,544		2,423
Total deferred tax liabilities		14,692		8,612
Net deferred tax asset	$	42,237	$	40,526

The Company paid no taxes paid the IRS for the years ended December 31, 2012 and 2011 that are available for recoupment in the event of future losses.

As of December 31, 2012, there were no material positions for which management believes it is more likely than not that the total amounts will significantly increase or decrease within 12 months of the reporting date. The Company classifies all interest and penalties related to tax contingencies as income tax expense. As of December 31, 2012, accrued interest of $0.04 million was recorded as an income tax liability. Tax years 2008 through 2012 are open under the statute of limitations and remain subject to examination by the IRS. The IRS is currently examining the Company's 2008 through 2011 consolidated Federal income tax returns.

Management currently provides a valuation allowance against deferred tax assets when it is more likely than not that some portion, or all, of deferred tax assets will not be realized. In the current year, management has established a valuation allowance of $4.8 million against deferred tax assets related to impairments and the indemnity settlement which are classified as capital losses for tax purposes.

13. Losses and Loss Adjustment Expenses

A reconciliation of unpaid losses and loss adjustment expenses as reported in the consolidated balance sheet as of December 31, 2012 and 2011 and for the years ended December 31, 2012 and 2011 are as follows (in thousands):

	2012	2011
Reserves for losses and LAE, beginning of year	$ 463,828	$ 492,028
Less reinsurance recoverables	(178,502)	(183,639)
Reserves for losses and LAE, beginning of year, net of reinsurance	285,326	308,389
Incurred, net of reinsurance, related to:		
Current year	73,740	140,109
Prior years	19,296	19,142
Total incurred, net of reinsurance	93,036	159,251
Paid, net of reinsurance, related to:		
Current year	24,130	63,712
Prior years	125,250	118,602
Total paid	149,380	182,314
Net reserves for losses and LAE at end of year	228,982	285,326
Plus reinsurance recoverables	160,171	178,502
Reserves for losses and LAE at end of year	$ 389,154	$ 463,828

Estimates of incurred losses and LAE attributable to insured events of prior years reflects adverse development of approximately $19.3 million and $19.1 million for the years ended December 31, 2012 and 2011, respectively The adverse development in 2012 primarily relates to reserve strengthening on certain cancelled workers' compensation and other liability program business. In 2011, the adverse development was primarily related to commercial auto and California workers' compensation programs, respectively. The commercial auto market deteriorated as a whole in 2011.

14. Premiums

Direct premiums written by line of business for the years ended December 31, 2012 and 2011 are as follows:

	2012	2011
Other liability occurrence	20.3%	11.6%
Accident and health	16.9	14.6
Commercial auto liability	14.4	18.2
Workers' compensation	10.1	14.3
Commercial multi-peril	7.6	17.5
Auto physical damage	5.7	11.6
Other	25.0	12.2
Total	100.0%	100.0%

For the years ended December 31, 2012 and 2011, the Company's direct premiums written came from the following states:

	2012	2011
Louisiana	20.2%	17.2%
Texas	19.0	13.2
Indiana	5.0	0.0
California	4.3	13.6
Michigan	3.9	4.0
Minnesota	3.4	4.1
Florida	3.0	0.0
Kentucky	2.9	4.8
New York	2.0	6.6
New Jersey	1.1	9.3
All other states	35.2	27.2
Total	100.0%	100.0%

15. Reinsurance

Certain premiums and benefits are assumed from and ceded to other insurance companies under various reinsurance agreements. The ceded reinsurance agreements provide the Company with increased capacity to write larger risks and maintain its exposure to loss within its capital resources. The Company remains obligated for amounts ceded in the event that the reinsurers do not meet their obligations.

15. Reinsurance (continued)

The effects of reinsurance on premiums written and earned for the years ended December 31, 2012 and 2011 are as follows:

	2012		2011	
	Written	**Earned**	**Written**	**Earned**
Direct premiums	$ 208,933	190,408	$ 180,929	$ 252,416
Assumed premiums	32,681	26,854	37,282	23,988
Ceded premiums	(104,131)	(100,551)	(87,387)	(84,147)
Net premiums	$ 137,483	$116,711	$ 130,824	$ 192,257
Ceded losses and LAE incurred		$ 92,242		$53,390

Reinsurance recoverables on unpaid losses and loss adjustment expense reserves ceded at December 31, 2012 and 2011 were approximately $160.2 and $178.5 million, respectively. Ceded unearned premiums at December 31, 2012 and 2011 were approximately $35.7 and $32.3 million, respectively.

The Company entered into agreements with one of its reinsurers, Maiden Reinsurance Company ("Maiden") whereby Maiden voluntarily established funded trust accounts at State Street Bank and Trust Company with the Company as the sole beneficiary. These trust accounts provide the Company additional security to collect claim recoverables under reinsurance contracts with Maiden. At December 31, 2012, the market value of these accounts was approximately $28.8 million representing case and IBNR loss reserves. The agreement provides that, as was customary in the past, the reinsurer will continue claim payment reimbursements without disturbing the trust balances. The trust amount will be adjusted periodically, by mutual agreement, based on the current activities of loss reserve recoverables.

16. Profit Commissions

The Company has entered into contractual agreements with program managers and reinsurers that transfer a limited amount of a program's profits or losses through contingent commissions. During the year ended December 31, 2012, and 2011, expenses (income) related to profit sharing commissions with program managers and reinsurers amounted to approximately $2.3 million and ($.38) million, respectively.

Additional or return commissions or other equivalent amounts pursuant to contractual agreements with program managers and reinsurers of a profit sharing nature are accrued based on the experience of the underlying business, using case and statistical methods. The Company recorded approximately $(0.1) million and $(0.15) million of (expenses) income related to profit sharing commissions on its ceded book of business during the years ended December 31, 2012 and 2011, respectively.

17. Stock-based Compensation

The Company has three stock-based compensation plans, the 2006 Stock Option and Incentive Plan (the 2006 Plan), the 2009 Incentive Stock Option Plan (the 2009 Plan) and the Employee Share Plan (the 2011 Plan). The Plans are administered by the Compensation Committee of the Board of Directors. The Company currently has stock options, restricted stock awards and outstanding shares under these plans.

Each option granted under the 2006 Plan and the 2009 Plan may be used to purchase one share of common stock. All stock options granted have a ten-year contractual term. Outstanding options vest over a period of up to seven years, with requisite service period. The 2006 Plan also has a performance vesting criteria which has not been satisfied as of December 31, 2012 and 2011.

The 2011 Plan allows key employees to purchase the Company's common stock at price based on the most recently audited book value of the Company. The Company then matches all purchases with stock grants. The grants vest over a period of up to five years. Key employees purchased 551,570 and 205,526 shares of the Company's stock in 2012 and 2011, respectively. In accordance with the plan the Company granted a match of 551,570 and 205,526 shares, of which 510,015 and 87,601 shares had vested as of December 31, 2012 and 2011, respectively. In 2012, 19,378 of additional shares were issued and granted, of which 8,259 are vested, to those employees who purchased shares in 2011. The additional shares were awarded based on the final 2011 audited book value of the Company. Included in the statement of stockholders' equity is $2.1 million and $1.8 million of stock subscriptions receivables from employees related to their purchase of common stock. The receivables bear interest at 2% per year. Interest is due annually and principal is due December 31, 2015.

During the years 2012 and 2011, the Company recorded $3.6 million and $0.98 million, respectively, of stock based compensation related to share grants under the 2011 Plan. The Company also granted 24,243 shares of common stock valued at $0.15 million to a non-management director as part of his annual compensation for serving on the Board of Directors. These shares vest over a five-year period on the anniversary of the grant date. The total tax benefit recognized in earnings from stock-based compensation arrangements was $1.3 million and $0.3 million for 2012 and 2011, respectively. The remaining unrecognized compensation expense related to unvested awards is approximately $1.1 and $.9 million at December 31, 2012 and 2011, respectively.

17. Stock-based Compensation (continued)

The Company estimates the value of its stock options using the calculated value on the grant date. The Company measures compensation cost of employee stock options based on the calculated value instead of fair value because it is not practical to estimate the volatility of its share price and a similar public company could not be identified. The Company does not maintain an internal market for its shares and its shares are rarely traded privately. The calculated value method requires that the volatility assumption used in an option-pricing model be based on the historical volatility of an appropriate industry sector index.

The Company uses the Black-Scholes-Merton formula to estimate the calculated value of its share-based payments. The volatility assumption used in the Black-Scholes-Merton formula is based on the volatility of the Dow Jones Property & Casualty Insurance Industry Index. The Company calculated the historical volatility of that index using the daily closing total returns for that index for the ten years immediately prior to August 2, 2006, March 12, 2008 and March 31, 2009.

The calculated value of each stock option grant was estimated on the date of the grant using the Black-Scholes-Merton option pricing model with the following weighted-average assumptions:

	March 31, 2009	March 12, 2008	August 2, 2006
Risk free interest rate	2.68%	3.57%	5.07%
Dividend yield	0.00	0.00	0.00
Expected volatility	10.64	9.03	7.18
Expected life of options (in years)	10	10	10

A summary of the status of the Company's stock option plans at December 31, 2012 and 2011 and changes during the year ending on that date is presented below:

	Options	Weighted Average Exercise Price	Weighted Average Contractual
Outstanding at January 1, 2012	$ 129,714	$ 10.16	10 years
Granted	-		-
Exercised	-		-
Forfeited	129,714		-
Outstanding at December 31, 2012	$ -	$ -	-
Vested and exercisable at end of period	-		

17. Stock-based Compensation (continued)

	Options	Weighted Average Exercise Price	Weighted Average Contractual
Outstanding at January 1, 2011	$ 271,282	$ 10.16	10 years
Granted	-	-	-
Exercised	-	-	-
Forfeited	(141,568)	-	-
Outstanding at December 31, 2011	129,714	$ 10.16	10 years
Vested and exercisable at end of period	$ 75,875		

There were no stock options exercised during the years ended December 31, 2012 and 2011.

A summary of the status of the Company's non-vested restricted common stock awards as of December 31, 2012 and 2011, and changes during the years ended December 31, 2012 and 2011, is presented below:

	2012	2011
Non-vested at beginning of period	117,925	27,549
Granted	595,191	205,526
Paid in kind dividend	-	-
Forfeited	-	-
Converted to common stock	-	-
Vested	(523,122)	(115,150)
Non-vested at end of period	189,994	117,925

At December 31, 2012 and 2011, the weighted-average period of time over which this cost will be recognized is 4.0 years.

18. Employee Benefit Plans

The HIIG 401(k) Plan (the HIIG Plan) is a multi-employer profit sharing plan. The Plan is subject to provisions of the Employee Retirement Income Security Act of 1974. The Plan is available to substantially all employees. Contributions are matched on a discretionary basis with Board of Directors' approval. The Company did not make any matching contributions in the years ended December 31, 2012 and 2011.

19. Related Party Transactions

Lightyear Capital, LLC (Lightyear) performs consulting and certain other services for the Company pursuant to an agreement to provide management, consulting and certain other services (the Advisory Services Agreement). Pursuant to the Advisory Services Agreement, the Company agrees to pay Lightyear $1.0 million per year, plus reasonable expenses incurred to provide the services. The Advisory Services Agreement will terminate on the earliest of (a) December 31, 2015 or (b) the date on which Lightyear owns less than 8% of the common stock outstanding of the Company. Partnerships affiliated with Lightyear owned 35.1% and 36.4% of the Company's voting common stock at December 31, 2012, and 2011, respectively. Pursuant to the Advisory Services Agreement, the Company incurred fees of approximately $1.0 million related to services provided by Lightyear for each of the years ended December 31, 2012, and 2011. Included in accounts payable and accrued liabilities is $0.25 million owed to Lightyear as of December 31, 2012, and 2011, respectively.

An earn-out liability is potentially due to former owners of assets acquired in 2012 and former owners of a business acquired in 2011, some of whom are officers of a subsidiary of the Company, as discussed in Note 23. Included in accounts payable and accrued liabilities is $8.5 million and $2 million of earn-out liability as of December 31, 2012 and 2011, respectively. Approximately $0.9 million of the earn-out was paid in December 2012.

During 2012 and 2011, the Company wrote an insurance policy through an affiliated broker for which it received fee income of $2.6 million and $0.3 million, respectively. In addition, the Company paid this affiliated broker $0.1 million and $0.5 million in 2012 and 2011, respectively, of commission related to insurance policies written during 2011 and $0.5 million of commission related to insurance policies written in 2012.

See Notes 6, 7, 8 and 16 for additional related party transactions.

20. Commitments and Contingencies

Leases

The Company leases office space under various lease agreements expiring through 2017. The Company also sub-leases office space to others under non-cancelable lease agreements expiring in 2014. The following is a schedule of future minimum annual lease payments and sub-lease income (in thousands) on operating leases having initial or remaining non-cancelable lease terms in excess of one year:

Year Ended	Gross Lease Payments	Sublease Income	Net
2013	$ 1,253	$ 161	$ 1,092
2014	1,264	161	1,103
2015	1,136	-	1,136
2016	1,100	-	1,100
2017	916	-	916
	$ 5,669	$ 322	$ 5,347

Rent expense incurred under operating leases was approximately $1.1 and $1.5 million for the years ended December 31, 2012 and 2011, respectively. During December 2011, the Company determined that it would close certain offices and move those operations to Houston. Therefore, the Company negotiated a final settlement on the related leases and included $3.7 million in accounts payable and accrued liabilities at December 31, 2011, related to the settlement of these leases. That amount was paid in 2012.

Litigation

The Company is named as a defendant in various legal actions arising from claims made under insurance policies and contracts. Those actions are considered by the Company in estimating the losses and loss adjustment expense reserves. Also, from time to time, the Company is a defendant in various legal actions that relate to disputes with third parties or that involve alleged errors and omissions. The Company records accruals for these items to the extent the losses are probable and reasonably estimable. Although the ultimate outcome of these matters cannot be determined at this time, based on present information, the availability of insurance coverage and advice received from outside legal counsel, management believes the resolution of any such matters will not, individually or in the aggregate, have a material adverse effect on the consolidated financial position, results of operations or cash flows of the Company.

20. Commitments and Contingencies (continued)

Indemnifications

In conjunction with the sale of business assets and subsidiaries, the Company has provided indemnifications to the buyers. Certain indemnifications cover typical representations and warranties related to the responsibilities to perform under the sales contracts. The amount of potential exposure covered by the indemnifications is difficult to determine because the indemnifications cover a variety of matters, operations and scenarios. Certain of these indemnifications have no time limit. For those with a time limit, the longest such indemnification expires in 2014.

The Agreement and Plan of Merger among Southwest Insurance Partners, Inc. (SWIP), Lightyear Delos Acquisition Corp. (LYDAC) and SW Merger Corporation and Others, whereby the Company was constituted, provided for certain indemnifications of the Company and the former shareholders of the two former separate entities. The Company and the former SWIP shareholders have made indemnity claims against the former LYDAC shareholders. A settlement agreement, which requires the approval of each of the former shareholders of SWIP and LYDAC, has been negotiated between the parties. The parties are currently in the process of obtaining the required approvals. The settlement agreement, if finally approved, requires the former LYDAC shareholders to surrender 3,003,979 shares of the Company's common stock to the Company for cancellation. If the settlement agreement had been effective as of December 31, 2012, the outstanding shares of the Company's common stock would have been reduced from 34,211,973 shares to 31,207,994 shares.

During 2012, the Company recorded a $14.3 million provision for a loss, which is included in realized investment losses, related to indemnification claims made against it by the purchaser of a former subsidiary of the Company in accordance with the terms of the Equity Purchase Agreement executed by the parties in December 2010. The provision was reduced by $2.0 million related to negotiating a recovery from another party. Management believes the net provision of $12.3 million represents the maximum expected exposure that the Company has as a result of the indemnification claims.

21. Regulatory Matters

A significant amount of the Company's consolidated assets represent assets of its insurance company subsidiaries, HSIC, IIC, GMIC and OSIC. IIC, OSIC and GMIC are all direct and indirect wholly owned subsidiaries of HSIC. HSIC is restricted by Texas law as to the amount of dividends it may pay without the approval of regulatory authorities. The maximum amount of dividends which can be paid by HSIC without prior approval is subject to restrictions relating to policyholder surplus, net income, and dividends declared or distributed during the preceding 12 months. As of December 31, 2012, HSIC cannot pay any dividends without prior approval of the Texas Department of Insurance. HSIC did not declare or pay the Company any dividends for the year ended December 31, 2012.

21. Regulatory Matters (continued)

Property and casualty insurance companies are subject to certain Risk Based Capital (RBC) requirements as specified by the National Association of Insurance Commissioners (NAIC). Under those requirements, the amount of capital and surplus maintained by a property and casualty insurance company is to be determined based on the various risk factors related to it. At December 31, 2012, and 2011, the Company's insurance company subsidiaries met the RBC requirements.

The capital and surplus and RBC level of HSIC on a consolidated statutory basis (including IIC, GMIC and OSIC) as of and for the year ended December 31, 2012, and 2011 was as follows:

	2012	2011
Statutory capital and surplus	$ 187,584	$ 191,875
RBC authorized control level	29,710	47,393

22. Statutory Accounting Principles

The statutory capital and surplus for the Company's principal operating subsidiaries at December 31, 2012, and 2011 were as follows:

	2012	2011
HSIC	$ 187,584	$ 191,875
OSIC	15,815	15,750
IIC	135,038	139,218
GMIC	53,058	50,026

These amounts include ownership interests in affiliated insurance subsidiaries.

The statutory net income (loss) for the Company's principal operating subsidiaries for the years ended December 31, 2012 and 2011 was as follows:

	2012	2011
HSIC	$ (225)	$ 1,896
OSIC	275	1
IIC	(6,938)	(4,692)
GMIC	(896)	(11,979)

23. Fair Value

Assets and liabilities recorded at fair value in the consolidated balance sheets are categorized based upon the level of judgment associated with the inputs used to measure their fair value. Level inputs are as follows:

Level Input	Input Definition
Level I	Inputs are unadjusted, quoted prices for identical assets or liabilities in active markets at the measurement date.
Level II	Inputs are other than quoted prices included in Level I that are observable for the asset or liability through corroboration with market data at the measurement date.
Level III	Unobservable inputs that reflect management's best estimate of what market participants would use in pricing the asset or liability at the measurement date.

The following methods and assumptions were used by the Company in estimating the fair value disclosures for financial instruments in the accompanying consolidated financial statements and in these notes:

Our Level 1 investments consist of U.S. Treasuries and equity securities traded in an active exchange market. We use unadjusted quoted prices for identical instruments to measure fair value.

Our Level 2 investments include most of our fixed income securities, which consist of U.S. government agency securities, municipal bonds, certain corporate debt securities and certain mortgage-backed and asset-backed securities. We measure fair value for the majority of our Level 2 investments using quoted prices of securities with similar characteristics. The remaining investments are valued using pricing models or matrix pricing. The fair value measurements consider observable assumptions, including benchmark yields, reported trades, broker/dealer quotes, issuer spreads, two-sided markets, benchmark securities, bids, offers, default rates, loss severity and other economic measures.

We use data provided by our third party investment manager to value our investments. The Company performs monthly analyses on the prices received from third parties to determine whether the prices are reasonable estimates of fair value. This analyses includes a review of month to month price fluctuations and, as needed, a comparison of pricing services' valuations to other pricing services' valuations for the identical security.

23. Fair Value (continued)

The following table summarizes fair value measurements by level at December 31, 2012 and 2011 for assets and liabilities measured at fair value on a recurring basis (in thousands):

	Quoted Prices In Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3	Total
December 31, 2012				
Bonds:				
U.S. treasury securities	$ 13,084	-	-	$ 13,084
U.S. agency securities	-	71,312	-	71,312
Corporate bonds	-	77,647	-	77,647
Municipal bonds	-	35,232	-	35,232
Residential mortgage-back securities	-	59,657	-	59,657
Commercial mortgage-backed securities	-	9,599	-	9,599
Asset-backed securities	-	7,942	-	7,942
Other	-	-	-	-
Total bonds	13,084	261,389	-	274,473
Mutual funds:				
Fixed income bond funds	72,649	-	-	72,649
Total mutual funds	72,649	-	-	72,649
Preferred Stock				
Other	-	-	-	-
Total Preferred Stock	-	-	-	-
Common stock:				
Consumer discretionary	1,990	-	-	1,990
Consumer stables	2,658	-	-	2,658
Energy	3,281	-	-	3,281
Finance	6,665	-	-	6,665
Healthcare	3,194	-	-	3,194
Industrial	3,649	-	-	3,649
Information technology	2,253	-	-	2,253
Utilities	646	-	-	646
Other	1,758	-	-	1,758
Total common stock	26,094	-	-	26,094
Total	$ 111,827	$ 261,389	$ -	$ 373,216

23. Fair Value (continued)

	Quoted Prices In Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3	Total
December 31, 2011				
Bonds:				
U.S. treasury securities	$ 65,056	$ -	$ -	$ 65,056
U.S. agency securities	-	77,156	-	77,156
Corporate bonds	-	77,481	-	77,481
Municipal bonds	-	9,991	-	9,991
Residential mortgage-backed securities	-	48,405	-	48,405
Commercial mortgage-backed securities	-	2,289	-	2,289
Asset-backed securities	-	2,342	-	2,342
Total bonds	65,056	217,664	-	282,720
Mutual funds:				
Fixed income bond funds	124,741	-	-	124,741
Total mutual funds	124,741	-	-	124,741
Common stock:				
Consumer discretionary	2,159	-	-	2,159
Consumer stables	3,504	-	-	3,504
Energy	3,279	-	-	3,279
Finance	7,363	-	-	7,363
Healthcare	3,022	-	-	3,022
Industrial	2,503	-	-	2,503
Information technology	2,621	-	-	2,621
Utilities	1,396	-	-	1,396
Other	1,816	-	-	1,816
Total common stock	27,663	-	-	27,663
Total	$ 217,460	$ 217,664	$ -	$ 435,124

The Company had no assets measured at fair value on a recurring basis using Level III inputs for the years ended December 31, 2012 and 2011.

23. Fair Value (continued)

During the year ended December 31, 2012 and 2011, certain securities, primarily certain mortgage-backed and asset-backed securities, were thinly traded due to concerns in the securities markets and the resulting lack of liquidity. Consequently, observable inputs were not always available and the fair values of these securities were estimated using internal estimates for inputs including, but not limited to, prepayments speeds, credit spreads, default rates and benchmark yields.

The Company measures certain assets, including the cost and equity method investments, at fair value on a nonrecurring basis. These assets are recognized at fair value when they are deemed to be other-than-temporarily impaired. At December 31, 2012, the fair value of the assets measured on a non-recurring basis was $6.2 million. This fair value was determined using models with significant unobservable inputs.

In addition to the preceding disclosures on assets and liabilities recorded at fair value in the consolidated balance sheets, guidance issued by FASB, also requires the disclosure of fair values for certain other financial instruments for which it is practicable to estimate fair value. Estimated fair value amounts, defined as the quoted market price of a financial instrument, have been determined using available market information and other appropriate valuation methodologies. However, considerable judgments are required in developing the estimates of fair value where quoted market prices are not available. Accordingly, these estimates are not necessarily indicative of the amounts that could be realized in a current market exchange. The use of different market assumptions or estimating methodologies may have an effect on the estimated fair value amounts.

The following methods and assumptions were used by the Company in estimating the fair value disclosures of trust debenture securities and the note payable:

Trust debenture securities: The carrying value approximates the estimated fair value for the Company’s trust debenture as the trust debenture accrues interest at current market rates.

Note payable: The carrying value approximates the estimated fair value for notes payable as the note payable accrues interest at current market rates.

Other financial instruments qualify as insurance-related products and are specifically exempted from fair value disclosure requirements.

24. Business Combination

On March 11, 2011, the Company acquired 100% of Casualty & Surety, Inc. (CSI). CSI is an underwriting agency in Birmingham, Alabama that specializes in small and medium size coal and natural gas mining operations and related contractors in the United States. The initial purchase price was $10 million in cash and common stock of the Company. The purchase agreement includes a contingency for future earn-out payments up to $2 million. The earn-out is calculated over three years and paid out over five years. It is based on both revenue and underwriting results. The business combination was recorded using the purchase method of accounting. The Company allocated the purchase price as follows:

Cash and restricted cash	$	1,892
Premium receivables		1,861
Other assets		229
Identifiable intangible assets		1,918
Goodwill		9,831
Accounts payable and other liabilities		(3,731)
Net assets acquired	$	12,000
Consideration given:		
Cash	$	6,000
Payable to former owner		2,000
Issuance of common stock		4,000
	$	12,000

Effective December 31, 2012, BHUA acquired certain assets of Axiom Insurance Managers Agency, LLC, (Axiom), and certain rights to solicit and sell insurance in the Hospitality segment. The business assets were primarily comprised of client lists, expiration rights, insurance producer lists, renewal rights, trademarks and fixed assets. The initial purchase price was $3.0 million in cash. The purchase agreement includes a contingency for future earnout payments up to $7.5 million which approximates fair value. Due to the probability of paying the earnout, the Company has accrued the $7.5 million as part of the purchase price. The earnout is calculated over three years, based on achieving certain underwriting results, and is paid out over five years. The acquisition was recorded using the purchase method of accounting. The Company allocated the purchase price as follows:

Non compete	$	139
Goodwill		10,361
Net assets acquired	$	10,500
Consideration given		
Cash	$	3,000
Payable to former owner		7,500
	$	10,500

25. Asset Disposition

Effective December 28, 2011, the Company sold certain insurance business assets of BHUA related to its Senior Living/FBO Programs, and certain rights to solicit and sell insurance in the Senior Living/FBO Program segment, including all the goodwill associated therewith for $10.95 million. The business assets were comprised primarily of insurance producer lists, distribution contracts and services contracts between BHUA and unaffiliated insurance companies, and all trademarks, service marks, and other intangibles associated with the Senior Living/FBO business. The Company reduced goodwill by $4.5 million and intangible assets by $6.4 million and recognized a realized gain of $0.9 million related to this transaction.

On October 31, 2012, GMIC sold NHIC to an unaffiliated insurance group. GMIC received $10.6 million of gross proceeds from the sale, which resulted in a net loss, after tax, of $1.0 million. The Company also reduced intangible assets by $2.6 million, the amount assigned to NHIC. In addition, GMIC expensed $0.1 million of costs directly related to the sale. The results of the sale of NHIC and the loss on the disposal are disclosed under discontinued operations for the year ended December 31, 2012. The comparative results for 2011 have been restated accordingly.

26. Subsequent Events

Subsequent events have been evaluated through June 3, 2013, which is the date the financial statements were issued. On May 1, 2013, HIIG executed agreements with the purchaser of a former subsidiary of the Company to settle certain indemnification claims against the Company. As a result of this settlement management still believes the recorded gross provision of $14.3 million represents the maximum expected exposure that the Company has as a result of the indemnification claims. On that date the Company also settled with another party which produced a recovery to the Company which includes 166,945 shares of the Company's common stock in addition to certain other property. (see Note 20).