

PROASSURANCE CORP  
Form 10-Q  
November 06, 2012  
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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 10-Q  
(Mark One)

Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the quarterly period ended September 30, 2012 or

Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 0-16533

ProAssurance Corporation

(Exact Name of Registrant as Specified in Its Charter)

Delaware

(State or Other Jurisdiction of  
Incorporation or Organization)

63-1261433

(IRS Employer Identification No.)

100 Brookwood Place, Birmingham, AL  
(Address of Principal Executive Offices)

35209

(Zip Code)

(205) 877-4400

(Registrant's Telephone Number,  
Including Area Code)

(Former Name, Former Address, and Former  
Fiscal Year, if Changed Since Last Report)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter), during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer

Accelerated filer

Non-accelerated filer  (Do not check if a smaller reporting company)

Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

As of October 26, 2012, there were 30,735,123 shares of the registrant's common stock outstanding.

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FORWARD-LOOKING STATEMENTS

Any statements in this Form 10-Q that are not historical facts are specifically identified as forward-looking statements. These statements are based upon our estimates and anticipation of future events and are subject to certain risks and uncertainties that could cause actual results to vary materially from the expected results described in the forward-looking statements. Forward-looking statements are identified by words such as, but not limited to, “anticipate”, “believe”, “estimate”, “expect”, “hope”, “hopeful”, “intend”, “may”, “optimistic”, “preliminary”, “potential”, “project”, “should”, and analogous expressions. There are numerous factors that could cause our actual results to differ materially from those in the forward-looking statements. Thus, sentences and phrases that we use to convey our view of future events and trends are expressly designated as forward-looking statements as are sections of this Form 10-Q that are identified as giving our outlook on future business.

Forward-looking statements relating to our business include among other things: statements concerning liquidity and capital requirements, investment valuation and performance, return on equity, financial ratios, net income, premiums, losses and loss reserves, premium rates and retention of current business, competition and market conditions, the expansion of product lines, the development or acquisition of business in new geographical areas, the availability of acceptable reinsurance, actions by regulators and rating agencies, court actions, legislative actions, payment or performance of obligations under indebtedness, payment of dividends and other matters.

These forward-looking statements are subject to significant risks, assumptions and uncertainties, including, among other things, the following factors that could affect the actual outcome of future events:

- general economic conditions, either nationally or in our market areas, that are different than anticipated;
- our ability to maintain our dividend payments;
- regulatory, legislative and judicial actions or decisions that could affect our business plans or operations;
- the enactment or repeal of tort reforms;
- the formation or dissolution of state-sponsored medical professional liability insurance entities that could remove or add sizable groups of physicians from or to the private insurance market;
- the impact of deflation or inflation;
- changes in the interest rate environment;
- changes in U.S. laws or government regulations regarding financial markets or market activity that may affect the U.S. economy and our business;
- changes in the ability of the U.S. government to meet its obligations that may affect the U.S. economy and our business;
- performance of financial markets affecting the fair value of our investments or making it difficult to determine the value of our investments;
- changes in accounting policies and practices that may be adopted by our regulatory agencies and the Financial Accounting Standards Board, the Securities and Exchange Commission, or the Public Company Accounting Oversight Board;
- changes in laws or government regulations affecting medical professional liability insurance or the financial community;
- the effects of changes in the healthcare delivery system, including but not limited to the Patient Protection and Affordable Care Act;
- consolidation of healthcare providers and entities that are more likely to self insure and not purchase medical professional liability insurance;
- uncertainties inherent in the estimate of loss and loss adjustment expense reserves and reinsurance, and changes in the availability, cost, quality, or collectability of insurance/reinsurance;
- the results of litigation, including pre- or post-trial motions, trials and/or appeals we undertake;
- allegation of bad faith which may arise from our handling of any particular claim, including failure to settle;
- loss of independent agents;
- changes in our organization, compensation and benefit plans;
- our ability to retain and recruit senior management;
- our ability to purchase reinsurance and collect recoveries from our reinsurers;

assessments from guaranty funds;

our ability to achieve continued growth through expansion into other states or through acquisitions or business combinations;

- changes to the ratings assigned by rating agencies to our insurance subsidiaries, individually or as a group;

provisions in our charter documents, Delaware law and state insurance law may impede attempts to replace or remove management or may impede a takeover;

state insurance restrictions may prohibit assets held by our insurance subsidiaries, including cash and investment

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securities, from being used for general corporate purposes;

taxing authorities can take exception to our tax positions and cause us to incur significant amounts of defense costs and, if our defense is not successful, additional tax costs, including interest and penalties;

insurance market conditions may alter the effectiveness of our current business strategy and impact our revenues; and expected benefits from completed and proposed acquisitions may not be achieved or may be delayed longer than expected due to business disruption, loss of customers, employees and key agents, increased operating costs or inability to achieve cost savings, and assumption of greater than expected liabilities, among other reasons.

Additional risks that could adversely affect the proposed mergers of Medmarc Insurance Group (Medmarc) and Independent Nevada Doctors Insurance Exchange (IND) into ProAssurance, include but are not limited to, the following:

- the businesses of ProAssurance and Medmarc or ProAssurance and IND may not be combined successfully, or such combination may take longer to accomplish than expected;
- the cost savings from either transaction may not be fully realized or may take longer to realize than expected;
- operating costs, customer loss and business disruption following either or both transactions, including adverse effects on relationships with employees, may be greater than expected;
- governmental approvals of either or both transactions may not be obtained or adverse regulatory conditions may be imposed in connection with governmental approvals of either or both transactions;
- there may be restrictions on our ability to achieve continued growth through expansion into other states or through acquisitions or business combinations;
- the board of directors of Medmarc or the Subscriber Advisory Committee (SAC) of IND may withdraw their recommendation in favor of a competing acquisition proposal; and
- those policyholders eligible to vote on the proposed Medmarc transaction may fail to approve it.

Our results may differ materially from those we expect and discuss in any forward-looking statements. The principal risk factors that may cause these differences are described in “Item 1A, Risk Factors” in our Form 10-K and other documents we file with the Securities and Exchange Commission, such as our current reports on Form 8-K, and our regular reports on Form 10-Q.

We caution readers not to place undue reliance on any such forward-looking statements, which are based upon conditions existing only as of the date made, and advise readers that these factors could affect our financial performance and could cause actual results for future periods to differ materially from any opinions or statements expressed with respect to future periods in any current statements. Except as required by law or regulations, we do not undertake and specifically decline any obligation to publicly release the result of any revisions that may be made to any forward-looking statements to reflect events or circumstances after the date of such statements or to reflect the occurrence of anticipated or unanticipated events.

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ProAssurance Corporation and Subsidiaries  
Condensed Consolidated Balance Sheets (Unaudited)  
(In thousands, except share data)

|   | September 30,<br>2012 | December 31,<br>2011 |
|---|-----------------------|----------------------|
| Assets  |                       |                      |
| Investments   |                       |                      |
| Fixed maturities, available for sale, at fair value; amortized cost, \$3,325,657 and \$3,465,720, respectively                  | \$3,570,179           | \$3,665,763          |
| Equity securities, available for sale, at fair value; cost, \$6 at December 31, 2011  | —                     | 25                   |
| Equity securities, trading, at fair value; cost, \$169,144 and \$101,078, respectively  | 183,978               | 103,133              |
| Short-term investments  | 167,516               | 119,421              |
| Business owned life insurance   | 52,070                | 52,651               |
| Investment in unconsolidated subsidiaries   | 120,670               | 111,324              |
| Other investments   | 31,221                | 38,224               |
| Total Investments   | 4,125,634             | 4,090,541            |
| Cash and cash equivalents   | 97,659                | 130,400              |
| Premiums receivable   | 125,204               | 120,220              |
| Receivable from reinsurers on paid losses and loss adjustment expenses  | 9,292                 | 4,175                |
| Receivable from reinsurers on unpaid losses and loss adjustment expenses  | 231,250               | 247,658              |
| Prepaid reinsurance premiums  | 16,100                | 12,568               |
| Deferred policy acquisition costs   | 25,042                | 26,626               |
| Deferred taxes  | 7,962                 | 30,989               |
| Real estate, net  | 41,111                | 40,432               |
| Intangible assets   | 50,209                | 53,703               |
| Goodwill  | 159,625               | 159,625              |
| Other assets  | 83,578                | 81,941               |
| Total Assets  | \$4,972,666           | \$4,998,878          |
| Liabilities and Shareholders' Equity  |                       |                      |
| Liabilities   |                       |                      |
| Policy liabilities and accruals   |                       |                      |
| Reserve for losses and loss adjustment expenses   | \$2,153,548           | \$2,247,772          |
| Unearned premiums   | 257,661               | 251,155              |
| Reinsurance premiums payable  | 86,047                | 82,039               |
| Total Policy Liabilities  | 2,497,256             | 2,580,966            |
| Other liabilities   | 126,012               | 203,772              |
| Long-term debt, \$35,507 at amortized cost and \$14,180 at fair value at December 31, 2011                                      | —                     | 49,687               |
| Total Liabilities   | 2,623,268             | 2,834,425            |
| Shareholders' Equity  |                       |                      |
| Common shares, par value \$0.01 per share, 100,000,000 shares authorized, 34,721,820 and 34,551,494 shares issued, respectively | 347                   | 346                  |
| Additional paid-in capital  | 543,471               | 538,625              |
| Accumulated other comprehensive income (loss), net of deferred tax expense (benefit) of \$85,583 and \$70,022, respectively     | 158,936               | 130,037              |
| Retained earnings   | 1,851,052             | 1,699,853            |

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|  |             |             |
|--|-------------|-------------|
| Treasury shares, at cost, 3,997,951 shares | 2,553,806   | 2,368,861   |
|  | (204,408 )  | (204,408 )  |
| Total Shareholders' Equity                 | 2,349,398   | 2,164,453   |
| Total Liabilities and Shareholders' Equity | \$4,972,666 | \$4,998,878 |
| See accompanying notes.                    |             |             |

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ProAssurance Corporation and Subsidiaries  
Condensed Consolidated Statements of Changes in Capital (Unaudited)  
(In thousands)

|  | Total       | Accumulated<br>Other<br>Comprehensive<br>Income (Loss) | Retained<br>Earnings | Other Capital<br>Accounts |   |
|--|-------------|--|----------------------|---------------------------|---|
| Balance at December 31, 2011   | \$2,164,453 | \$ 130,037   | \$1,699,853          | \$334,563                 |   |
| Net income   | 174,204     | —  | 174,204              | —                         |   |
| Dividends to shareholders  | (23,005     | ) —  | (23,005              | ) —                       |   |
| Change in net unrealized gains (losses) on<br>investments, after tax, net of reclassification<br>adjustments                       | 28,899      | 28,899   | —                    | —                         |   |
| Common shares issued for compensation and net<br>effect of restricted and performance shares issued<br>and stock options exercised | (1,534      | ) —  | —                    | (1,534                    | ) |
| Share-based compensation   | 6,381       | —  | —                    | 6,381                     |   |
| Balance at September 30, 2012  | \$2,349,398 | \$ 158,936   | \$1,851,052          | \$339,410                 |   |

|   | Total       | Accumulated<br>Other<br>Comprehensive<br>Income (Loss) | Retained<br>Earnings | Other Capital<br>Accounts |   |
|---|-------------|--|----------------------|---------------------------|---|
| Balance at December 31, 2010  | \$1,855,863 | \$ 79,124  | \$1,428,026          | \$348,713                 |   |
| Net income  | 146,494     | —  | 146,494              | —                         |   |
| Dividends to shareholders   | (7,632      | ) —  | (7,632               | ) —                       |   |
| Change in net unrealized gains (losses) on<br>investments, after tax, net of reclassification<br>adjustments        | 43,224      | 43,224   | —                    | —                         |   |
| Common shares reacquired  | (21,013     | ) —  | —                    | (21,013                   | ) |
| Common shares issued for compensation and net<br>effect of performance shares issued and stock<br>options exercised | (595        | ) —  | —                    | (595                      | ) |
| Share-based compensation  | 5,422       | —  | —                    | 5,422                     |   |
| Balance at September 30, 2011   | \$2,021,763 | \$ 122,348   | \$1,566,888          | \$332,527                 |   |
| See accompanying notes.   |             |  |                      |                           |   |



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ProAssurance Corporation and Subsidiaries  
Condensed Consolidated Statements of Income and Comprehensive Income (Unaudited)  
(In thousands, except per share data)

|  | Three Months Ended<br>September 30 |                  | Nine Months Ended<br>September 30 |                   |
|--|------------------------------------|------------------|-----------------------------------|-------------------|
|  | 2012                               | 2011             | 2012                              | 2011              |
| <b>Revenues</b>  |                                    |                  |                                   |                   |
| Net premiums earned  | \$ 127,125                         | \$ 134,627       | \$ 395,050                        | \$ 403,766        |
| Net investment income  | 33,910                             | 34,116           | 101,912                           | 106,573           |
| Equity in earnings (loss) of unconsolidated subsidiaries   | 211                                | (2,264)          | (4,082)                           | (6,044)           |
| Net realized investment gains (losses):  |                                    |                  |                                   |                   |
| Other-than-temporary impairment (OTTI) losses  | (142)                              | (1,389)          | (1,566)                           | (4,291)           |
| Portion of OTTI losses recognized in (reclassified from) other comprehensive income before taxes | —                                  | (142)            | (201)                             | (823)             |
| Net impairment losses recognized in earnings   | (142)                              | (1,531)          | (1,767)                           | (5,114)           |
| Other net realized investment gains (losses)   | 13,361                             | (10,441)         | 24,115                            | (534)             |
| Total net realized investment gains (losses)   | 13,219                             | (11,972)         | 22,348                            | (5,648)           |
| Other income   | 1,529                              | 7,471            | 5,207                             | 11,745            |
| <b>Total revenues</b>  | <b>175,994</b>                     | <b>161,978</b>   | <b>520,435</b>                    | <b>510,392</b>    |
| <b>Expenses</b>  |                                    |                  |                                   |                   |
| Losses and loss adjustment expenses  | 63,675                             | 71,777           | 197,112                           | 218,270           |
| Reinsurance recoveries   | (7,054)                            | (8,601)          | (22,208)                          | (20,319)          |
| Net losses and loss adjustment expenses  | 56,621                             | 63,176           | 174,904                           | 197,951           |
| Underwriting, policy acquisition and operating expenses  | 33,280                             | 34,954           | 103,083                           | 103,534           |
| Interest expense   | 350                                | 932              | 2,002                             | 2,645             |
| Loss on extinguishment of debt   | 2,163                              | —                | 2,163                             | —                 |
| <b>Total expenses</b>  | <b>92,414</b>                      | <b>99,062</b>    | <b>282,152</b>                    | <b>304,130</b>    |
| <b>Income before income taxes</b>  | <b>83,580</b>                      | <b>62,916</b>    | <b>238,283</b>                    | <b>206,262</b>    |
| <b>Provision for income taxes</b>  |                                    |                  |                                   |                   |
| Current expense (benefit)  | 19,017                             | 19,220           | 56,612                            | 46,049            |
| Deferred expense (benefit)   | 4,457                              | (9)              | 7,467                             | 13,719            |
| Total income tax expense (benefit)   | 23,474                             | 19,211           | 64,079                            | 59,768            |
| <b>Net income</b>  | <b>\$ 60,106</b>                   | <b>\$ 43,705</b> | <b>\$ 174,204</b>                 | <b>\$ 146,494</b> |
| Other comprehensive income, after tax, net of reclassification adjustments (see Note 9)          | 18,885                             | 23,291           | 28,899                            | 43,224            |
| <b>Comprehensive income</b>  | <b>\$ 78,991</b>                   | <b>\$ 66,996</b> | <b>\$ 203,103</b>                 | <b>\$ 189,718</b> |
| <b>Earnings per share:</b>   |                                    |                  |                                   |                   |
| Basic  | \$ 1.96                            | \$ 1.43          | \$ 5.69                           | \$ 4.79           |
| Diluted  | \$ 1.94                            | \$ 1.42          | \$ 5.64                           | \$ 4.75           |

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Weighted average number of common shares  
outstanding:

|         |        |        |        |        |
|---------|--------|--------|--------|--------|
| Basic   | 30,674 | 30,557 | 30,641 | 30,577 |
| Diluted | 30,938 | 30,847 | 30,902 | 30,844 |

|  |        |        |        |        |
|--|--------|--------|--------|--------|
| Cash dividends declared per common share | \$0.25 | \$0.25 | \$0.75 | \$0.25 |
|--|--------|--------|--------|--------|

See accompanying notes.

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ProAssurance Corporation and Subsidiaries  
Condensed Consolidated Statements of Cash Flows (Unaudited)  
(In thousands)

|  | Nine Months Ended<br>September 30 |            |
|--|-----------------------------------|------------|
|  | 2012                              | 2011       |
| <b>Operating Activities</b>  |                                   |            |
| Net income   | \$ 174,204                        | \$ 146,494 |
| Depreciation and amortization  | 28,280                            | 27,182     |
| Loss (gain) on extinguishment of debt                                | 2,163                             | —          |
| Net realized investment (gains) losses                               | (22,348                           | ) 5,648    |
| Share-based compensation   | 6,381                             | 5,422      |
| Deferred income taxes  | 7,467                             | 13,719     |
| Other  | (2,423                            | ) (328     |
| Changes in assets and liabilities:                                   |                                   |            |
| Premiums receivable  | (4,984                            | ) (17,061  |
| Other assets   | (3,633                            | ) 4,090    |
| Reserve for losses and loss adjustment expenses                      | (94,224                           | ) (21,008  |
| Unearned premiums  | 6,506                             | 21,652     |
| Reinsurance related assets and liabilities                           | 11,767                            | (8,510     |
| Other liabilities  | (47,800                           | ) (70,882  |
| Net cash provided by operating activities                            | 61,356                            | 106,418    |
| <b>Investing Activities</b>  |                                   |            |
| Purchases of:  |                                   |            |
| Fixed maturities, available for sale                                 | (533,780                          | ) (597,762 |
| Equity securities, trading   | (84,008                           | ) (87,787  |
| Other investments  | (9,539                            | ) (429     |
| Funding of tax credit limited partnerships                           | (29,458                           | ) (21,542  |
| (Investments in) distributions from unconsolidated subsidiaries, net | (6,451                            | ) —        |
| Proceeds from sale or maturities of:                                 |                                   |            |
| Fixed maturities, available for sale                                 | 666,054                           | 586,455    |
| Equity securities, available for sale                                | —                                 | 3,836      |
| Equity securities, trading   | 33,343                            | 40,648     |
| Other investments  | 588                               | 596        |
| Net sales or maturities (purchases) of short-term investments        | (48,230                           | ) 71,614   |
| Unsettled security transactions, net                                 | 3,399                             | 4,897      |
| Cash received (paid) for other assets                                | (5,651                            | ) (9,581   |
| Net cash provided (used) by investing activities                     | (13,733                           | ) (9,055   |
| <b>Financing Activities</b>  |                                   |            |
| Repayment of long-term debt and related swap                         | (57,660                           | ) —        |
| Repurchase of common stock   | —                                 | (21,013    |
| Dividends to shareholders  | (22,922                           | ) —        |
| Other  | 218                               | (1,494     |

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|  |          |           |   |
|--|----------|-----------|---|
| Net cash provided (used) by financing activities | (80,364  | ) (22,507 | ) |
| Increase (decrease) in cash and cash equivalents | (32,741  | ) 74,856  |   |
| Cash and cash equivalents at beginning of period | 130,400  | 50,851    |   |
| Cash and cash equivalents at end of period       | \$97,659 | \$125,707 |   |
| See accompanying notes.                          |          |           |   |

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ProAssurance Corporation and Subsidiaries

Notes to Condensed Consolidated Financial Statements (Unaudited)

September 30, 2012

1. Basis of Presentation

The accompanying unaudited Condensed Consolidated Financial Statements include the accounts of ProAssurance Corporation and its consolidated subsidiaries (ProAssurance or PRA). The financial statements have been prepared in accordance with U.S. Generally Accepted Accounting Principles (GAAP) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and notes required by GAAP for complete financial statements. In the opinion of management, all adjustments considered necessary for a fair presentation, consisting of normal recurring adjustments, have been included. ProAssurance's results for the three- and nine-month periods ended September 30, 2012 are not necessarily indicative of the results that may be expected for the year ending December 31, 2012. The accompanying Condensed Consolidated Financial Statements should be read in conjunction with the Consolidated Financial Statements and Notes contained in ProAssurance's December 31, 2011 report on Form 10-K. In connection with its preparation of the Condensed Consolidated Financial Statements, ProAssurance evaluated events that occurred subsequent to September 30, 2012 for recognition or disclosure in its financial statements and notes to financial statements.

Accounting Changes Not Yet Adopted

Intangibles-Goodwill and Other

Effective for fiscal years beginning after September 15, 2012, the FASB revised guidance related to impairment testing of indefinite-lived intangible assets. The new guidance permits an entity to assess qualitative factors to determine whether the existence of events and circumstances indicates that it is more likely than not that an indefinite-lived intangible asset is impaired. Quantitative impairment testing is required only if the assessment of qualitative factors indicates it is more likely than not that impairment exists. ProAssurance plans to adopt the guidance beginning January 1, 2013. Adoption of this guidance is expected to have no effect on ProAssurance's results of operations or financial position.

Disclosures About Offsetting Assets and Liabilities

Effective for fiscal years beginning on or after January 1, 2013, the Financial Accounting Standards Board (FASB) revised guidance related to disclosures about certain assets and liabilities in an entity's financial statements. The guidance requires disclosures related to the net and gross positions of certain financial instruments and transactions that are either eligible for offset in accordance with existing GAAP guidance or subject to an agreement that requires such offset. The guidance must be applied retrospectively for all prior periods presented. ProAssurance plans to adopt the guidance beginning January 1, 2013. Adoption of this guidance is expected to have no effect on ProAssurance's results of operations or financial position as it impacts disclosures only.

Accounting Changes

Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts

Effective for fiscal years beginning after December 15, 2011, the FASB revised guidance regarding the interpretation of which costs relating to the acquisition of new or renewal insurance contracts qualify for deferral. The guidance permits deferral of qualifying costs only when associated with successful contract acquisitions. Internal selling agent and underwriter salary and benefit costs allocated to unsuccessful contracts, as well as advertising costs, are excluded. The guidance must be applied prospectively, but may be applied retrospectively for all prior periods. ProAssurance prospectively adopted the guidance on January 1, 2012. Adoption of this guidance had no material effect on ProAssurance's results of operations or financial position.

Fair Value Measurements

Effective for interim and annual reporting periods beginning after December 15, 2011, the FASB revised guidance related to fair value measurements and disclosures, all of which are to be applied prospectively. The new guidance increases disclosure requirements regarding valuation methods used to determine fair value measurements categorized as Level 3, as well as the sensitivity to change of those measurements, and requires additional disclosures regarding the consideration given to highest and best use in fair value measurements of nonfinancial assets. The guidance also

requires that when fair value measurements of items not carried at fair value are disclosed, the fair value measurements are to be categorized by level of the fair value hierarchy. Additionally, the guidance also clarifies or revises certain fair value measurement principles related to the valuation of financial instruments managed within a portfolio, the valuation of instruments classified as a part of shareholders' equity, the appropriate application of the highest and best use valuation premise, and the consideration of premium and discounts in a fair value measurement. ProAssurance adopted the guidance on January 1, 2012. Adoption of this guidance had no material effect on ProAssurance's results of operations or financial position.

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ProAssurance Corporation and Subsidiaries

Notes to Condensed Consolidated Financial Statements (Unaudited)

September 30, 2012

2. Fair Value Measurement

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. A three level hierarchy has been established for valuing assets and liabilities based on how transparent (observable) the inputs are that are used to determine fair value, with the inputs considered most observable categorized as Level 1 and those that are the least observable categorized as Level 3. Hierarchy levels are defined as follows:

- Level 1: quoted (unadjusted) market prices in active markets for identical assets and liabilities. For ProAssurance, Level 1 inputs are generally quotes for debt or equity securities actively traded in exchange or over-the-counter markets.
- Level 2: market data obtained from sources independent of the reporting entity (observable inputs). For ProAssurance, Level 2 inputs generally include quoted prices in markets that are not active, quoted prices for similar assets or liabilities, and results from pricing models that use observable inputs such as interest rates and yield curves that are generally available at commonly quoted intervals.
- Level 3: the reporting entity's own assumptions about market participant assumptions based on the best information available in the circumstances (non-observable inputs). For ProAssurance, Level 3 inputs are used in situations where little or no Level 1 or 2 inputs are available or are inappropriate given the particular circumstances. Level 3 inputs include results from pricing models for which some or all of the inputs are not observable, discounted cash flow methodologies, single non-binding broker quotes and adjustments to externally quoted prices that are based on management judgment or estimation.

Fair values of assets and liabilities measured at fair value on a recurring basis as of September 30, 2012 and December 31, 2011, including financial instruments for which ProAssurance has elected fair value, are shown in the following tables. The tables also indicate the fair value hierarchy of the valuation techniques utilized to determine those fair values. For some assets, the inputs used to measure fair value may fall into different levels of the fair value hierarchy. When this is the case, the asset is categorized based on the level of the most significant input to the fair value measurement. Assessments of the significance of a particular input to the fair value measurement requires judgment and consideration of factors specific to the assets being valued.

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ProAssurance Corporation and Subsidiaries

Notes to Condensed Consolidated Financial Statements (Unaudited)

September 30, 2012

## 2. Fair Value Measurement (continued)

| (In thousands)  | September 30, 2012                       |             |          | Total<br>Fair Value |
|---|--|-------------|----------|---------------------|
|   | Fair Value Measurements Using<br>Level 1 | Level 2     | Level 3  |                     |
| Assets:   |  |             |          |                     |
| Fixed maturities, available for sale                                  |  |             |          |                     |
| U.S. Treasury obligations   | \$—                                      | \$218,542   | \$—      | \$218,542           |
| U.S. Government-sponsored enterprise obligations                      | —  | 62,691      | —        | 62,691              |
| State and municipal bonds   | —  | 1,206,113   | 7,175    | 1,213,288           |
| Corporate debt, multiple observable inputs                            | —  | 1,453,004   | —        | 1,453,004           |
| Corporate debt, limited observable inputs:                            |  |             |          |                     |
| Private placement senior notes  | —  | —           | 349      | 349                 |
| Other corporate debt, NRSRO ratings available                         | —  | —           | 16,570   | 16,570              |
| Other corporate debt, NRSRO ratings not available                     | —  | —           | 6,847    | 6,847               |
| Residential mortgage-backed securities                                | —  | 375,673     | —        | 375,673             |
| Agency commercial mortgage-backed securities                          | —  | 71,462      | —        | 71,462              |
| Other commercial mortgage-backed securities                           | —  | 76,742      | —        | 76,742              |
| Other asset-backed securities   | —  | 70,986      | 4,025    | 75,011              |
| Equity securities   |  |             |          |                     |
| Financial   | 66,885                                   | —           | —        | 66,885              |
| Utilities/Energy  | 29,207                                   | —           | —        | 29,207              |
| Consumer oriented   | 46,394                                   | —           | —        | 46,394              |
| Technology  | 10,543                                   | —           | —        | 10,543              |
| Industrial  | 16,374                                   | —           | —        | 16,374              |
| All other   | 14,575                                   | —           | —        | 14,575              |
| Short-term investments  | 72,632                                   | 94,884      | —        | 167,516             |
| Financial instruments carried at fair value, classified as a part of: |  |             |          |                     |
| Investment in unconsolidated subsidiaries                             | —  | —           | 31,479   | 31,479              |
| Total assets  | \$256,610                                | \$3,630,097 | \$66,445 | \$3,953,152         |
| Liabilities:  |  |             |          |                     |
| 2019 Note payable   | —  | —           | —        | —                   |
| Interest rate swap agreement  | —  | —           | —        | —                   |
| Total liabilities   | \$—                                      | \$—         | \$—      | \$—                 |



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ProAssurance Corporation and Subsidiaries  
Notes to Condensed Consolidated Financial Statements (Unaudited)  
September 30, 2012

## 2. Fair Value Measurement (continued)

| (In thousands)  | December 31, 2011                        |             |          | Total<br>Fair Value |
|---|--|-------------|----------|---------------------|
|   | Fair Value Measurements Using<br>Level 1 | Level 2     | Level 3  |                     |
| Assets:   |  |             |          |                     |
| Fixed maturities, available for sale                                  |  |             |          |                     |
| U.S. Treasury obligations   | \$—                                      | \$283,865   | \$—      | \$283,865           |
| U.S. Government-sponsored enterprise obligations                      | —  | 68,104      | —        | 68,104              |
| State and municipal bonds   | —  | 1,221,187   | 7,200    | 1,228,387           |
| Corporate debt, multiple observable inputs                            | —  | 1,359,866   | —        | 1,359,866           |
| Corporate debt, limited observable inputs:                            |  |             |          |                     |
| Private placement senior notes  | —  | —           | 612      | 612                 |
| Other corporate debt, NRSRO ratings available                         | —  | —           | 6,310    | 6,310               |
| Other corporate debt, NRSRO ratings not available                     | —  | —           | 1,160    | 1,160               |
| Residential mortgage-backed securities                                | —  | 452,932     | —        | 452,932             |
| Agency commercial mortgage-backed securities                          | —  | 81,530      | —        | 81,530              |
| Other commercial mortgage-backed securities                           | —  | 81,188      | —        | 81,188              |
| Other asset-backed securities   | —  | 101,809     | —        | 101,809             |
| Equity securities   |  |             |          |                     |
| Financial   | 25,281                                   | —           | —        | 25,281              |
| Utilities/Energy  | 18,748                                   | —           | —        | 18,748              |
| Consumer oriented   | 29,711                                   | —           | —        | 29,711              |
| Technology  | 7,556                                    | —           | —        | 7,556               |
| Industrial  | 9,185                                    | —           | —        | 9,185               |
| All other   | 12,677                                   | —           | —        | 12,677              |
| Short-term investments  | 111,359                                  | 8,062       | —        | 119,421             |
| Financial instruments carried at fair value, classified as a part of: |  |             |          |                     |
| Investment in unconsolidated subsidiaries                             | —  | —           | 23,841   | 23,841              |
| Other investments   | —  | —           | 15,873   | 15,873              |
| Total assets  | \$214,517                                | \$3,658,543 | \$54,996 | \$3,928,056         |
| Liabilities:  |  |             |          |                     |
| 2019 Note payable   | —  | —           | 14,180   | 14,180              |
| Interest rate swap agreement  | —  | —           | 4,659    | 4,659               |
| Total liabilities   | \$—                                      | \$—         | \$18,839 | \$18,839            |

The fair values for securities included in the Level 2 category, with the few exceptions described below, have been developed by third party, nationally recognized pricing services. These services use complex methodologies to determine values for securities and subject the values they develop to quality control reviews. Management reviews service-provided values for reasonableness by comparing data among pricing services and to available market and trade data. Values that appear inconsistent are further reviewed for appropriateness. If a value does not appear reasonable, the valuation is discussed with the service that provided the value and would be adjusted, if necessary. No such adjustments have been necessary in 2012 or 2011.



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ProAssurance Corporation and Subsidiaries

Notes to Condensed Consolidated Financial Statements (Unaudited)

September 30, 2012

2. Fair Value Measurement (continued)

Level 2 Valuations

Below is a summary description of the valuation methodologies primarily used by the pricing services for securities in the Level 2 category, by security type:

U.S. Treasury obligations are valued based on quoted prices for identical assets, or, in markets that are not active, quotes for similar assets, taking into consideration adjustments for variations in contractual cash flows and yields to maturity.

U.S. Government-sponsored enterprise obligations are valued using pricing models that consider current and historical market data, normal trading conventions, credit ratings, and the particular structure and characteristics of the security being valued, such as yield to maturity, redemption options, and contractual cash flows. Adjustments to model inputs or model results are included in the valuation process when necessary to reflect recent events, such as regulatory, government or corporate actions or significant economic, industry or geographic events that would affect the security's fair value.

State and municipal bonds are valued using a series of matrices that consider credit ratings, the structure of the security, the sector in which the security falls, yields, and contractual cash flows. Valuations are further adjusted, when necessary, to reflect recent events such as significant economic or geographic events or ratings changes that would affect the security's fair value.

Corporate debt with multiple observable inputs consists primarily of corporate bonds, but also includes a small number of bank loans. The methodology used to value Level 2 corporate bonds is the same as the methodology previously described for U.S. Government-sponsored enterprise obligations. Bank loans are valued by an outside vendor based upon a widely distributed, loan-specific listing of average bid and ask prices published daily by an investment industry group. The publisher of the listing derives the averages from data received from multiple market-makers for bank loans.

Residential and commercial mortgage backed securities. Agency pass-through securities are valued using a matrix, considering the issuer type, coupon rate and longest cash flows outstanding. The matrix is developed daily based on available market information. Agency and non-agency collateralized mortgage obligations are both valued using models that consider the structure of the security, current and historical information regarding prepayment speeds, ratings and ratings updates, and current and historical interest rate and interest rate spread data. Evaluations of Alt-A mortgages include a review of collateral performance data, which is generally updated monthly.

Other asset-backed securities are valued using models that consider the structure of the security, monthly payment information, current and historical information regarding prepayment speeds, ratings and ratings updates, and current and historical interest rate and interest rate spread data. Spreads and prepayment speeds consider collateral type. Evaluations of subprime home equity loans use the same evaluation methodology as previously described for Alt-A mortgages.

Short-term investments included in the Level 2 category are commercial paper and certificates of deposit maturing within one year, carried at cost which approximates the fair value of the security due to the short term to maturity.

Level 3 Valuations

Below is a summary description of the valuation processes and methodologies used as well as quantitative information regarding securities in the Level 3 category.

Level 3 Valuation Processes

Level 3 securities are priced by the Company's Vice President of Investments, who reports to the Chief Financial Officer.

Level 3 valuations are computed quarterly. Prices are evaluated quarterly against prior period prices and the expected change in price.

The Company's Level 3 valuations are not overly sensitive to changes in the unobservable inputs used. The securities noted in the disclosure are primarily investment grade debt where comparable market inputs are commonly available

for evaluating the securities in question.

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ProAssurance Corporation and Subsidiaries  
 Notes to Condensed Consolidated Financial Statements (Unaudited)  
 September 30, 2012

## 2. Fair Value Measurement (continued)

## Level 3 Valuation Methodologies

State and municipal bonds consists of auction rate municipal bonds valued internally using published quotes for similar securities or by using a model based on discounted cash flows using yields currently available on fixed rate securities with a similar term and collateral, adjusted to consider the effect of a floating rate and a premium for illiquidity. At September 30, 2012 and December 31, 2011 all of these bonds were rated A- or better.

Corporate debt with limited observable inputs consists of private placement senior notes guaranteed by large regional banks and contain corporate bonds. Valuations are determined using dealer quotes for similar securities or discounted cash flow models using yields currently available for similar securities. Similar securities are defined as securities having like terms and payment features that are of comparable credit quality. Assessments of credit quality are based on NRSRO ratings, if available, or are subjectively determined by management if not available. At September 30, 2012, the average rating of rated securities, primarily NRSRO ratings, was BBB+.

Other asset-backed securities consists of securitizations of receivables valued using dealer quotes for similar securities or discounted cash flow models using yields currently available for similar securities.

Investment in unconsolidated subsidiaries and Other investments consist of limited partnership (LP) and limited liability company (LLC) interests valued using the net asset value (NAV) provided by the LP/LLC, which approximates the fair value of the interest.

Such interests included the following:

| (In thousands)  | Unfunded      | Fair Value    |              |
|---|---------------|---------------|--------------|
|   | Commitments   | September 30, | December 31, |
|   | September 30, | September 30, | 2011         |
|   | 2012          | 2012          |              |
| Investment in unconsolidated subsidiaries:            |               |               |              |
| LP primarily invested in long/short equities (1)      | None          | \$17,740      | \$17,123     |
| LPs primarily invested in non-public equities (2)     | \$46,712      | 13,739        | 6,718        |
|   |               | 31,479        | 23,841       |
| Other investments:                                    |               |               |              |
| LLC primarily invested in private equity and debt (3) | None          | —             | 15,873       |
|   |               | \$31,479      | \$39,714     |

The LP holds both long and short U.S. and North American equities, and targets absolute returns using a strategy designed to take advantage of event-driven market opportunities. Redemptions are allowed with a notice (1) requirement of up to 45 days and are paid within 30 days of the redemption date, unless the redemption request is for 90% or more of the requestor's capital balance. Redemptions at the 90% and above level will be paid at 90%, with the remainder paid after the LP's annual audit.

The LPs are structured to provide capital appreciation through diversified investments in private equity, which can include investments in buyout, venture capital, mezzanine debt, distressed debt and other private equity-oriented (2) LPs. Redemptions are not allowed for one of the LPs, except by special permission of the LP. Income and capital are to be periodically distributed at the discretion of the LP over an anticipated time frame that spans from 4 to 7 years.

The LLC converted into a publicly traded investment fund during the second quarter of 2012. Prior to conversion, (3) the LLC was structured to provide income through diversified investments in private equity, including mezzanine debt, distressed debt, syndicated bank loans and other private equity-oriented investments.

Liabilities are valued using the present value of expected underlying cash flows of the instrument, discounted at rates available on the valuation date for similar instruments issued by entities with a similar credit standing to ProAssurance.



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ProAssurance Corporation and Subsidiaries  
 Notes to Condensed Consolidated Financial Statements (Unaudited)  
 September 30, 2012

## 2. Fair Value Measurement (continued)

## Quantitative Information Regarding Level 3 Valuations

## Quantitative Information about Level 3 Fair Value Measurements

| (In millions)                                 | Fair Value at<br>September<br>30, 2012 | Valuation Technique          | Unobservable Input       | Range<br>(Weighted Average) |
|---|--|------------------------------|--------------------------|-----------------------------|
| Assets:                                       |  |                              |                          |                             |
| State and municipal bonds                     | \$7.2                                  | Market Comparable Securities | Comparability Adjustment | 0% - 10% (5%)               |
|   |  | Discounted Cash Flows        | Comparability Adjustment | 0% - 10% (5%)               |
| Corporate debt with limited observable inputs | \$23.8                                 | Market Comparable Securities | Comparability Adjustment | 0% - 5% (2.5%)              |
|   |  | Discounted Cash Flows        | Comparability Adjustment | 0% - 5% (2.5%)              |
| Other asset-backed securities                 | \$4.0                                  | Market Comparable Securities | Comparability Adjustment | 0% - 5% (2.5%)              |
|   |  | Discounted Cash Flows        | Comparability Adjustment | 0% - 5% (2.5%)              |

The significant unobservable inputs used in the fair value measurement of the entity's corporate bonds are the valuations of comparable securities with similar issuer, credit quality and maturity. Changes in the availability of comparable securities could result in changes in the fair value measurements.

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ProAssurance Corporation and Subsidiaries

Notes to Condensed Consolidated Financial Statements (Unaudited)

September 30, 2012

## 2. Fair Value Measurement (continued)

The following tables (the Level 3 Tables) present summary information regarding changes in the fair value of assets and liabilities measured at fair value using Level 3 inputs, including financial instruments for which ProAssurance has elected fair value accounting.

| (In thousands)  | September 30, 2012                       |                   |                            |   |                      |          |
|---|--|-------------------|----------------------------|---|----------------------|----------|
|   | Level 3 Fair Value Measurements – Assets |                   |                            |   |                      |          |
|   | State and<br>Municipal<br>Bonds          | Corporate<br>Debt | Asset-backed<br>Securities | Investment in<br>Unconsolidated<br>Subsidiaries | Other<br>Investments | Total    |
| Balance June 30, 2012   | \$7,175                                  | \$10,510          | \$ 1,795                   | \$ 24,028                                       | \$ —                 | \$43,508 |
| Total gains (losses) realized and unrealized:   |  |                   |                            |   |                      |          |
| Included in earnings, as a part of:   |  |                   |                            |   |                      |          |
| Equity in earnings of unconsolidated subsidiaries   | —  | —                 | —                          | 419   | —                    | 419      |
| Net realized investment gains (losses)  | —  | 14                | —                          | —   | —                    | 14       |
| Included in other comprehensive income  | —  | 15                | 25                         | —   | —                    | 40       |
| Purchases   | —  | 6,978             | 4,939                      | 7,032   | —                    | 18,949   |
| Sales   | —  | (1,051)           | (1,118)                    | —   | —                    | (2,169)  |
| Transfers in  | —  | 9,220             | —                          | —   | —                    | 9,220    |
| Transfers out   | —  | (1,920)           | (1,616)                    | —   | —                    | (3,536)  |
| Balance September 30, 2012  | \$7,175                                  | \$23,766          | \$ 4,025                   | \$ 31,479                                       | \$ —                 | \$66,445 |
| Change in unrealized gains (losses) included in earnings for the above period for Level 3 assets held at period-end | \$—                                      | \$—               | \$—                        | \$ 419  | \$—                  | \$419    |

| (In thousands)                                    | September 30, 2012                       |                   |                            |   |                      |          |
|---|--|-------------------|----------------------------|---|----------------------|----------|
|   | Level 3 Fair Value Measurements – Assets |                   |                            |   |                      |          |
|   | State and<br>Municipal<br>Bonds          | Corporate<br>Debt | Asset-backed<br>Securities | Investment in<br>Unconsolidated<br>Subsidiaries | Other<br>Investments | Total    |
| Balance December 31, 2011                         | \$7,200                                  | \$8,082           | \$ —                       | \$ 23,841                                       | \$ 15,873            | \$54,996 |
| Total gains (losses) realized and unrealized:     |  |                   |                            |   |                      |          |
| Included in earnings, as a part of:               |  |                   |                            |   |                      |          |
| Equity in earnings of unconsolidated subsidiaries | —  | —                 | —                          | 1,189   | —                    | 1,189    |
| Net realized investment gains (losses)            | —  | 14                | —                          | —   | (131)                | (117)    |
| Included in other comprehensive income            | —  | 593               | 25                         | —   | —                    | 618      |
| Purchases   | —  | 8,915             | 6,734                      | 7,032   | —                    | 22,681   |
| Sales   | (25)                                     | (1,138)           | (1,118)                    | (583)   | —                    | (2,864)  |



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|   |         |          |          |           |           |           |
|---|---------|----------|----------|-----------|-----------|-----------|
| Transfers in  | —       | 9,220    | —        | —         | —         | 9,220     |
| Transfers out   | —       | (1,920 ) | (1,616 ) | —         | (15,742 ) | (19,278 ) |
| Balance September 30, 2012  | \$7,175 | \$23,766 | \$ 4,025 | \$ 31,479 | \$—       | \$66,445  |
| Change in unrealized gains (losses) included in earnings for the above period for Level 3 assets held at period-end | \$—     | \$—      | \$—      | \$ 1,189  | \$—       | \$1,189   |

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ProAssurance Corporation and Subsidiaries

Notes to Condensed Consolidated Financial Statements (Unaudited)

September 30, 2012

## 2. Fair Value Measurement (continued)

| (In thousands)   | September 30, 2011                       |                   |                            |   |                      |          |
|--|--|-------------------|----------------------------|---|----------------------|----------|
|  | Level 3 Fair Value Measurements – Assets |                   |                            |   |                      |          |
|  | State and<br>Municipal<br>Bonds          | Corporate<br>Debt | Asset-backed<br>Securities | Investment in<br>Unconsolidated<br>Subsidiaries | Other<br>Investments | Total    |
| Balance June 30, 2011  | \$7,325                                  | \$7,830           | \$ 1,684                   | \$ 25,127                                       | \$—                  | \$41,966 |
| Total gains (losses) realized and<br>unrealized:   |  |                   |                            |   |                      |          |
| Included in earnings, as a part of:  |  |                   |                            |   |                      |          |
| Equity in earnings of<br>unconsolidated subsidiaries   | —  | —                 | —                          | (297 )  | —                    | (297 )   |
| Net realized investment gains<br>(losses)  | —  | —                 | —                          | —   | —                    | —        |
| Included in other comprehensive<br>income  | —  | (638 )            | —                          | —   | —                    | (638 )   |
| Purchases  | —  | —                 | —                          | —   | —                    | —        |
| Sales  | (75 )                                    | —                 | —                          | —   | —                    | (75 )    |
| Transfers in   | —  | 2,904             | —                          | —   | 16,191               | 19,095   |
| Transfers out  | —  | —                 | (1,684 )                   | —   | —                    | (1,684 ) |
| Balance September 30, 2011   | \$7,250                                  | \$ 10,096         | \$—                        | \$ 24,830                                       | \$ 16,191            | \$58,367 |
| Change in unrealized gains (losses)<br>included in earnings for the above<br>period for Level 3 assets held at<br>period-end | \$—                                      | \$—               | \$—                        | \$ (297 )                                       | \$—                  | \$(297 ) |

| (In thousands)                                       | September 30, 2011                       |                   |                            |   |                      |           |
|--|--|-------------------|----------------------------|---|----------------------|-----------|
|  | Level 3 Fair Value Measurements – Assets |                   |                            |   |                      |           |
|  | State and<br>Municipal<br>Bonds          | Corporate<br>Debt | Asset-backed<br>Securities | Investment in<br>Unconsolidated<br>Subsidiaries | Other<br>Investments | Total     |
| Balance December 31, 2010                            | \$7,550                                  | \$21,229          | \$ 2,220                   | \$ 25,112                                       | \$—                  | \$56,111  |
| Total gains (losses) realized and<br>unrealized:     |  |                   |                            |   |                      |           |
| Included in earnings, as a part of:                  |  |                   |                            |   |                      |           |
| Equity in earnings of<br>unconsolidated subsidiaries | —  | —                 | —                          | (282 )  | —                    | (282 )    |
| Net realized investment gains<br>(losses)            | —  | —                 | 314                        | —   | —                    | 314       |
| Included in other comprehensive<br>income            | —  | (1,352 )          | (15 )                      | —   | —                    | (1,367 )  |
| Purchases  | —  | —                 | 1,684                      | —   | —                    | 1,684     |
| Sales  | (300 )                                   | (8,504 )          | (1,921 )                   | —   | —                    | (10,725 ) |
| Transfers in   | —  | 6,350             | —                          | —   | 16,191               | 22,541    |
| Transfers out  | —  | (7,627 )          | (2,282 )                   | —   | —                    | (9,909 )  |
| Balance September 30, 2011                           | \$7,250                                  | \$ 10,096         | \$—                        | \$ 24,830                                       | \$ 16,191            | \$58,367  |

Change in unrealized gains (losses)  
included in earnings for the above  
period for Level 3 assets held at  
period-end

|     |     |     |         |   |     |        |   |
|-----|-----|-----|---------|---|-----|--------|---|
| \$— | \$— | \$— | \$ (282 | ) | \$— | \$(282 | ) |
|-----|-----|-----|---------|---|-----|--------|---|

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ProAssurance Corporation and Subsidiaries  
 Notes to Condensed Consolidated Financial Statements (Unaudited)  
 September 30, 2012

## 2. Fair Value Measurement (continued)

## Transfers

There were no transfers between the Level 1 and Level 2 categories during the three and nine months ended September 30, 2012 or 2011.

Transfers shown in the preceding Level 3 Tables are as of the end of the period and were to or from Level 2, unless otherwise noted.

The transfers of Other investments reported in the Level 3 Tables for the 2012 nine-month period and the 2011 three- and nine-month periods relate to an interest in an LLC. The interest in the LLC, a cost method investment, was not carried at fair value at December 31, 2010. During 2011, the LLC announced a planned conversion to a public fund. Subsequent to the announcement, ProAssurance, through the recognition of OTTI, carried the LLC interest at fair value, based on the NAV provided by fund management; such valuation is considered to be in the Level 3 category. The LLC converted into a publicly traded investment fund during the second quarter of 2012 and the interest in the LLC was valued using Level 1 inputs at September 30, 2012.

All remaining transfers during the three and nine months ended September 30, 2012 and September 30, 2011 related to securities held for which there was little market activity for identical or nearly identical securities during the period and represented transfers to or from Level 2. Such securities were valued using multiple observable inputs when those inputs were available; otherwise the securities were valued using limited observable inputs.

| (In thousands)  | September 30, 2012                            |                              |           |
|---|---|------------------------------|-----------|
|   | Level 3 Fair Value Measurements - Liabilities |                              |           |
|   | 2019 Note Payable                             | Interest rate swap agreement | Total     |
| Balance June 30, 2012   | \$ 14,777                                     | \$ 4,734                     | \$ 19,511 |
| Total (gains) losses realized and unrealized:   |   |                              |           |
| Included in earnings as a part of:  |   |                              |           |
| Net realized investment (gains) losses  | —   | 401                          | 401       |
| Loss on extinguishment of debt  | 2,163   | —                            | 2,163     |
| Settlements   | (16,940)                                      | (5,135)                      | (22,075)  |
| Balance September 30, 2012  | \$—   | \$—                          | \$—       |
| Change in unrealized (gains) losses included in earnings for the above period for Level 3 liabilities outstanding at period-end | \$—   | \$—                          | \$—       |

| (In thousands)  | September 30, 2012                            |                              |           |
|---|---|------------------------------|-----------|
|   | Level 3 Fair Value Measurements - Liabilities |                              |           |
|   | 2019 Note Payable                             | Interest rate swap agreement | Total     |
| Balance December 31, 2011   | \$ 14,180                                     | \$ 4,659                     | \$ 18,839 |
| Total (gains) losses realized and unrealized:   |   |                              |           |
| Included in earnings as a part of:  |   |                              |           |
| Net realized investment (gains) losses  | 769   | 476                          | 1,245     |
| Loss on extinguishment of debt  | 2,163   | —                            | 2,163     |
| Settlements   | (17,112)                                      | (5,135)                      | (22,247)  |
| Balance September 30, 2012  | \$—   | \$—                          | \$—       |
| Change in unrealized (gains) losses included in earnings for the above period for Level 3 liabilities outstanding at period-end | \$—   | \$—                          | \$—       |



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ProAssurance Corporation and Subsidiaries  
 Notes to Condensed Consolidated Financial Statements (Unaudited)  
 September 30, 2012

## 2. Fair Value Measurement (continued)

| (In thousands)  | September 30, 2011                            |                              |           |
|---|---|------------------------------|-----------|
|   | Level 3 Fair Value Measurements - Liabilities |                              |           |
|   | 2019 Note Payable                             | Interest rate swap agreement | Total     |
| Balance June 30, 2011   | \$ 15,863                                     | \$ 3,852                     | \$ 19,715 |
| Total (gains) losses realized and unrealized:<br>Included in earnings as a part of:   |   |                              |           |
| Net realized investment (gains) losses  | (1,370  | ) 897                        | (473 )    |
| Settlements   | (82   | ) —                          | (82 )     |
| Balance September 30, 2011  | \$ 14,411                                     | \$ 4,749                     | \$ 19,160 |
| Change in unrealized (gains) losses included in earnings for the above period for Level 3 liabilities outstanding at period-end | \$(1,370                                      | ) \$ 897                     | \$(473 )  |

| (In thousands)  | September 30, 2011                            |                              |           |
|---|---|------------------------------|-----------|
|   | Level 3 Fair Value Measurements - Liabilities |                              |           |
|   | 2019 Note Payable                             | Interest rate swap agreement | Total     |
| Balance December 31, 2010   | \$ 15,616                                     | \$ 3,658                     | \$ 19,274 |
| Total (gains) losses realized and unrealized:<br>Included in earnings as a part of:   |   |                              |           |
| Net realized investment (gains) losses  | (962  | ) 1,091                      | 129       |
| Settlements   | (243  | ) —                          | (243 )    |
| Balance September 30, 2011  | \$ 14,411                                     | \$ 4,749                     | \$ 19,160 |
| Change in unrealized (gains) losses included in earnings for the above period for Level 3 liabilities outstanding at period-end | \$(962  | ) \$ 1,091                   | \$ 129    |

## Fair Value Option Elections

The 2019 Note Payable (the Note) and a related interest rate swap agreement (the Swap) were repaid in July 2012, as discussed in Note 8. Prior to repayment, both the Note and the Swap were measured at fair value on a recurring basis, with changes in the fair value of each liability recorded in net realized gains (losses). ProAssurance assumed both liabilities as part of a previous acquisition. The fair value option was elected for the Note and the Swap because valuation at fair value better reflected the economics of the related liabilities and eliminated the inconsistency that would have otherwise resulted from carrying the Note on an amortized cost basis and the Swap at fair value.

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## 2. Fair Value Measurement (continued)

## Financial Instruments - Methodologies Other Than Fair Value

The following table provides the estimated fair value of our financial instruments that, in accordance with GAAP for the type of investment, are measured using a methodology other than fair value. All fair values provided fall within the Level 3 fair value category.

| (In thousands)                            | September 30, 2012 |                      | December 31, 2011 |                      |
|---|--------------------|----------------------|-------------------|----------------------|
|   | Carrying Value     | Estimated Fair Value | Carrying Value    | Estimated Fair Value |
| Financial assets:                         |                    |                      |                   |                      |
| Other Investments                         | \$31,221           | \$38,494             | \$22,351          | \$28,226             |
| Investment in Unconsolidated Subsidiaries | 89,191             | 97,426               | 87,483            | 96,443               |
| BOLI                                      | 52,070             | 52,070               | 52,651            | 52,651               |
| Other Assets                              | 11,638             | 11,561               | 9,636             | 9,636                |
| Financial liabilities:                    |                    |                      |                   |                      |
| Trust Preferred Securities due 2034       | \$—                | \$—                  | \$22,992          | \$22,992             |
| Surplus Notes due May 2034                | —                  | —                    | 12,000            | 12,000               |
| Note Payable due February 2012            | —                  | —                    | 515               | 519                  |
| Other Liabilities                         | 14,052             | 13,968               | 15,076            | 14,946               |

Other Investments listed in the table above include interests in certain investment fund LPs/LLCs accounted for using the cost method, investments in Federal Home Loan Bank (FHLB) common stock carried at cost, and an annuity investment carried at amortized cost. The estimated fair value of the LP/LLC interests is based on the NAV provided by the LP/LLC managers. The estimated fair value of the FHLB common stock is based on the amount ProAssurance would receive if its membership were canceled, as the membership cannot be sold. The fair value of the annuity is the present value of the expected future cash flows discounted using a rate available in active markets for similarly structured instruments.

Investment in Unconsolidated Subsidiaries consists of investments in tax credit partnerships and a non-controlling interest in a limited liability company. Fair values of investments in tax credit partnerships are based on the present value of the cash flows expected to be generated by the partnerships discounted at rates for investments with similar risk structures and repayment periods. The fair value of the LLC interest is estimated as the proceeds ProAssurance would receive upon liquidation of the LLC.

The fair value of the BOLI is the cash surrender value associated with the policies on the valuation date.

Other Assets and Other Liabilities primarily consist of related investment assets and liabilities associated with funded deferred compensation agreements. Other Liabilities also includes certain contractual liabilities related to prior business combinations. Fair values of the funded deferred compensation assets and liabilities are based on the NAVs of the underlying securities. The fair values of the business combination liabilities are based on the present value of the expected cash flows, discounted at ProAssurance's assumed incremental borrowing rate on the valuation date for unsecured liabilities with similar repayment structures.

The fair value of the long-term debt is the present value of expected underlying cash flows of the debt, discounted at rates available on the valuation date for similar debt issued by entities with a similar credit standing to ProAssurance or, if issued by an insurance subsidiary, the subsidiary issuing the debt.

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September 30, 2012

## 3. Investments

Available-for-sale securities at September 30, 2012 and December 31, 2011 include the following:

| (In thousands)                                   | September 30, 2012 |                        |                         |                      |
|--|--------------------|------------------------|-------------------------|----------------------|
|  | Amortized Cost     | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
| Fixed maturities                                 |                    |                        |                         |                      |
| U.S. Treasury obligations                        | \$202,579          | \$15,997               | \$(34 )                 | \$218,542            |
| U.S. Government-sponsored enterprise obligations | 57,505             | 5,186                  | —                       | 62,691               |
| State and municipal bonds                        | 1,122,008          | 91,324                 | (44 )                   | 1,213,288            |
| Corporate debt                                   | 1,378,565          | 99,855                 | (1,650 )                | 1,476,770            |
| Residential mortgage-backed securities           | 351,935            | 24,392                 | (654 )*                 | 375,673              |
| Agency commercial mortgage-backed securities     | 68,227             | 3,270                  | (35 )                   | 71,462               |
| Other commercial mortgage-backed securities      | 70,319             | 6,427                  | (4 )                    | 76,742               |
| Other asset-backed securities                    | 74,519             | 1,329                  | (837 )                  | 75,011               |
|  | \$3,325,657        | \$247,780              | \$(3,258 )              | \$3,570,179          |

| (In thousands)                                   | December 31, 2011 |                        |                         |                      |
|--|-------------------|------------------------|-------------------------|----------------------|
|  | Amortized Cost    | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
| Fixed maturities                                 |                   |                        |                         |                      |
| U.S. Treasury obligations                        | \$267,120         | \$16,748               | \$(3 )                  | \$283,865            |
| U.S. Government-sponsored enterprise obligations | 62,520            | 5,584                  | —                       | 68,104               |
| State and municipal bonds                        | 1,145,025         | 83,568                 | (206 )                  | 1,228,387            |
| Corporate debt                                   | 1,307,504         | 68,105                 | (7,661 )                | 1,367,948            |
| Residential mortgage-backed securities           | 426,319           | 27,171                 | (559 )*                 | 452,931              |
| Agency commercial mortgage-backed securities     | 78,817            | 2,800                  | (86 )                   | 81,531               |
| Other commercial mortgage-backed securities      | 76,366            | 4,881                  | (59 )                   | 81,188               |
| Other asset-backed securities                    | 102,049           | 1,277                  | (1,517 )                | 101,809              |
|  | 3,465,720         | 210,134                | (10,091 )               | 3,665,763            |
| Equity securities                                | 6                 | 19                     | —                       | 25                   |
|  | \$3,465,726       | \$210,153              | \$(10,091 )             | \$3,665,788          |

\*Includes other-than-temporary impairments recognized in accumulated other comprehensive income of \$3.1 million at September 30, 2012 and \$3.3 million at December 31, 2011.



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Notes to Condensed Consolidated Financial Statements (Unaudited)

September 30, 2012

## 3. Investments (continued)

The recorded cost basis and estimated fair value of available-for-sale fixed maturities at September 30, 2012, by contractual maturity, are shown below. Actual maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

| (In thousands)                                   | Amortized Cost | Due in one year or less | Due after one year through five years | Due after five years through ten years | Due after ten years | Total Fair Value |
|--|----------------|-------------------------|---------------------------------------|--|---------------------|------------------|
| Fixed maturities, available for sale             |                |                         |                                       |  |                     |                  |
| U.S. Treasury obligations                        | \$202,579      | \$39,077                | \$114,646                             | \$61,534                               | \$3,285             | \$218,542        |
| U.S. Government-sponsored enterprise obligations | 57,505         | 4,624                   | 50,704                                | 7,113                                  | 250                 | 62,691           |
| State and municipal bonds                        | 1,122,008      | 37,051                  | 375,764                               | 536,597                                | 263,876             | 1,213,288        |
| Corporate debt                                   | 1,378,565      | 79,156                  | 675,869                               | 668,901                                | 52,844              | 1,476,770        |
| Residential mortgage-backed securities           | 351,935        |                         |                                       |  |                     | 375,673          |
| Agency commercial mortgage-backed securities     | 68,227         |                         |                                       |  |                     | 71,462           |
| Other commercial mortgage-backed securities      | 70,319         |                         |                                       |  |                     | 76,742           |
| Other asset-backed securities                    | 74,519         |                         |                                       |  |                     | 75,011           |
|  | \$3,325,657    |                         |                                       |  |                     | \$3,570,179      |

Excluding investments in bonds and notes of the U.S. Government, U.S. Government-sponsored enterprise obligations, or pre-refunded state and municipal bonds which are 100% backed by U.S. Treasury obligations, no investment in any entity or its affiliates exceeded 10% of shareholders' equity at September 30, 2012.

Available-for-sale securities with a fair value of \$24.5 million were on deposit with various state insurance departments to meet regulatory requirements at September 30, 2012.

## Business Owned Life Insurance (BOLI)

ProAssurance holds BOLI policies on management employees that are carried at the current cash surrender value of the policies (original cost \$34 million). The primary purpose of the program is to offset future employee benefit expenses through earnings on the cash value of the policies. ProAssurance is the owner and principal beneficiary of these policies.

## Other Investments

Other Investments at September 30, 2012 and December 31, 2011 was comprised as follows:

| (In millions)                                    | September 30, 2012 | December 31, 2011 |
|--|--------------------|-------------------|
| Investments in LPs/LLCs, at cost                 | \$25.2             | \$16.2            |
| Investment in LLC, at NAV                        | —                  | 15.9              |
| FHLB capital stock, at cost                      | 4.3                | 4.4               |
| Other, principally an annuity, at amortized cost | 1.7                | 1.7               |
|  | \$31.2             | \$38.2            |

FHLB capital stock is not marketable, but may be liquidated by terminating membership in the FHLB. The liquidation process can take up to five years.

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September 30, 2012

## 3. Investments (continued)

## Unconsolidated Subsidiaries

ProAssurance holds investments in unconsolidated subsidiaries, accounted for under the equity method. The investments include the following:

| (In millions)           | September 30, 2012   |                      | Carrying Value     |                   |
|-------------------------|----------------------|----------------------|--------------------|-------------------|
|                         | Unfunded Commitments | Percentage Ownership | September 30, 2012 | December 31, 2011 |
| Investment LPs/LLCs:    |                      |                      |                    |                   |
| Tax credit partnerships | \$26.8               | < 20%                | \$89.2             | \$86.8            |
| Long/Short equity fund  | —                    | < 20%                | 17.8               | 17.1              |
| Non-public equity funds | 46.7                 | < 20%                | 13.7               | 6.7               |
| Business LLC            | —                    | See Below            | —                  | 0.7               |
|                         |                      |                      | \$120.7            | \$111.3           |

Tax credit partnerships interests held by ProAssurance generate investment returns by providing tax benefits to fund investors in the form of project operating losses and tax credits. The related properties are principally low income housing projects.

The Long/Short equity fund LP targets absolute returns using a strategy designed to take advantage of event-driven market opportunities.

The Non-public equity fund LPs hold diversified private equities and are structured to provide capital appreciation.

The Business LLC interest is a convertible preferred interest in a service-related business that began business operations in 2011. The preferred interest can be converted into a non-controlling common interest in May 2015, but conversion is not required. As of September 30, 2012 the carrying value of the interest was zero due to the recognition of losses incurred to-date by the LLC.

## Investments Held in a Loss Position

The following tables provide summarized information with respect to investments held in an unrealized loss position at September 30, 2012 and December 31, 2011, including the length of time the investment had been held in a continuous unrealized loss position.

| (In thousands)                               | September 30, 2012 |                 |                                |                 |                                |                 |
|--|--------------------|-----------------|--------------------------------|-----------------|--------------------------------|-----------------|
|  | Total Fair Value   | Unrealized Loss | Less than 12 months Fair Value | Unrealized Loss | More than 12 months Fair Value | Unrealized Loss |
| Fixed maturities, available for sale         |                    |                 |                                |                 |                                |                 |
| U.S. Treasury obligations                    | \$3,448            | \$(34)          | \$3,448                        | \$(34)          | \$—                            | \$—             |
| State and municipal bonds                    | 4,081              | (44)            | 2,080                          | (7)             | 2,001                          | (37)            |
| Corporate debt                               | 68,119             | (1,650)         | 56,045                         | (1,019)         | 12,074                         | (631)           |
| Residential mortgage-backed securities       | 9,019              | (654)           | 7,700                          | (641)           | 1,319                          | (13)            |
| Agency commercial mortgage-backed securities | 4,004              | (35)            | 3,218                          | (26)            | 786                            | (9)             |
| Other commercial mortgage-backed securities  | 1,121              | (4)             | 124                            | —               | 997                            | (4)             |
| Other asset-backed securities                | 5,118              | (837)           | 203                            | (1)             | 4,915                          | (836)           |
|  | \$94,910           | \$(3,258)       | \$72,818                       | \$(1,728)       | \$22,092                       | \$(1,530)       |
| Other investments                            |                    |                 |                                |                 |                                |                 |
| Investments in LPs/LLCs carried at cost      | \$11,052           | \$(1,124)       | \$10,301                       | \$(935)         | \$751                          | \$(189)         |



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Notes to Condensed Consolidated Financial Statements (Unaudited)

September 30, 2012

## 3. Investments (continued)

| (In thousands)                               | December 31, 2011 |                 |                     |                 |                     |                 |
|--|-------------------|-----------------|---------------------|-----------------|---------------------|-----------------|
|  | Total             |                 | Less than 12 months |                 | More than 12 months |                 |
|  | Fair Value        | Unrealized Loss | Fair Value          | Unrealized Loss | Fair Value          | Unrealized Loss |
| Fixed maturities, available for sale         |                   |                 |                     |                 |                     |                 |
| U.S. Treasury obligations                    | \$8,379           | \$(3 )          | \$8,379             | \$(3 )          | \$—                 | \$—             |
| State and municipal bonds                    | 9,743             | (206 )          | 7,143               | (10 )           | 2,600               | (196 )          |
| Corporate debt                               | 205,605           | (7,661 )        | 194,057             | (6,691 )        | 11,548              | (970 )          |
| Residential mortgage-backed securities       | 33,605            | (558 )          | 31,213              | (349 )          | 2,392               | (209 )          |
| Agency commercial mortgage-backed securities | 8,433             | (87 )           | 4,682               | (47 )           | 3,751               | (40 )           |
| Other commercial mortgage-backed securities  | 4,086             | (59 )           | 3,143               | (2 )            | 943                 | (57 )           |
| Other asset-backed securities                | 26,518            | (1,517 )        | 21,282              | (123 )          | 5,236               | (1,394 )        |
|  | \$296,369         | \$(10,091 )     | \$269,899           | \$(7,225 )      | \$26,470            | \$(2,866 )      |

## Other investments

Investments in LPs/LLCs carried at cost \$4,198      \$(984 )      \$3,815      \$(856 )      \$383      \$(128 )

As of September 30, 2012, there were 97 debt securities (3.8% of all available-for-sale fixed maturity securities held) in an unrealized loss position representing 94 issuers. The single greatest unrealized loss position was approximately \$0.7 million; the second greatest unrealized loss position was approximately \$0.5 million. The securities were evaluated for impairment as of September 30, 2012.

As of December 31, 2011, there were 251 debt securities (9.6% of all available-for-sale fixed maturity securities held) in an unrealized loss position representing 224 issuers. The single greatest unrealized loss position approximated \$1.2 million; the second greatest unrealized loss position approximated \$1.0 million. The securities were evaluated for impairment as of December 31, 2011.

Each quarter, ProAssurance performs a detailed analysis for the purpose of assessing whether any of the securities it holds in an unrealized loss position have suffered an other-than-temporary impairment in value. A detailed discussion of the factors considered in the assessment is included in Note 1 of the Notes to Consolidated Financial Statements included in ProAssurance's December 31, 2011 Form 10-K.

Fixed maturity securities held in an unrealized loss position at September 30, 2012, excluding asset-backed securities, have paid all scheduled contractual payments and are expected to continue doing so. Expected future cash flows of asset-backed securities held in an unrealized loss position were estimated as part of the September 30, 2012 impairment evaluation using the most recently available six-month historical performance data for the collateral (loans) underlying the security or, if historical data was not available, sector based assumptions, and equaled or exceeded the current amortized cost basis of the security.

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September 30, 2012

## 3. Investments (continued)

## Net Investment Income

Net investment income by investment category was as follows:

| (In thousands)                | Three Months Ended |          | Nine Months Ended |           |
|-------------------------------|--------------------|----------|-------------------|-----------|
|                               | September 30       |          | September 30      |           |
|                               | 2012               | 2011     | 2012              | 2011      |
| Fixed maturities              | \$32,747           | \$33,939 | \$100,110         | \$106,573 |
| Equities                      | 1,907              | 569      | 4,556             | 985       |
| Short-term investments        | 51                 | 20       | 108               | 93        |
| Other invested assets         | 39                 | 573      | 480               | 2,137     |
| Business owned life insurance | 653                | 635      | 1,571             | 1,571     |
|                               | 35,397             | 35,736   | 106,825           | 111,359   |
| Investment expenses           | (1,487             | ) (1,620 | ) (4,913          | ) (4,786  |
| Net investment income         | \$33,910           | \$34,116 | \$101,912         | \$106,573 |

## Net Realized Investment Gains (Losses)

The following table provides detailed information regarding net realized investment gains (losses):

| (In thousands)   | Three Months Ended |            | Nine Months Ended |           |
|--|--------------------|------------|-------------------|-----------|
|  | September 30       |            | September 30      |           |
|  | 2012               | 2011       | 2012              | 2011      |
| Total other-than-temporary impairment losses:                              |                    |            |                   |           |
| Residential mortgage-backed securities                                     | \$ (94             | ) \$ (13   | ) \$ (557         | ) \$ (782 |
| Corporate debt   | (48                | ) —        | (878              | ) —       |
| Other investments  | —                  | (1,376     | ) (131            | ) (3,509  |
| Portion recognized in (reclassified from) Other Comprehensive Income:      |                    |            |                   |           |
| Residential mortgage-backed securities                                     | —                  | (142       | ) (201            | ) (823    |
| Net impairment losses recognized in earnings                               | (142               | ) (1,531   | ) (1,767          | ) (5,114  |
| Gross realized gains, available-for-sale securities                        | 4,269              | 1,441      | 10,418            | 11,733    |
| Gross realized (losses), available-for-sale securities                     | (452               | ) (296     | ) (635            | ) (1,653  |
| Net realized gains (losses), short term                                    | 6                  | —          | 6                 | —         |
| Net realized gains (losses), trading securities                            | 933                | (357       | ) 1,660           | 2,558     |
| Change in unrealized holding gains (losses), trading securities            | 7,874              | (11,702    | ) 12,779          | (13,043   |
| Decrease (increase) in the fair value of liabilities carried at fair value | (401               | ) 473      | (1,245            | ) (129    |
| Other  | \$ 1,132           | \$ —       | \$ 1,132          | \$ —      |
| Net realized investment gains (losses)                                     | \$13,219           | \$ (11,972 | ) \$22,348        | \$ (5,648 |

ProAssurance recognized credit-related impairments in earnings of \$0.1 million and \$0.8 million during the 2012 three- and nine-month periods, respectively, and \$0.2 million and \$1.6 million for the same respective periods of 2011, related to certain residential mortgage-backed securities because the expected future cash flows from the securities were less than the carrying value.

ProAssurance recognized credit-related impairments of \$0.8 million related to a corporate debt security during the first quarter of 2012 due to deterioration of the credit standing of the issuer.

ProAssurance recognized impairments of \$0.1 million during the first quarter of 2012 and \$1.4 million and \$3.5 million for the 2011 three- and nine-month periods, respectively, related to an interest in an LLC accounted for using

the cost method. The LLC announced in 2011 a plan to convert to a publicly traded investment fund, and OTTI was recognized in subsequent periods in order to carry the interest at the NAV reported by the fund. The conversion occurred during the second quarter of 2012.

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## 3. Investments (continued)

The following table presents a roll forward of cumulative credit losses recorded in earnings related to impaired debt securities for which a portion of the other-than-temporary impairment was recorded in Other Comprehensive Income.

| (In thousands)   | Three Months Ended |         | Nine Months Ended |         |
|--|--------------------|---------|-------------------|---------|
|  | September 30       |         | September 30      |         |
|  | 2012               | 2011    | 2012              | 2011    |
| Balance beginning of period  | \$6,138            | \$5,728 | \$5,870           | \$4,446 |
| Additional credit losses recognized during the period, related to securities for which OTTI has been previously recognized | —                  | 142     | 268               | 1,424   |
| Balance September 30   | \$6,138            | \$5,870 | \$6,138           | \$5,870 |

Other information regarding sales and purchases of available-for-sale securities was as follows:

| (In millions)  | Three Months Ended |         | Nine Months Ended |         |
|--|--------------------|---------|-------------------|---------|
|  | September 30       |         | September 30      |         |
|  | 2012               | 2011    | 2012              | 2011    |
| Proceeds from sales (exclusive of maturities and paydowns) | \$140.5            | \$60.7  | \$446.4           | \$371.6 |
| Purchases  | \$186.6            | \$144.9 | \$533.7           | \$597.8 |

## 4. Income Taxes

ProAssurance estimates its annual effective tax rate at the end of each quarterly reporting period which is used to record the provision for income taxes in the interim financial statements. The provision for income taxes is different from that which would be obtained by applying the statutory Federal income tax rate to income before taxes primarily because a portion of ProAssurance's investment income is tax-exempt and because ProAssurance utilizes tax credit benefits transferred from tax credit partnership investments.

The Internal Revenue Service has begun but has not completed an examination of the 2009 and 2010 returns. Except for the 2006 tax year, the statutes of limitation are closed for all years prior to 2009. The statute for the 2006 tax year has been extended from May 31, 2012 to September 15, 2013.

ProAssurance's liability for unrecognized tax benefits, exclusive of accrued interest, was \$23.7 million at September 30, 2012 and \$18.6 million at December 31, 2011. The increase in the provision during 2012 was entirely attributable to unrecognized benefits associated with tax positions taken in a prior year. Unrecognized tax benefits at September 30, 2012 and December 31, 2011, if recognized, would not affect the effective tax rate but would accelerate the payment of tax. As with any uncertain tax position, there is a possibility that the ultimate deduction recognized could differ from the provision established by ProAssurance.

## 5. Deferred Policy Acquisition Costs

Policy acquisition costs, most significantly commissions, premium taxes, and underwriting salaries, that are primarily and directly related to the successful production of new and renewal insurance contracts are capitalized as policy acquisition costs and amortized to expense as the related premium revenues are earned.

As discussed in Note 1, revised FASB guidance effective January 1, 2012 requires that policy acquisition costs related to unsuccessful contracts be expensed immediately. ProAssurance adopted the revised guidance on a prospective basis. Under prior guidance, policy acquisition costs capitalized during the three and nine months ended September 30, 2012 would have been \$14.9 million and \$45.2 million, respectively, as compared to \$13.9 million and \$42.0 million, respectively, capitalized under the current guidance.

Amortization of deferred policy acquisition costs was \$14.0 million and \$43.5 million for the three and nine months ended September 30, 2012, respectively, and \$15.5 million and \$44.5 million for the three and nine months ended September 30, 2011, respectively.

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6. Reserve for Losses and Loss Adjustment Expenses

The reserve for losses is established based on estimates of individual claims and actuarially determined estimates of future losses based on ProAssurance's past loss experience, available industry data and projections as to future claims frequency, severity, inflationary trends and settlement patterns. Estimating reserves, and particularly liability reserves, is a complex process. Claims may be resolved over an extended period of time, often five years or more, and may be subject to litigation. Estimating losses for liability claims requires ProAssurance to make and revise judgments and assessments regarding multiple uncertainties over an extended period of time. As a result, reserve estimates may vary significantly from the eventual outcome. The assumptions used in establishing ProAssurance's reserves are regularly reviewed and updated by management as new data becomes available. Changes to estimates of previously established reserves are included in earnings in the period in which the estimate is changed.

ProAssurance recognized favorable net loss development of \$50.0 million and \$157.5 million related to previously established reserves for the three and nine months ended September 30, 2012, respectively. The favorable net loss development reflects reductions in the Company's estimates of claims severity, principally for the 2004 through 2010 accident years.

For the three and nine months ended September 30, 2011, ProAssurance recognized favorable net loss development of \$52.1 million and \$142.3 million, respectively, to reflect reductions in estimated claim severity principally for accident years 2004 through 2009.

7. Commitments and Contingencies

ProAssurance is involved in various legal actions related to insurance policies and claims handling including, but not limited to, claims asserted by policyholders. These types of legal actions arise in the Company's ordinary course of business and, in accordance with GAAP for insurance entities, are considered as a part of the Company's loss reserving process, which is described in detail under "Accounting Policies – Losses and Loss Adjustment Expenses" in Note 1 of the Notes to the Consolidated Financial Statements in ProAssurance's 2011 Form 10-K.

ProAssurance has commitments related to acquisitions and non-public investment entities totaling approximately \$295.6 million, expected to be paid as follows: \$213.7 million within six months, \$74.8 million within seven months to three years, and \$7.1 million within four to five years.



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## 8. Long-term Debt

ProAssurance's outstanding long-term debt consisted of the following:

|  | (In thousands)        |                      |
|--|-----------------------|----------------------|
|  | September 30,<br>2012 | December 31,<br>2011 |
| Trust Preferred Securities due 2034, unsecured, interest at a variable rate of LIBOR plus 3.85%, reset quarterly. Note repaid in August 2012 at no gain or loss.   | \$—                   | \$22,992             |
| Surplus Notes due May 2034, unsecured, interest at a variable rate of LIBOR plus 3.85%, reset quarterly. Note repaid in August 2012 at no gain or loss.  | —                     | 12,000               |
| Note Payable due February 2019 (the 2019 Note), interest at a variable rate of LIBOR plus 0.7%, carried at fair value, monthly principal payments required, outstanding principal at December 31, 2011 of \$17.1 million. Outstanding principal repaid in July 2012. A loss of \$2.2 million was recognized on the extinguishment. | —                     | 14,180               |
| Note Payable due February 2012. Note was repaid in February 2012.  | —                     | 515                  |
| Revolving Credit Agreement, expires in 2016, maximum outstanding borrowing of \$150 million, interest rate set at the time funds are borrowed. No borrowings occurred during the periods shown.  | —                     | —                    |
|  | \$—                   | \$49,687             |

## Interest Rate Swap

A related interest rate swap (the Swap) effectively fixed the rate on the 2019 Note at 6.6%. The Swap was terminated for \$5.1 million at the time the 2019 Note was repaid. The liability for the Swap, which was carried at fair value as a part of other liabilities, approximated \$4.7 million at December 31, 2011.

## Covenant Compliance

ProAssurance is currently in compliance with all covenants.

## Additional Information

For additional information regarding ProAssurance's long-term debt see Note 10 of the Notes to the Consolidated Financial Statements included in ProAssurance's December 31, 2011 Form 10-K.

## 9. Shareholders' Equity

At September 30, 2012 and December 31, 2011, ProAssurance had 100 million shares of authorized common stock and 50 million shares of authorized preferred stock. The Board of Directors of ProAssurance Corporation (the Board) has the authority to determine provisions for the issuance of preferred shares, including the number of shares to be issued, the designations, powers, preferences and rights, and the qualifications, limitations or restrictions of such shares. To date, the Board has not approved the issuance of preferred stock.

During 2011 the Board instituted a cash dividend policy. ProAssurance declared cash dividends of \$0.25 per common share for each of the first three quarters of 2012, totaling \$23.0 million, which included the third quarter dividend of \$7.7 million that was paid in October 2012. ProAssurance declared its initial quarterly dividend of \$0.25 per common share, \$7.6 million in total, during the third quarter of 2011 that was paid in October 2011. The liability for unpaid dividends is included in Other liabilities. Any decision to pay future cash dividends is subject to the Board's final determination after a comprehensive review of financial performance, future expectations and other factors deemed relevant by the Board.

At September 30, 2012, approximately \$135.1 million of Board authorizations for the repayment of debt or repurchase of common shares remained available for use. During the nine months ended September 30, 2012, authorizations totaling approximately \$52.5 million were used to repay debt.

ProAssurance did not repurchase any common shares during the three and nine months ended September 30, 2012.

ProAssurance repurchased approximately 341,000 common shares, having a total cost of \$21.0 million, during the nine months ended September 30, 2011, including approximately 6,900 forfeited employer match shares (cost basis of

\$0.4 million) reacquired due to the termination of the ProAssurance Corporation Stock Ownership Plan.

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ProAssurance Corporation and Subsidiaries

Notes to Condensed Consolidated Financial Statements (Unaudited)

September 30, 2012

## 9. Shareholders' Equity (continued)

Share-based compensation expense was \$1.3 million and \$6.4 million for the three and nine months ended September 30, 2012, respectively, and \$1.7 million and \$5.4 million for the three and nine months ended September 30, 2011, respectively. Related tax benefits were \$0.5 million and \$2.2 million for the three and nine months ended September 30, 2012, respectively, and \$0.6 million and \$1.9 million for the three and nine months ended September 30, 2011, respectively.

ProAssurance awarded approximately 25,000 restricted share units and 100,000 (target) performance share units to employees in February 2012. The fair value of each unit awarded was estimated at \$89.28, equal to the market value of a ProAssurance common share on the date of grant. All awards are charged to expense as an increase to equity over the service period (generally the vesting period) associated with the award. Restricted share units and performance share units vest in their entirety at the end of a three-year period following the grant date based on a continuous service requirement and, for performance share units, achievement of a performance objective. Partial vesting is permitted for retirees. A ProAssurance common share is issued for each unit once vesting requirements are met, except that units sufficient to satisfy required tax withholdings are paid in cash. The number of common shares issued for performance share units varies from 75% to 125% of base awards depending upon the degree to which stated performance objectives are achieved. ProAssurance issued approximately 17,000 and 50,000 common shares, respectively, to employees in February 2012 related to restricted share units and performance share units granted in 2009. Shares issued for performance share units were awarded at the maximum level (125%).

ProAssurance issued approximately 19,000 and 20,000 common shares to employees in February 2012 and February 2011, respectively, as bonus compensation, as approved by the Compensation Committee of the Board. The shares issued were valued at fair value (the market price of a ProAssurance common share on the date of award).

## Other Comprehensive Income

For all periods presented, other comprehensive income was comprised of unrealized gains and losses, including non-credit impairment losses, arising during the period related to available-for-sale securities less reclassification adjustments for gains (losses) from available-for-sale securities recognized in current period net income (net of tax). Accumulated other comprehensive income was comprised entirely of unrealized gains and losses from available for sale securities, net of tax, at both September 30, 2012 and December 31, 2011.

Reclassification adjustments related to available-for-sale securities for the three and nine months ended September 30, 2012 and 2011 were as follows:

| (In thousands)  | Three Months Ended |              | Nine Months Ended |              |
|---|--------------------|--------------|-------------------|--------------|
|   | September 30       | September 30 | September 30      | September 30 |
|   | 2012               | 2011         | 2012              | 2011         |
| Net realized investment gains (losses) included in the calculation of net income    | \$3,675            | \$990        | \$8,147           | \$8,475      |
| Tax effect (at 35%)   | (1,286             | ) (347       | ) (2,851          | ) (2,966     |
| Net realized investment gains (losses) reclassified from other comprehensive income | \$2,389            | \$643        | \$5,296           | \$5,509      |

## 10. Variable Interest Entities

ProAssurance holds passive interests in a number of entities that are considered to be Variable Interest Entities (VIEs) under GAAP guidance. ProAssurance's VIE interests include 1) interests in LPs/LLCs formed for the purpose of achieving diversified equity and debt returns and 2) a limited liability interest in a development stage business operation. ProAssurance VIE interests carried as a part of Other Investments totaled \$25.2 million at September 30, 2012 and \$32.1 million at December 31, 2011. ProAssurance VIE interests carried as a part of Investment in Unconsolidated Subsidiaries totaled \$31.5 million at September 30, 2012 and \$24.5 million at December 31, 2011. ProAssurance has not consolidated these VIE's because it has either very limited or no power to control the activities that most significantly affect the economic performance of these entities and is not the primary beneficiary of any of

the entities. ProAssurance's involvement with each entity is limited to its direct ownership interest in the entity. ProAssurance has no arrangements or agreements of significance with any of the entities to provide other financial support to or on behalf of the entity. At September 30, 2012 ProAssurance's maximum loss exposure relative to these investments was limited to the carrying value of ProAssurance's investment in the VIE.

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ProAssurance Corporation and Subsidiaries

Notes to Condensed Consolidated Financial Statements (Unaudited)

September 30, 2012

11. Earnings Per Share

Diluted weighted average shares is calculated as basic weighted average shares plus the effect, calculated using the treasury stock method, of assuming that dilutive stock options have been exercised and that performance and restricted share units have vested.

Stock options are not dilutive when the option exercise price exceeds the average price of a common share during the period or when the result from assuming an option is exercised is a net decrease to outstanding shares. All outstanding options were dilutive for the three- and nine-month periods ended September 30, 2012 and 2011.

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ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

The following discussion should be read in conjunction with the unaudited Condensed Consolidated Financial Statements and Notes to those statements which accompany this report as well as our 2011 Form 10-K. A glossary of insurance terms and phrases is available on the investor section of our website. Throughout the discussion, references to "ProAssurance", "PRA", "Company", "we", "us" and "our" refer to ProAssurance Corporation and its consolidated subsidiaries. The discussion contains certain forward-looking information that involves risks and uncertainties. As discussed under "Forward-Looking Statements", our actual financial condition and operating results could differ significantly from these forward-looking statements.

Critical Accounting Estimates

Our Condensed Consolidated Financial Statements are prepared in conformity with U.S. generally accepted accounting principles (GAAP). Preparation of these financial statements requires us to make estimates and assumptions that affect the amounts we report on those statements. We evaluate these estimates and assumptions on an ongoing basis based on current and historical developments, market conditions, industry trends and other information that we believe to be reasonable under the circumstances. There can be no assurance that actual results will conform to our estimates and assumptions; reported results of operations may be materially affected by changes in these estimates and assumptions.

Management considers the following accounting estimates to be critical because they involve significant judgment by management and the effect of those judgments could result in a material effect on our financial statements.

Reserve for Losses and Loss Adjustment Expenses

The largest component of our liabilities is our reserve for losses and loss adjustment expenses (reserve for losses or reserve), and the largest component of expense for our operations is incurred losses and loss adjustment expenses (also referred to as "loss and loss adjustment expenses", "incurred losses", "losses incurred" and "losses"). Incurred losses reported in any period reflect our estimate of losses incurred related to the premiums earned in that period as well as any changes to our estimates of the reserve established for losses of prior periods.

The estimation of professional liability losses is inherently difficult and is the subject of significant judgment on the part of management. Loss costs, even for claims with similar characteristics, can vary significantly depending upon many factors, including but not limited to: the nature of the claim and the personal situation of the claimant or the claimant's family, the outcome of jury trials, the legislative and judicial climate where the insured event occurred, general economic conditions and, for Medical Professional Liability (MPL) claims, the trend of healthcare costs. Professional liability claims are typically resolved over an extended period of time, often five years or more. The combination of changing conditions and the extended time required for claim resolution results in a loss cost estimation process that requires actuarial skill and the application of significant judgment, and such estimates require periodic revision.

Our reserves are established by management after taking into consideration a variety of factors including premium rates, claims frequency, historical paid and incurred loss development trends, the effect of inflation, general economic trends, the legal and political environment and the conclusions reached by our internal and consulting actuaries. We update and review the data underlying the estimation of our reserve for losses each reporting period and make adjustments to loss estimation assumptions that we believe best reflect emerging data. Both our internal and consulting actuaries perform an in-depth review of our reserve for losses on at least a semi-annual basis using the loss and exposure data of our insurance subsidiaries. We engage consulting actuaries to review our data and provide us with their observations regarding our data and the adequacy of our established reserve, believing that the consulting actuaries provide an independent view of our loss data as well as a broader perspective on industry loss trends.

Initial Reserve Estimates

In establishing our initial reserves for a given accident year, due to the lack of available data for both open and closed claims for that accident year, we rely heavily on the loss assumptions that are used in our pricing models. Loss assumptions used in our pricing models are based on our analysis of our actual and projected claims data, adjusted for perceived differences between the current legal and economic environment and that of the periods associated with the claims data. In recent years, our analysis of claims has indicated reductions in average loss costs, and we have

reflected those reductions in our pricing loss assumptions. Our average pricing for 2012 is approximately 16 percentage points below our average pricing in 2006 (exclusive of our podiatry and chiropractic lines acquired in 2009), principally reflecting expected reductions in loss costs.

Historically, and at present, in establishing our initial reserves we utilize loss ratios that are approximately 8 to 10 percentage points above the loss ratios incorporated within the pricing targets for that accident year. We believe this reflects expected loss costs but also considers the inherent risks associated with our rate development process and the historic volatility of professional liability losses (the industry has experienced accident year loss ratios as high as 163% and as low as 57% over

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the past 30 years) and produces a reasonable best estimate of the reserves required to cover actual ultimate unpaid losses. In the current environment this equates to an initial loss ratio of approximately 85% on our physician business as compared to an average loss ratio of approximately 75% assumed in our pricing.

### The Effect of Changing Severity

Severity is defined as the average cost of resolving claims. The severity trend assumption (the expected annual percentage change in severity) is a key assumption for our pricing models. Our current pricing model assumes an average severity trend of 3% to 4% in most states and lines of business. If the severity trend were to be higher by 1 percentage point, the impact would be an increase in our expected loss ratio of 3.2 percentage points. An increase in the severity trend of 3 percentage points would result in a 10.1 percentage point increase in our expected loss ratio. Due to the long-tailed nature of MPL claims and the previously discussed historical volatility of loss costs, selection of a severity trend assumption is a subjective process that is inherently likely to prove inaccurate over time. Given this long tail and the previously discussed historical volatility of loss costs, we are generally cautious in making changes to our severity assumptions and actuarial estimations.

Recent changes in frequency have also complicated the selection of an appropriate severity trend. Both our internal and consulting actuaries have observed fluctuating but generally lower claims frequency that cannot be attributed to any single factor. We believe that much of the reduction in the number of claims is the result of a decline in the filing of frivolous lawsuits that historically have been dismissed or otherwise result in no payment of indemnity on the part of our insureds. With fewer frivolous claims being filed we expect that the claims that are filed have the potential for greater average losses, or greater severity. As a result, we cannot be certain as to the impact this decline will ultimately have on the average cost of claims. Based on a weighted average of payments, resolution of 85% of claims for a given accident year requires more than eight years (based on a weighted average of payments). Due to this long tail, it will be several years before we are able to determine if the decline in frequency has indeed resulted in a related increase in severity.

Additionally, given the length of time required for resolution of our claims, we are cautious in giving full credibility to claims data indicating emerging trends. Numerical data both within our own information and in the broader MPL marketplace may in the short term indicate development of a trend, whether positive or negative, that mitigates or reverses over the longer term as claims mature and additional data becomes available. Our current severity trend assumption gives recognition to both the indications from our recent claims data and the known volatility associated with the long tail claims environment in which we operate.

### Loss Development

We re-evaluate our previously established reserves each period based on our most recently available claims data and available industry trend information. Changes to previously established reserve estimates are recognized in the current period if management's best estimate of ultimate losses differs from the estimate previously established. While management considers a variety of variables in determining its best estimate, in general, as claims age, our methodologies for estimating reserves give more weight to actual loss costs which, as a whole, continue to indicate that ultimate loss costs will be lower than our previous estimates. The development recognized in the first nine months of both 2012 and 2011 was primarily attributable to the favorable resolution of claims during the period and an evaluation of established case reserves and paid claims data that indicated that the actual severity associated with the remaining claims will be lower than we had previously estimated. The Critical Accounting Estimates discussion in our 2011 Form 10K includes a more detailed discussion of the methodologies used to evaluate our reserves, beginning on page 30.

### Reinsurance

We use insurance and reinsurance (collectively, "reinsurance") to provide capacity to write larger limits of liability, to provide protection against losses in excess of policy limits and to stabilize underwriting results in years in which higher losses occur. The purchase of reinsurance does not relieve us from the ultimate risk on our policies, but it does provide reimbursement for certain losses we pay.

We evaluate each of our ceded reinsurance contracts at inception to confirm that there is sufficient risk transfer to allow the contract to be accounted for as reinsurance under current accounting guidance. At September 30, 2012, all ceded contracts were accounted for as risk transferring contracts.



Our receivable from reinsurers on unpaid losses and loss adjustment expenses represents our estimate of the amount of our reserve for losses that will be recoverable under our reinsurance programs. We base our estimate of funds recoverable upon our expectation of ultimate losses and the portion of those losses that we estimate to be allocable to reinsurers based upon the terms of our reinsurance agreements. Our assessment of the collectability of the recorded amounts receivable from reinsurers

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considers the payment history of the reinsurer, publicly available financial and rating agency data, our interpretation of the underlying contracts and policies, and responses by reinsurers.

Given the uncertainty inherent in our estimates of losses and related amounts recoverable from reinsurers, these estimates may vary significantly from the ultimate outcome.

Under the terms of certain of our reinsurance agreements, the amount of premium that we cede to our reinsurers is based in part on the losses we recover under the agreements. Therefore we make an estimate of premiums ceded under these reinsurance agreements subject to certain maximums and minimums.

Any adjustments to our estimates of either balances recoverable under our reinsurance agreements or premiums owed under our agreements are reflected in then-current operations. Due to the size of our reinsurance balances, an adjustment to these estimates could have a material effect on our results of operations for the period in which the adjustment is made.

We make a determination of the amount of insurance risk we choose to retain based upon numerous factors, including our risk tolerance and the capital we have to support it, the price and availability of reinsurance, volume of business, level of experience with a particular set of claims and our analysis of the potential underwriting results. We purchase reinsurance from a number of companies to mitigate concentrations of credit risk. We utilize a reinsurance broker to assist us in the placement of our reinsurance program and in the analysis of the credit quality of our reinsurers. The determination of which reinsurers we choose to do business with is based upon an evaluation of the then-current financial strength, rating and stability of prospective reinsurers. However, the financial strength of our reinsurers and their corresponding ability to pay us may change in the future due to forces or events we cannot control or anticipate. We have not experienced significant collection difficulties due to the financial condition of any reinsurer as of September 30, 2012; however, periodically, reinsurers may dispute our claim for reimbursement from them based upon their interpretation of the terms of our agreements. We have established appropriate reserves for any balances that we believe may not be ultimately collected. Should future events lead us to believe that any reinsurer will not meet its obligations to us, adjustments to the amounts recoverable would be reflected in the results of current operations. Such an adjustment has the potential to be material to the results of operations in the period in which it is recorded; however, we would not expect such an adjustment to have a material effect on our capital position or our liquidity.

**Investment Valuations**

We record the majority of our investments at fair value as shown in the table below. The distribution of our investments based on GAAP fair value hierarchies (levels) was as follows:

|                   | Distribution by GAAP Fair Value Hierarchy |         |         | September 30,<br>2012 |   |
|-------------------|---|---------|---------|-----------------------|---|
|                   | Level 1                                   | Level 2 | Level 3 | Total Investments     |   |
| Fair value        | 6   | % 88    | % 2     | % 96                  | % |
| Other valuations  |   |         |         | 4                     | % |
| Total Investments |   |         |         | 100                   | % |

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. All of our fixed maturity and equity security investments are carried at fair value. Our short-term securities are carried at amortized cost, which approximates fair value.

Because of the number of securities we own and the complexity and cost of developing accurate fair values, we utilize multiple independent pricing services to assist us in establishing the fair value of individual securities. The pricing services provide fair values based on exchange traded prices, if available. If an exchange traded price is not available, the pricing services, if possible, provide a fair value that is based on multiple broker/dealer quotes or that has been developed using pricing models. Pricing models vary by asset class and utilize currently available market data for securities comparable to ours to estimate the fair value for our security. The pricing services scrutinize market data for consistency with other relevant market information before including the data in the pricing models. The pricing services disclose the types of pricing models used and the inputs used for each asset class. Determining fair values using these pricing models requires the use of judgment to identify appropriate comparable securities and to choose a

valuation methodology that is appropriate for the asset class and available data.

The pricing services provide a single value per instrument quoted. We review the values provided for reasonableness each quarter by comparing market yields generated by the supplied value versus market yields observed in the market place. In addition, we compare provided information for consistency with our other pricing services, known market data and information from our own trades, considering both values and valuation trends. We also compare yields indicated by the provided values to appropriate benchmark yields and review for values that are unchanged or that reflect an unanticipated variation as compared to prior period values. We also review weekly trades versus the prices supplied by our vendors. If a supplied value appears

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unreasonable, we discuss the valuation in question with the pricing service and make adjustments if deemed necessary. To date, we have not adjusted any values supplied by the pricing services.

The pricing services do not provide a fair value unless an exchange traded price or multiple observable inputs are available. As a result, the pricing services may provide a fair value for a security in some periods but not others, depending upon the level of recent market activity for the security or comparable securities.

**Level 1 Investments**

Fair values for our equity and a portion of our short-term securities are determined using exchange traded prices. There is little judgment involved when fair value is determined using an exchange traded price. In accordance with GAAP, for disclosure purposes we classify securities valued using an exchange traded price as Level 1 securities.

**Level 2 Investments**

Most fixed income securities do not trade daily, and thus exchange traded prices are generally not available for these securities. However, market information (often referred to as observable inputs or market data, including but not limited to, last reported trade, non-binding broker quotes, bids, benchmark yield curves, issuer spreads, two sided markets, benchmark securities, offers and recent data regarding assumed prepayment speeds, cash flow and loan performance data) is available for most of our fixed income securities. We determine fair value for a large portion of our fixed income securities using available market information. In accordance with GAAP, for disclosure purposes we classify securities valued based on multiple market observable inputs as Level 2 securities.

**Level 3 Investments**

When a pricing service does not provide a value for one of our fixed maturity securities, management estimates fair value using either a single non-binding broker quote or pricing models that utilize market based assumptions which have limited observable inputs. The process involves significant judgment in selecting the appropriate data and modeling techniques to use in the valuation process. For disclosure purposes we classify fixed maturity securities valued using limited observable inputs as Level 3 securities.

We also classify as Level 3 our investment interests that are carried at fair value based on a fund-provided NAV. All investments valued in this manner are LP interests that hold debt and equity securities. At September 30, 2012 interests valued using a fund-provided NAV totaled \$31.5 million, or 1% of total investments, and were classified as part of our Investment in Unconsolidated Subsidiaries.

**Investments - Other Valuation Methodologies**

Certain of our investments, in accordance with GAAP for the type of investment, are measured using methodologies other than fair value. At September 30, 2012 these investments had a carrying value of approximately \$172.5 million, which represented 4% of total investments, as shown in the following table. Additional information about these investments is provided in Notes 2 and 3 of the Notes to Condensed Consolidated Financial Statements.

| (In millions)                                     | Carrying Value | GAAP Measurement Method |
|---|----------------|-------------------------|
| <b>Other investments:</b>                         |                |                         |
| Investments in LP/LLCs                            | \$25.2         | Cost                    |
| Federal Home Loan Bank (FHLB) capital stock       | 4.3            | Cost                    |
| Other   | 1.7            | Cost                    |
| Total other investments                           | \$31.2         |                         |
| <b>Investment in unconsolidated subsidiaries:</b> |                |                         |
| Investments in tax credit partnerships            | \$89.2         | Equity                  |
| Business owned life insurance                     | \$52.1         | Cash surrender value    |
| Total investments - Other valuation methodologies | \$172.5        |                         |

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### Investment Impairments

We evaluate our investments on at least a quarterly basis for declines in fair value that represent OTTI. In all instances we consider an impairment to be an OTTI if we intend to sell the security or if we believe we will be required to sell the security before we fully recover the amortized cost basis of the security. Otherwise, we consider various factors in our evaluation, depending upon the type of security, as discussed below.

For debt securities, we consider whether we expect to fully recover the amortized cost basis of the security, based upon consideration of some or all of the following:

- third party research and credit rating reports;
- the current credit standing of the issuer, including credit rating downgrades;
- the extent to which the decline in fair value is attributable to credit risk specifically associated with an investment or its issuer;
- our internal assessments and those of our external portfolio managers regarding specific circumstances surrounding an investment, which can cause us to believe the investment is more or less likely to recover its value than other investments with a similar structure;
- for asset-backed securities, the origination date of the underlying loans, the remaining average life, the probability that credit performance of the underlying loans will deteriorate in the future, and our assessment of the quality of the collateral underlying the loan;
- failure of the issuer of the security to make scheduled interest or principal payments;
- any changes to the rating of the security by a rating agency;
- recoveries or additional declines in fair value subsequent to the balance sheet date; and
- our intent to sell and whether it is more likely than not we will be required to sell the investment before the recovery of its amortized cost basis.

In assessing whether we expect to recover the cost basis of debt securities, particularly asset-backed securities, we must make a number of assumptions regarding the cash flows that we expect to receive from the security in future periods. These judgments are subjective in nature and may subsequently be proved to be inaccurate.

We evaluate our cost method interests in LPs/LLCs for OTTI by considering whether there has been a decline in fair value below the recorded value, which involves assumptions and estimates. We receive a report from each of the LPs/LLCs at least quarterly which provides us a NAV for our interest in the LP/LLC. The NAV is based on the fair values of securities held by the LP/LLC as determined by the LP/LLC manager. We consider the most recent NAV provided, the performance of the LP/LLC relative to the market, the stated objectives of the LP/LLC, the cash flows expected from the LP/LLC and audited financial statements of the entity, if available, in considering whether an OTTI exists.

Our investments in tax credit partnerships are evaluated for OTTI by comparing cash flow projections of the underlying projects generating the tax credits to our recorded basis, and by considering our ability to utilize the tax credits generated by the investments.

We also evaluate our holdings of FHLB securities for impairment. We consider the current capital status of the FHLB, whether the FHLB is in compliance with regulatory minimum capital requirements, and the FHLB's most recently reported operating results.

### Deferred Policy Acquisition Costs

Policy acquisition costs (primarily commissions, premium taxes and underwriting salaries) which are directly related to the successful acquisition of new and renewal premiums are capitalized as deferred policy acquisition costs and charged to expense as the related premium revenue is recognized. We evaluate the recoverability of our deferred policy acquisition costs each reporting period, and any amounts estimated to be unrecoverable are charged to expense in the current period. Beginning January 1, 2012, in order to comply with adopted Financial Accounting Standards Board (FASB) guidance, we no longer capitalize internal selling agent and underwriter salary and benefit costs that are allocated to unsuccessful insurance contracts. Adoption of this guidance had no material effect on our results of operations or financial position.

### Deferred Taxes

Deferred federal income taxes arise from the recognition of temporary differences between the basis of assets and liabilities determined for financial reporting purposes and the basis determined for income tax purposes. Our temporary differences principally relate to loss reserves, unearned premiums, deferred policy acquisition costs, unrealized investment

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gains (losses) and investment impairments. Deferred tax assets and liabilities are measured using the enacted tax rates expected to be in effect when such benefits are realized. We review our deferred tax assets quarterly for impairment. If we determine that it is more likely than not that some or all of a deferred tax asset will not be realized, a valuation allowance is recorded to reduce the carrying value of the asset. In assessing the need for a valuation allowance, management is required to make certain judgments and assumptions about our future operations based on historical experience and information as of the measurement period regarding reversal of existing temporary differences, carryback capacity, future taxable income (including its capital and operating characteristics) and tax planning strategies.

### Unrecognized Tax Benefits

We evaluate tax positions taken on tax returns and recognize positions in our financial statements when it is more likely than not that we will sustain the position upon resolution with a taxing authority. If recognized, the benefit is measured as the largest amount of benefit that has a greater than fifty percent probability of being realized. We review uncertain tax positions each period, considering changes in facts and circumstances, such as changes in tax law, interactions with taxing authorities and developments in case law, and make adjustments as we consider necessary. Adjustments to our unrecognized tax benefits may affect our income tax expense, and settlement of uncertain tax positions may require the use of cash. At September 30, 2012, our current tax liability included \$23.7 million for unrecognized tax benefits, and \$1.3 million for related accrued interest.

### Goodwill

Management evaluates the carrying value of goodwill annually during the fourth quarter. If, at any time during the year, events occur or circumstances change that would more likely than not reduce the fair value below the carrying value, we also evaluate goodwill at that time. We evaluate goodwill as one reporting unit because we operate as a single operating segment and our segment components are economically similar. We estimate the fair value of our reporting unit on the evaluation date based on market capitalization and an expected premium that would be paid to acquire control of our Company (a control premium). We then perform a sensitivity analysis using a range of historical stock prices and control premiums. We concluded as of our last evaluation date, October 3, 2011, that the fair value of our reporting unit exceeded the carrying value and no adjustment to impair goodwill was necessary.

### Accounting Changes

We are not aware of any accounting changes that we have not yet adopted as of September 30, 2012 that would have a material impact on our results of operations or financial position. Note 1 of the Notes to Condensed Consolidated Financial Statements provides additional detail regarding accounting changes.

## Liquidity and Capital Resources and Financial Condition

### Overview

ProAssurance Corporation is a holding company and is a legal entity separate and distinct from its subsidiaries. Because the holding company has no other business operations, dividends from its operating subsidiaries represent a significant source of funds for its obligations, including debt service and dividends. At September 30, 2012, we held cash and liquid investments of approximately \$436.1 million outside our insurance subsidiaries that were available for use without regulatory approval. During the nine months ended September 30, 2012, our insurance subsidiaries paid dividends of approximately \$119.7 million, including extraordinary dividends of \$25.0 million. In October 2012, our insurance subsidiaries paid approximately \$159 million of the permitted dividends. Our insurance subsidiaries, in aggregate, are permitted to pay additional dividends of approximately \$16 million over the remainder of 2012 without the prior approval of state insurance regulators. However, the payment of any dividend requires prior notice to the insurance regulator in the state of domicile, and the regulator may prevent the dividend if, in its judgment, payment of the dividend would have an adverse effect on the surplus of the insurance subsidiary.

### Operating Activities and Related Cash Flows

The principal components of our operating cash flows are the excess of premiums collected and net investment income over losses paid and operating costs, including income taxes. Timing delays exist between the collection of premiums and the payment of losses associated with the premiums. Premiums are generally collected within the twelve-month period after the policy is written, while our claim payments are generally paid over a more extended

period of time. Likewise, timing delays exist between the payment of claims and the collection of any associated reinsurance recoveries.



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Our operating activities provided positive cash flows of approximately \$61.4 million and \$106.4 million for the nine months ended September 30, 2012 and 2011, respectively. Operating cash flows for 2012 and 2011 compare as follows:

| (In millions)  | Operating<br>Cash Flow |
|--|------------------------|
| Cash provided by operating activities for the nine months ended September 30, 2011 | \$106                  |
| Increase (decrease) in operating cash flows:                                       |                        |
| Decrease in premium receipts (1)   | (8 )                   |
| Decrease in payments to reinsurers (2)   | 3                      |
| Increase in losses paid, net of reinsurance recoveries (3)                         | (32 )                  |
| Increase in deposit contracts (4)  | 5                      |
| Decrease in cash received for investments (5)                                      | (9 )                   |
| Decrease in cash paid for other expenses (6)                                       | 10                     |
| Increase in Federal and state income tax payments (7)                              | (9 )                   |
| Other amounts not individually significant, net                                    | (5 )                   |
| Cash provided by operating activities for the nine months ended September 30, 2012 | \$61                   |

(1) The reduction in premium receipts reflected lower premium volume in 2012, exclusive of a volume decline related to two-year term policies and a volume increase related to tail policies. Two-year term policies affect gross written premium, but have little effect on timing of premium receipts since half of the written amount is billed in the second term. Tail policies are typically collected in the period written.

(2) Reinsurance contracts are generally for premiums written in a specific annual period, but, absent a commutation agreement, remain in effect until all claims under the contract have been resolved. Some contracts require annual settlements while others require settlement only after a number of years have elapsed, thus the amounts paid can vary widely from period to period.

(3) The timing of our net loss payments varies from period to period because the process for resolving claims is complex and occurs at an uneven pace depending upon the circumstances of the individual claim. The increase in loss payments for the first nine months of 2012 primarily reflected a greater number of claims resolved with large indemnity payments, a portion of which was recovered or is expected to be recovered under existing reinsurance arrangements. As of September 30, 2012 we estimated that an additional \$9 million will be received from reinsurers relative to losses paid in 2012. The additional loss payments were not isolated to any one state or to any specific risk groups. We have not seen evidence in our loss data that suggests the increase in loss payments for the nine-month period represents a change in loss trends and as such have not changed our loss assumptions for the current period.

(4) We are party to certain contracts that involve claims handling but do not transfer insurance risk. As required by GAAP, receipts and disbursements for these contracts are not considered as receipts of premium or payments of losses, but rather are considered as deposits received or returned. These contracts do not constitute a significant business activity for us, but, increased our cash flows on a net basis by \$5 million in 2012.

(5) The decrease in cash received for investments reflected the decrease in net investment income as well as timing differences of interest receipts between periods.

(6) The decrease in cash paid for other expenses was principally attributable to non-recurring payments of American Physicians Service Group, Inc.(APS) integration costs, primarily compensation-related, during 2011.

(7) The net increase in tax payments during 2012 was attributable to:

• An increase in estimated tax payments for the current year of \$1.2 million, and an increase in the final payments for the prior fiscal year of \$7.4 million.

• Federal tax refunds received in 2011 of \$7.5 million.

• Payments of \$5.9 million made in 2011 for the 2008 and 2007 tax years as a result of federal tax return audits conducted by the Internal Revenue Service. The payments reduced tax liabilities recognized prior to January 1, 2011 and did not increase or decrease 2011 tax expense.

• A reduction in state and other tax payments of \$1.5 million.



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Our operating activities provided positive cash flows of approximately \$106.4 million and \$108.6 million for the nine months ended September 30, 2011 and 2010, respectively. Operating cash flows for 2011 and 2010 compared as follows:

| (In millions)  | Operating<br>Cash Flow |
|--|------------------------|
| Cash provided by operating activities for the nine months ended September 30, 2010 | \$ 109                 |
| Increase (decrease) in operating cash flows:                                       |                        |
| Decrease in premium receipts (1)   | (21 )                  |
| Increase in payments to reinsurers (2)   | (2 )                   |
| Decrease in losses paid, net of reinsurance recoveries (3)                         | 28                     |
| Increase in Federal and state income tax payments (4)                              | (20 )                  |
| Cash flows attributable to operations acquired from APS (excluding tax payments)   | 17                     |
| Other amounts not individually significant, net                                    | (5 )                   |
| Cash provided by operating activities for the nine months ended September 30, 2011 | \$ 106                 |

The decline in premium receipts primarily reflected a \$11.3 million reduction in gross written premiums exclusive of the business acquired from APS. Written premiums associated with two-year term policies increased by (1) approximately \$11.9 million for the nine-month period ended 2011 as compared to 2010, while approximately half of the written amount is not scheduled to be collected until 2012. Additionally, in 2011 more of our insureds elected to take advantage of payment plans offered to them.

Reinsurance contracts are generally for premiums written in a specific annual period, but, absent a commutation agreement, remain in effect until all claims under the contract have been resolved. Some contracts require annual (2) settlements while others require settlement only after a number of years have elapsed, thus the amounts paid can vary widely from period to period.

The timing of our net loss payments varies from period to period because the process for resolving claims is (3) complex and occurs at an uneven pace depending upon the circumstances of the individual claim. Net loss payments are also subject to reinsurance recoveries under existing reinsurance arrangements. Approximately \$2 million of expected recoveries against losses paid in 2011 had not been collected as of September 30, 2011.

(4) The net increase in tax payments during 2011 primarily reflected:

- An increase in estimated tax payments for the current year of \$11.8 million and an increase in the final payments for the prior fiscal year of \$6.0 million.

▲ \$3.6 million increase in federal tax refunds due to capital loss carry-backs during 2011.

• Payments of \$5.9 million made in 2011 for the 2008 and 2007 tax years as a result of Federal tax return audits conducted by the Internal Revenue Service, as previously discussed.

#### Reinsurance

We use reinsurance to provide capacity to write larger limits of liability, to provide protection against losses in excess of policy limits, and to stabilize underwriting results in years in which higher losses occur. The purchase of reinsurance does not relieve us from the ultimate risk on our policies, but it does provide reimbursement from the reinsurer for certain losses paid by us.

Our risk retention level is dependent upon numerous factors including our risk tolerance and the capital we have to support it, the price and availability of reinsurance, volume of business, level of experience with a particular set of claims and our analysis of the potential underwriting results. We purchase reinsurance from a number of companies to mitigate concentrations of credit risk. We utilize a reinsurance broker to assist us in the placement of our reinsurance coverage and in the analysis of the credit quality of our reinsurers. We base our reinsurance buying decisions on an evaluation of the then-current financial strength, rating and stability of prospective reinsurers. However, the financial strength of our reinsurers, and their corresponding ability to pay us, may change in the future due to forces or events we cannot control or anticipate.

#### Taxes

We have received a draft Notice of Proposed Adjustment from the IRS related to its audit of our 2009 and 2010 federal income tax returns stating that the IRS intends to disallow a substantial portion of the loss and loss adjustment

expense deduction taken on our returns for these years. The proposed adjustment represents a temporary timing difference and impacts the timing of deductions, rather than their allowance, and would shift tax from deferred to current tax expense but would not increase total tax expense. As now written, the Notice of Proposed Adjustment would require that we reduce our current

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deduction for loss and loss adjustment expenses, thereby increasing our current tax liability by approximately \$100 million including interest associated with the timing of the payment. For financial reporting purposes, the tax liability asserted in the Notice of Proposed Adjustment would be offset, excluding the interest component, by the establishment of a deferred tax asset in recognition that these losses and loss adjustment expenses will be deductible in future periods. We believe that our loss and loss adjustment expense deduction was computed in a manner consistent with tax law, our past practices, and the practices of other MPL insurers. We remain in discussions with the IRS, challenging the position asserted in the draft Notice of Proposed Adjustment. There are other taxpayers with legal actions pending against the IRS in the United States Tax Court challenging IRS audit findings with regard to loss and loss adjustment expense deductions, and any rulings on these cases may influence the timing and amount of any asserted additional tax liability in any final report we receive from the IRS, and in our response to the final report. Any payments made would come out of our cash and investments and could impact future investment earnings, but, except for interest on past-due taxes, if any, recorded tax expense will not change. We do not know when a final resolution will be reached with the IRS, or the amount of additional tax payments or interest that might be asserted.

Litigation

We are involved in various legal actions related to insurance policies and claims handling including, but not limited to, claims asserted against us by policyholders. These types of legal actions arise in the ordinary course of business and, in accordance with GAAP for insurance entities, are considered as a part of our loss reserving process, which is described in detail under “Critical Accounting Estimates – Reserve for Losses and Loss Adjustment Expenses (reserve for losses or reserve).”

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## Investing Activities and Related Cash Flows

## Investment Exposures

The following table provides summarized information regarding our investments as of September 30, 2012:

| (\$ in thousands)                                | Carrying Value | Included in Carrying Value: |                   |                | (1)   | % Total Investments |
|--|----------------|-----------------------------|-------------------|----------------|-------|---------------------|
|  |                | Unrealized Gains            | Unrealized Losses | Average Rating |       |                     |
| <b>Fixed Maturities</b>                          |                |                             |                   |                |       |                     |
| <b>Government</b>                                |                |                             |                   |                |       |                     |
| U.S. Treasury                                    | \$218,542      | \$15,997                    | \$(34)            | AA+            | (2) 5 | %                   |
| U.S. Government-sponsored enterprise             | 62,691         | 5,186                       | —                 | AA+            | (2) 2 | %                   |
| Total government                                 | 281,233        | 21,183                      | (34)              | AA+            | (2) 7 | %                   |
| <b>State and Municipal Bonds</b>                 |                |                             |                   |                |       |                     |
| Pre-refunded                                     | 124,670        | 8,434                       | —                 | AA             | 3     | %                   |
| General obligation                               | 395,749        | 30,135                      | —                 | AA+            | 10    | %                   |
| Special revenue                                  | 692,869        | 52,755                      | (44)              | AA             | 17    | %                   |
| Total state and municipal bonds                  | 1,213,288      | 91,324                      | (44)              | AA             | 29    | %                   |
| <b>Corporate Debt</b>                            |                |                             |                   |                |       |                     |
| Financial institutions                           | 432,620        | 25,189                      | (403)             | A              | 10    | %                   |
| Communications                                   | 105,946        | 6,970                       | (34)              | BBB            | 3     | %                   |
| Utilities/Energy                                 | 279,079        | 22,288                      | (233)             | BBB+           | 7     | %                   |
| Industrial                                       | 647,744        | 44,892                      | (980)             | BBB+           | 16    | %                   |
| Other  | 11,381         | 516                         | —                 | A              | <1%   |                     |
| Total corporate debt                             | 1,476,770      | 99,855                      | (1,650)           | A-             | 36    | %                   |
| <b>Securities backed by:</b>                     |                |                             |                   |                |       |                     |
| Agency mortgages                                 | 357,103        | 23,799                      | (43)              | AA+            | 9     | %                   |
| Non-agency mortgages                             | 14,323         | 561                         | (519)             | BB+            | <1%   |                     |
| Subprime home equity loans                       | 7,294          | 52                          | (837)             | A-             | <1%   |                     |
| Alt -A mortgages                                 | 4,247          | 32                          | (92)              | CCC+           | <1%   |                     |
| Agency commercial mortgages                      | 71,462         | 3,270                       | (35)              | AA+            | 2     | %                   |
| Other commercial mortgages                       | 76,742         | 6,427                       | (4)               | AAA            | 2     | %                   |
| Credit card loans                                | 17,601         | 602                         | —                 | AAA            | <1%   |                     |
| Automobile loans                                 | 35,108         | 369                         | —                 | AAA            | 1     | %                   |
| Other asset loans                                | 15,008         | 306                         | —                 | AAA            | <1%   |                     |
| Total asset-backed securities                    | 598,888        | 35,418                      | (1,530)           | AA+            | 15    | %                   |
| Total fixed maturities                           | 3,570,179      | 247,780                     | (3,258)           | AA-            | 87    | %                   |
| <b>Equities</b>                                  |                |                             |                   |                |       |                     |
| Financial  | 66,885         | —                           | —                 |                | 2     | %                   |
| Utilities/Energy                                 | 29,207         | —                           | —                 |                | 1     | %                   |
| Consumer oriented                                | 46,394         | —                           | —                 |                | 1     | %                   |
| Technology                                       | 10,543         | —                           | —                 |                | <1%   |                     |
| Industrial                                       | 16,374         | —                           | —                 |                | <1%   |                     |
| All Other  | 14,575         | —                           | —                 |                | <1%   |                     |
| Total equities                                   | 183,978        | —                           | —                 |                | 4     | %                   |
| Short-Term                                       | 167,516        | —                           | —                 |                | 4     | %                   |
| Business-owned life insurance (BOLI)             | 52,070         | —                           | —                 |                | 1     | %                   |
| <b>Investment in Unconsolidated Subsidiaries</b> |                |                             |                   |                |       |                     |
| Investment in tax credit partnerships            | 89,191         | —                           | —                 |                | 2     | %                   |
| Investment in LPs                                | 31,479         | —                           | —                 |                | 1     | %                   |
|  | 120,670        | —                           | —                 |                | 3     | %                   |

Total investment in unconsolidated subsidiaries

|                         |             |           |            |     |   |
|-------------------------|-------------|-----------|------------|-----|---|
| Other Investments       |             |           |            |     |   |
| FHLB capital stock      | 4,278       | —         | —          | <1% |   |
| Investments in LP/LLCs  | 25,246      | —         | —          | 1   | % |
| Other                   | 1,697       | —         | —          | <1% |   |
| Total other investments | 31,221      | —         | —          | 1   | % |
| Total Investments       | \$4,125,634 | \$247,780 | \$(3,258 ) | 100 | % |

(1) A weighted average rating is calculated using available ratings from Standard & Poor's, Moody's and Fitch. The table presents the Standard & Poor's rating that is equivalent to the computed average.

(2) The rating presented is the Standard & Poor's rating rather than the average. The Moody's rating is Aaa and the Fitch rating is AAA.

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A detailed listing of our investment holdings as of September 30, 2012 is presented in an Investor Supplement we make available in the Investor Relations section of our website, [www.proassurance.com](http://www.proassurance.com), or directly at [www.proassurance.com/investorrelations/supplemental.aspx](http://www.proassurance.com/investorrelations/supplemental.aspx).

We manage our investments to ensure that we will have sufficient liquidity to meet our obligations, taking into consideration the timing of cash flows from our investments, including interest payments, dividends and principal payments, as well as the expected cash flows to be generated by our operations. In addition to the interest and dividends we will receive, we anticipate that between \$60 million and \$130 million of our investments will mature (or be paid down) each quarter of the next year and become available, if needed, to meet our cash flow requirements. The primary outflow of cash at our insurance subsidiaries is related to paid losses and operating costs, including income taxes. The payment of individual claims cannot be predicted with certainty; therefore, we rely upon the history of paid claims in estimating the timing of future claims payments. To the extent that we may have an unanticipated shortfall in cash we may either liquidate securities or borrow funds under existing borrowing arrangements through our \$150 million credit facility and the FHLB system. However, given the relatively short duration of our investments, we do not foresee any such shortfall. Additional information regarding the credit facility is detailed in Note 8 of the Notes to Condensed Consolidated Financial Statements.

Our investment portfolio continues to be primarily composed of high quality fixed income securities with approximately 93% of our fixed maturities being investment grade securities as determined by national rating agencies. The weighted average effective duration of our fixed maturity securities at September 30, 2012 was 3.8 years; the weighted average effective duration of our fixed maturity securities combined with our short-term securities was 3.6 years.

We increased our investment in tax credit limited partnerships by an additional \$7 million and \$32 million during the first nine months of 2012 and 2011, respectively. These investments are comprised of multiple separate limited partner interests designed to generate investment returns by providing tax benefits to investors in the form of project operating losses and tax credits. The related properties are principally low income housing properties. The \$89.2 million carrying value of the partnerships reflected the commitments to the partnerships (less amortization) of which approximately \$26.8 million had not yet been funded as of September 30, 2012. As of December 31, 2011 the carrying value of the partnerships approximated \$86.8 million, of which approximately \$49.3 million had not yet been funded.

During the third quarter of 2012, we committed to invest \$50.0 million in an investment LP of which approximately \$43.2 million had not yet been funded as of September 30, 2012. The commitment will be paid over 5 years as requested by the fund manager.

**European Debt Exposure**

We have no direct European sovereign debt exposure. We have indirect exposure through our investments in debt securities and through our reinsurance receivables. Issuers of our debt securities and our reinsurers may hold European sovereign debt or have counterparty exposure to European banks or European corporations. Entities that have significant European exposure may suffer credit downgrades due to European sovereign debt exposure or due to European creditor exposure if they have significant business in the Euro-zone or Eurocurrency denominated business should either or both fail, or should a severe European recession arise.

Our debt securities at September 30, 2012 included \$117.0 million (3% of our total investments) where the issuer is domiciled in Europe or the underlying revenue stream supporting the security is European.

Our investments outside of Europe, and particularly our financial sector investments, could also be negatively affected by a significant European economic crisis. At September 30, 2012 we held non-European financial sector debt securities of approximately \$390.1 million. Also, our reinsurers typically operate globally and have large investment portfolios which may be linked directly or indirectly to the European economy. As of December 31, 2011, two of our largest reinsurers were domiciled in Europe; our net receivables with these reinsurers totaled approximately \$61 million. Our reinsurance receivables totaled \$240.5 million at September 30, 2012.

We do not currently write insurance policies in Europe and do not have any notes or accounts receivable from European issuers, exclusive of our reinsurance receivables.

**Acquisitions**



In June 2012, we entered into agreements to acquire Medmarc Mutual Insurance Company (Medmarc) and Independent Nevada Doctors Insurance Exchange (IND). Medmarc will be acquired through a sponsored demutualization that will provide Medmarc's eligible members with cash payments of \$146.2 million and future policy credits of \$7.5 million. The transaction is expected to close in early January 2013. Medmarc is an underwriter of product liability insurance for medical technology and life sciences and also underwrites a book of legal professional liability insurance. Medmarc had direct written premium of \$41 million for the year ended December 31, 2011 and statutory net assets of \$160 million at June 30, 2012. The transaction is subject to customary conditions, including approval by Medmarc's eligible members and insurance regulators in Vermont

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where Medmarc is domiciled. IND is a Nevada reciprocal exchange and in 2011 was the leading writer of MPL insurance in the state of Nevada. IND will become a part of ProAssurance through a conversion from a reciprocal to a stock insurance company. The IND transaction requires approval of IND subscribers and the Nevada Division of Insurance. Proceeds from the transaction will be paid in cash to eligible IND subscribers; terms of the transaction are not material to our financial statements. It is anticipated that both acquisitions will be funded with existing capital. On November 30, 2010, we acquired 100% of the outstanding shares of American Physicians Service Group, Inc., a MPL provider principally insuring physicians in the state of Texas, in a transaction valued at \$237 million including cash paid of \$233 million and liabilities assumed of \$4 million.

Financing Activities and Related Cash Flows

Treasury Shares

We did not repurchase any common shares during the nine months ended September 30, 2012. We reacquired approximately 341,000 common shares having a total cost of \$21.0 million during the nine-month period ended September 30, 2011, including approximately 6,900 forfeited employer match shares (cost basis of \$0.4 million) reacquired due to the termination of the ProAssurance Corporation Stock Ownership Plan. At September 30, 2012, approximately \$135.1 million of Board authorizations for the repayment of debt or repurchase of common shares remain available for use. During the first three quarters of 2012, Board authorizations of \$52.5 million were used to repay debt (see discussion under "Debt").

Shareholder Dividends

The Board of Directors of ProAssurance declared cash dividends of \$0.25 per common share for each of the first three quarters of 2012 totaling \$23.0 million, which included the third quarter dividend of \$7.7 million that was paid in October 2012. The initial quarterly dividend of \$0.25 per common share was declared during the third quarter of 2011 totaling \$7.6 million and was paid in October of 2011. Any decision to pay future cash dividends is subject to the Board's final determination after a comprehensive review of financial performance, future expectations and other factors deemed relevant by the Board. The liability for unpaid dividends is included in Other Liabilities.

Debt

During the third quarter of 2012, we used \$57.1 million to repay all long-term debt and terminate a related interest rate swap and recognized a loss on the debt repayment of \$2.2 million. We made scheduled debt repayments of \$0.6 million during the first six months of 2012. We have no outstanding long-term debt as of September 30, 2012. Our revolving credit agreement allows us to borrow up to \$150 million that would be used for general corporate purposes, including, but not limited to, short-term working capital, share repurchases as authorized by the Board, and support for other activities we enter into in the normal course of business. In September 2012, we amended the agreement and extended its expiration date to April 15, 2016. To date, we have not borrowed any funds under the agreement. We are also a member of the FHLB. Through membership, we have access to secured cash advances which can be used for liquidity purposes or other operational needs. To date, we have not established a FHLB line of credit or materially utilized our membership.

ProAssurance is currently in compliance with all covenants associated with its borrowing arrangements. Additional information regarding our debt is provided in Note 8 of the Notes to Condensed Consolidated Financial Statements.

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## Overview of Results—Three and Nine Months Ended September 30, 2012 and 2011

Net income and Operating income (a non-GAAP financial measure, see reconciliation below) were as follows:

| (In millions, except per share data) | Three Months Ended |        | Nine Months Ended |         |
|--------------------------------------|--------------------|--------|-------------------|---------|
|                                      | September 30       |        | September 30      |         |
|                                      | 2012               | 2011   | 2012              | 2011    |
| Net income                           | \$60.1             | \$43.7 | \$174.2           | \$146.5 |
| Operating income                     | \$52.9             | \$48.4 | \$160.6           | \$147.0 |
| Net income per diluted share         | \$1.94             | \$1.42 | \$5.64            | \$4.75  |
| Operating income per diluted share   | \$1.71             | \$1.57 | \$5.20            | \$4.77  |

Results from the three and nine months ended September 30, 2012 and 2011 compare as follows:

## Revenues

Net premiums earned decreased for the 2012 three- and nine-month periods by approximately \$7.5 million or 5.6% and \$8.7 million or 2.2%, respectively. Results for both periods reflected the effects of a competitive market place. The nine-month period also reflected an increase in net earned premium of \$9.3 million related to tail coverages, a net earned premium increase of \$2.9 million related to the prior year reinsurance arrangements, and a decrease to net earned premium of \$5.6 million attributable to a commutation recorded in 2011.

Our net investment result (which includes both net investment income and earnings from unconsolidated subsidiaries) increased by \$2.3 million or 7.1% for the 2012 three-month period and decreased \$2.7 million or 2.7% for the nine-month period. Net Investment Income decreased \$0.2 million and \$4.7 million for the 2012 three- and nine-month periods, respectively, primarily due to lower average fixed income investment balances and, for the nine-month period, lower yields on our fixed income portfolio. Equity in Earnings of Unconsolidated Subsidiaries increased \$2.5 million and \$2.0 million for the 2012 three- and nine-month periods, respectively, primarily reflecting higher earnings from our interests in certain LPs and, for the three-month period, lower amortization of our tax credit partnership investments.

Net realized investment gains for the 2012 three- and nine-month periods were \$13.2 million and \$22.3 million, respectively, as compared to net realized investment losses of \$12.0 million and \$5.6 million for the same respective periods of 2011. Our trading portfolio generated holding gains in both the three- and nine-month periods of 2012 as compared to holding losses in 2011. Sales of available-for-sale securities produced net gains during both 2012 and 2011, but net gains were higher in the 2012 three-month period. Impairments recognized in 2012 were lower for both the three- and nine-month periods.

Other income decreased by \$5.9 million and \$6.5 million for the 2012 three- and nine-month periods, respectively. The decrease is primarily due to a \$4.9 million confidential settlement received during the third quarter of 2011 related to litigation with a service provider.

## Expenses

Current accident year net losses decreased by \$8.7 million or 7.5% and \$7.9 million or 2.3% for the 2012 three- and nine-month periods, respectively. The decline was principally attributable to a reduction in the number of insured risks which, for the nine-month period, was mitigated by an increase in tail exposures. We reduced net losses by \$50.0 million and \$157.5 million for the 2012 three- and nine-month periods, respectively, and by \$52.1 million and \$142.3 million for the same periods in 2011 as a result of our review of our estimate of net losses incurred for prior accident years.

Underwriting, policy acquisition and operating expenses decreased by \$1.7 million or 4.8% and \$0.5 million or 0.4% for the 2012 three- and nine-month periods, respectively, which reflected the net of lower costs associated with the operations we acquired from APS, additional expense incurred related to our acquisition of Medmarc, an expense increase due to the adoption of new FASB guidance regarding policy acquisition costs and, for the nine-month period, higher compensation costs.

We recognized losses of \$2.2 million during the 2012 nine-month period related to the repayment of the 2019 Note Payable which was carried at fair value.



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## Ratios

Our net loss ratio decreased by 2.4 percentage points and 4.7 percentage points for the 2012 three- and nine-month periods, respectively, reflecting reductions of 0.7 percentage points and 4.5 percentage points, respectively, attributable to prior year favorable development. Our current accident year net loss ratio decreased 1.7 percentage points and 0.2 percentage points for the 2012 three- and nine-month periods, respectively, due to changes in the mix of insured risks, and, for the nine-month period, a 0.5 percentage point reduction attributable to reinsurance.

Our underwriting expense ratio increased 0.2 and 0.6 percentage points for the 2012 three- and nine-month periods, respectively. Both the three- and the nine-month period ratios reflected an increase attributable to lower net premiums earned in 2012, but for the 2012 three-month period, the increase was substantially offset by an overall reduction in expenses.

Our operating ratio declined by 3.6 and 3.5 percentage points for the 2012 three- and nine-month periods, respectively. The three-month period decline reflected improvements in the 2012 net loss and investment ratios. The nine-month period reflected an improvement in the 2012 net loss ratio, somewhat offset by a higher expense and a lower investment ratio in 2012.

Return on equity was 10.4% and 10.3% for the 2012 three- and nine-month periods, respectively, on an annualized basis.

## Book Value per Share

Our book value per share at September 30, 2012 was \$76.47 compared to \$70.84 at December 31, 2011. The increase primarily reflected the effect of our 2012 comprehensive income, partially offset by dividends declared during the nine months ended September 30, 2012 which reduced our book value per share by \$0.75. Due to the size of our Shareholders' Equity (approximately \$2.3 billion at September 30, 2012), the growth rate of our book value per share may slow. The past growth rates of our book value per share do not necessarily predict similar future results.

## Non-GAAP Financial Measures

Operating income is a non-GAAP financial measure that is widely used to evaluate the performance of insurance entities. Operating income excludes the after-tax effects of net realized investment gains or losses, guaranty fund assessments, debt retirement gain or loss and the effect of confidential settlements that do not reflect normal operating results. We believe operating income presents a useful view of the performance of our insurance operations, but should be considered in conjunction with net income computed in accordance with GAAP.

The following table is a reconciliation of Net income to Operating income:

|  | Three Months Ended<br>September 30 |          | Nine Months Ended<br>September 30 |           |
|--|------------------------------------|----------|-----------------------------------|-----------|
| (In thousands, except per share data)                  | 2012                               | 2011     | 2012                              | 2011      |
| Net income   | \$60,106                           | \$43,705 | \$174,204                         | \$146,494 |
| Items excluded in the calculation of operating income: |                                    |          |                                   |           |
| (Gain) loss on extinguishment of debt                  | 2,163                              | —        | 2,163                             | —         |
| Net realized investment (gains) losses                 | (13,219                            | ) 11,972 | (22,348                           | ) 5,648   |
| Guaranty fund assessments (recoupments)                | 41                                 | 99       | 16                                | 41        |
| Effect of confidential settlements, net                | —                                  | (4,900   | ) (714                            | ) (4,900  |
| Pre-tax effect of exclusions                           | (11,015                            | ) 7,171  | (20,883                           | ) 789     |
| Tax effect, at 35%                                     | 3,855                              | (2,510   | ) 7,309                           | (276      |
| Operating income                                       | \$52,946                           | \$48,366 | \$160,630                         | \$147,007 |
| Per diluted common share:                              |                                    |          |                                   |           |
| Net income   | \$1.94                             | \$1.42   | \$5.64                            | \$4.75    |
| Effect of exclusions                                   | (0.23                              | ) 0.15   | (0.44                             | ) 0.02    |
| Operating income per diluted common share              | \$1.71                             | \$1.57   | \$5.20                            | \$4.77    |



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Results of Operations—Three and Nine Months Ended September 30, 2012 Compared to Three and Nine Months Ended September 30, 2011

Selected consolidated financial data for each period is summarized in the table below.

| (\$ in thousands, except share data)                     | Three Months Ended September 30 |           |            | Nine Months Ended September 30 |           |            |
|--|---------------------------------|-----------|------------|--------------------------------|-----------|------------|
|  | 2012                            | 2011      | Change     | 2012                           | 2011      | Change     |
| <b>Revenues:</b>   |                                 |           |            |                                |           |            |
| Net premiums earned                                      | \$127,125                       | \$134,627 | \$(7,502 ) | \$395,050                      | \$403,766 | \$(8,716 ) |
| Net investment income                                    | 33,910                          | 34,116    | (206 )     | 101,912                        | 106,573   | (4,661 )   |
| Equity in earnings (loss) of unconsolidated subsidiaries | 211                             | (2,264 )  | 2,475      | (4,082 )                       | (6,044 )  | 1,962      |
| Net realized investment gains (losses)                   | 13,219                          | (11,972 ) | 25,191     | 22,348                         | (5,648 )  | 27,996     |
| Other income   | 1,529                           | 7,471     | (5,942 )   | 5,207                          | 11,745    | (6,538 )   |
| Total revenues   | 175,994                         | 161,978   | 14,016     | 520,435                        | 510,392   | 10,043     |
| <b>Expenses:</b>   |                                 |           |            |                                |           |            |
| Losses and loss adjustment expenses                      | 63,675                          | 71,777    | (8,102 )   | 197,112                        | 218,270   | (21,158 )  |
| Reinsurance recoveries                                   | (7,054 )                        | (8,601 )  | 1,547      | (22,208 )                      | (20,319 ) | (1,889 )   |
| Net losses and loss adjustment expenses                  | 56,621                          | 63,176    | (6,555 )   | 174,904                        | 197,951   | (23,047 )  |
| Underwriting, policy acquisition and operating expenses  | 33,280                          | 34,954    | (1,674 )   | 103,083                        | 103,534   | (451 )     |
| Interest expense   | 350                             | 932       | (582 )     | 2,002                          | 2,645     | (643 )     |
| Loss on extinguishment of debt                           | 2,163                           | —         | 2,163      | 2,163                          | —         | 2,163      |
| Total expenses   | 92,414                          | 99,062    | (6,648 )   | 282,152                        | 304,130   | (21,978 )  |
| Income before income taxes                               | 83,580                          | 62,916    | 20,664     | 238,283                        | 206,262   | 32,021     |
| Income taxes   | 23,474                          | 19,211    | 4,263      | 64,079                         | 59,768    | 4,311      |
| Net income   | \$60,106                        | \$43,705  | \$16,401   | \$174,204                      | \$146,494 | \$27,710   |
| <b>Earnings per share:</b>                               |                                 |           |            |                                |           |            |
| Basic  | \$1.96                          | \$1.43    | \$0.53     | \$5.69                         | \$4.79    | \$0.90     |
| Diluted  | \$1.94                          | \$1.42    | \$0.52     | \$5.64                         | \$4.75    | \$0.89     |
| Net loss ratio   | 44.5                            | % 46.9    | % (2.4 )   | 44.3                           | % 49.0    | % (4.7 )   |
| Underwriting expense ratio                               | 26.0                            | % 25.8    | % 0.2      | 25.8                           | % 25.2    | % 0.6      |
| Combined ratio   | 70.5                            | % 72.7    | % (2.2 )   | 70.1                           | % 74.2    | % (4.1 )   |
| Operating ratio  | 43.8                            | % 47.4    | % (3.6 )   | 44.3                           | % 47.8    | % (3.5 )   |
| Tax ratio  | 28.1                            | % 30.5    | % (2.4 )   | 26.9                           | % 29.0    | % (2.1 )   |
| Return on equity*  | 10.4                            | % 8.8     | % 1.6      | 10.3                           | % 10.1    | % 0.2      |

\* Annualized

In all tables that follow, the abbreviation “nm” indicates that the percentage change is not meaningful.

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## Premiums Written

Changes in our premium volume are driven by four primary factors: (1) our retention of existing business, (2) the premium charged for business that is renewed, which is affected by rates charged and by the amount and type of coverage an insured chooses to purchase, (3) the timing of premium written for business generated by multi-period policies, and (4) the amount of new business we generate. The professional liability market remains competitive with some competitors choosing to compete primarily on price.

Gross, ceded and net premiums written were as follows:

| (\$ in thousands)      | Three Months Ended September 30 |           |             | Nine Months Ended September 30 |           |           |             |         |
|------------------------|---------------------------------|-----------|-------------|--------------------------------|-----------|-----------|-------------|---------|
|                        | 2012                            | 2011      | Change      | 2012                           | 2011      | Change    |             |         |
| Gross premiums written | \$156,547                       | \$174,680 | \$(18,133 ) | (10.4 %)                       | \$429,223 | \$450,795 | \$(21,572 ) | (4.8 %) |
| Ceded premiums written | (8,738 )                        | (9,882 )  | 1,144       | (11.6 %)                       | (31,547 ) | (29,103 ) | (2,444 )    | 8.4 %   |
| Net premiums written   | \$147,809                       | \$164,798 | \$(16,989 ) | (10.3 %)                       | \$397,676 | \$421,692 | \$(24,016 ) | (5.7 %) |

## Gross Premiums Written

Gross premiums written by component were as follows:

| (\$ in thousands)                       | Three Months Ended September 30 |           |             | Nine Months Ended September 30 |           |           |             |          |
|---|---------------------------------|-----------|-------------|--------------------------------|-----------|-----------|-------------|----------|
|   | 2012                            | 2011      | Change      | 2012                           | 2011      | Change    |             |          |
| Gross premiums written:                 |                                 |           |             |                                |           |           |             |          |
| Physician                               | \$129,573                       | \$143,673 | \$(14,100 ) | (9.8 %)                        | \$335,390 | \$365,198 | \$(29,808 ) | (8.2 %)  |
| Non-physician healthcare providers      | 11,639                          | 13,282    | (1,643 )    | (12.4 %)                       | 33,363    | 35,358    | (1,995 )    | (5.6 %)  |
| Hospital and facility                   | 4,948                           | 5,494     | (546 )      | (9.9 %)                        | 20,220    | 19,079    | 1,141       | 6.0 %    |
| Other                                   | 4,955                           | 4,770     | 185         | 3.9 %                          | 15,272    | 14,455    | 817         | 5.7 %    |
| Non-continuing                          | 55                              | 1,020     | (965 )      | (94.6 %)                       | 761       | 1,758     | (997 )      | (56.7 %) |
| Tail coverage premium, all policy types | 5,377                           | 6,441     | (1,064 )    | (16.5 %)                       | 24,217    | 14,947    | 9,270       | 62.0 %   |
| Total                                   | \$156,547                       | \$174,680 | \$(18,133 ) | (10.4 %)                       | \$429,223 | \$450,795 | \$(21,572 ) | (4.8 %)  |

## Physician Premiums

As compared to 2011, physician premiums declined for both the three- and the nine-month periods of 2012. The expected timing differences associated with two-year policies accounted for more than 30% of total physician premium decrease in both the third quarter and year-to-date periods.

Our retention rate for our standard physician business was 89% and 90% for the three and nine months ended September 30, 2012, respectively, as compared to 89% for both the 2011 three- and nine-month periods. We calculate our retention rate as retained premium divided by all premium subject to renewal. Retention rates are affected by a number of factors. We may lose insureds to competitors or to alternative insurance mechanisms such as risk retention groups or self-insurance entities (often when physicians join hospitals or large group practices) or due to pricing or other issues. We may choose not to renew an insured as a result of our underwriting evaluation. Insureds may also terminate coverage because they have left the practice of medicine for various reasons, principally for retirement but also for personal reasons or due to disability or death.

Charged rates for our renewed physician business have averaged 2% and 1% higher than the expiring premiums during the 2012 three- and nine-month periods, respectively, partially driven by our podiatric line of business. Podiatric renewals are concentrated in the third quarter and 2012 third quarter podiatric renewals reflected average rate increases of approximately 4%. Our charged rates include the effects of filed rates, surcharges and discounts. Approximately \$4.6 million and \$10.7 million of the written premium decrease for the 2012 three- and nine-month periods, respectively, was associated with two-year term policies. Gross premiums written associated with these policies were \$3.5 million and \$11.1 million for the three and nine months ended September 30, 2012, respectively, as compared to \$8.1 million and \$20.7 million for the same respective periods in 2011. We offer two-year term policies



(as opposed to a one-year term) to our physician insureds in one selected jurisdiction. The premium associated with both years is included in written premium in the period the policy is written.

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New physician business written in 2012 approximated \$3 million and \$7 million for the three- and nine-month periods, respectively.

**Non-physician Premiums**

Non-physician healthcare providers are primarily dentists, chiropractors and allied health professionals. Premium volume for these coverages declined in 2012 with the decrease primarily attributable to allied health coverages. Hospital and facility premiums decreased for the 2012 three-month period due to volume reductions in premiums written but increased for the 2012 nine-month period primarily due to new business in the first and second quarters. Non-physician "other" premiums are primarily legal professional liability premiums. Changes in premium volume for these coverages for the 2012 three- and nine-month periods are principally related to legal professional liability premiums.

Non-continuing premiums consist of premiums derived from optometry coverages discontinued in early 2012 and certain miscellaneous liability coverages which were discontinued in 2010 but that continued to produce small amounts of written premium in 2011 and 2012.

**Tail Coverage Premiums**

We offer extended reporting endorsement or "tail" coverage to insureds that are discontinuing their claims-made coverage with us, and we also periodically offer "tail" coverage through custom policies. The amount of tail coverage premium written can vary widely from period to period. A large portion of the increase in tail premium for the 2012 nine-month period was attributable to a single custom policy issued to a hospital that terminated its self insurance arrangement.

**Ceded Premiums Written**

Ceded premiums written compared as follows:

| (\$ in thousands)   | Three Months Ended September 30 |         |            | Nine Months Ended September 30 |          |            |
|---|---------------------------------|---------|------------|--------------------------------|----------|------------|
|   | 2012                            | 2011    | Change     | 2012                           | 2011     | Change     |
| Primary reinsurance arrangements                          | \$4,800                         | \$6,033 | \$(1,233 ) | \$16,907                       | \$18,600 | \$(1,693 ) |
| Reduction in premiums owed under reinsurance arrangements | —                               | —       | —          | (2,850 )                       | —        | (2,850 )   |
| Ascension Certitude program                               | 1,530                           | 1,063   | 467        | 6,683                          | 4,802    | 1,881      |
| Commutation   | —                               | —       | —          | —                              | (5,634 ) | 5,634      |
| Other premiums ceded                                      | 2,408                           | 2,786   | (378 )     | 10,807                         | 11,335   | (528 )     |
| Total ceded premiums written                              | \$8,738                         | \$9,882 | \$(1,144 ) | \$31,547                       | \$29,103 | \$2,444    |

Ceded premiums represent the amounts owed to our reinsurers for their assumption of a portion of our losses. The ultimate amount owed under certain of our reinsurance arrangements is variable and is determined by the loss experience of the business ceded, subject to minimums and maximums. Many years may elapse before all losses recoverable under a reinsurance arrangement are known. In the intervening periods, amounts owed are estimated.

Premiums ceded for the current period includes both our estimate of premiums owed under reinsurance arrangements of the current period and changes to our previous estimate of premiums owed under reinsurance arrangements of prior periods. During the second quarter of 2012, we reduced our estimate of premiums owed under reinsurance arrangements for prior years by \$2.9 million.

We reinsure most of our MPL coverages under a single reinsurance agreement that is renewed annually (referred to as our primary reinsurance arrangements). Professional liability offered to dentists, allied health professionals, certain smaller facilities as well as higher limit MPL coverages are reinsured under separately negotiated contracts. Amounts due to reinsurers under these separate contracts are identified in the preceding table as "Other premiums ceded."

We share the risk of loss for policies written or renewed under the Ascension Health (Ascension) Certitude program with an Ascension affiliate under a quota share arrangement. Growth in the program increased ceded premium in 2012 as compared to 2011. The increase is more pronounced in the year-to-date period as there was only a nominal amount of Ascension premium written prior to the second quarter of 2011.

During the second quarter of 2011, we commuted (terminated) certain of our reinsurance arrangements with Colisee Re (formerly AXA Reassurance S.A.) in return for approximately \$4.3 million in cash. The commutation reduced Ceded Premium, on both a written and an earned basis, by \$5.6 million and reduced Reinsurance Recoveries by approximately \$4.0 million.

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## Ceded Premiums Ratio

The principal components of the change in our ceded premiums ratio (ceded premiums written as a percentage of gross premiums written) are shown in the following table:

|   | Three Months Ended September 30 |       |          | Nine Months Ended September 30 |         |          |
|---|---------------------------------|-------|----------|--------------------------------|---------|----------|
|   | 2012                            | 2011  | Change   | 2012                           | 2011    | Change   |
| Ceded premiums ratio, excluding other listed factors      | 4.7                             | % 5.1 | % (0.4 ) | 6.6                            | % 6.7   | % (0.1 ) |
| Effect on ceded premiums ratio from:                      |                                 |       |          |                                |         |          |
| Reduction in premiums owed under reinsurance arrangements | —                               | —     | —        | (0.7 %)                        | —       | (0.7 %)  |
| Ascension Certitude program                               | 0.9                             | % 0.6 | % 0.3    | 1.4                            | % 1.1   | % 0.3    |
| Commutation   | —                               | —     | —        | —                              | (1.3 %) | 1.3 %    |
| Ceded premiums ratio, as reported                         | 5.6                             | % 5.7 | % (0.1 ) | 7.3                            | % 6.5   | % 0.8    |

## Net Premiums Earned

Net premiums earned were as follows:

| (\$ in thousands)   | Three Months Ended September 30 |           |                    | Nine Months Ended September 30 |           |                    |
|---------------------|---------------------------------|-----------|--------------------|--------------------------------|-----------|--------------------|
|                     | 2012                            | 2011      | Change             | 2012                           | 2011      | Change             |
| Premiums earned     | \$137,050                       | \$145,844 | \$(8,794 ) (6.0 %) | \$423,065                      | \$429,627 | \$(6,562 ) (1.5 %) |
| Premiums ceded      | (9,925 )                        | (11,217 ) | 1,292 (11.5 %)     | (28,015 )                      | (25,861 ) | (2,154 ) 8.3 %     |
| Net premiums earned | \$127,125                       | \$134,627 | \$(7,502 ) (5.6 %) | \$395,050                      | \$403,766 | \$(8,716 ) (2.2 %) |

Net premiums earned consist of premiums earned less the portion of earned premiums that we cede to our reinsurers for their assumption of a portion of our losses. Because premiums are generally earned pro rata over the entire policy period, fluctuations in premiums earned tend to lag those of premiums written. Generally, our policies carry a term of one year, but as discussed above, we renew certain policies with a two-year term. Tail coverage premiums are generally 100% earned in the period written because the policies insure only incidents that occurred in prior periods and are not cancellable. Additionally, ceded premium changes due to commutations or changes to estimates of premiums owed under reinsurance arrangements are fully earned in the period of change.

Premiums earned were lower for both the three- and the nine-month periods of 2012, as compared to 2011, principally due to the pro-rata effect of lower non-tail physician premiums written during the preceding twelve months, offset by higher tail premiums written and earned in 2012. Components of the change in premiums ceded for the 2012 three- and nine-month periods are detailed in the following table:

| (\$ in thousands)  | Ceded Premiums Earned Increase (Decrease) 2012 versus 2011 |                                |
|--|--|--------------------------------|
|  | Three Months Ended September 30                            | Nine Months Ended September 30 |
| Reduction in premiums owed under reinsurance arrangements* | \$—  | \$(2,850 )                     |
| Ascension Certitude program*                               | 529  | 2,533                          |
| Commutation*   | —  | 5,634                          |
| All other factors  | (1,821 )   | (3,163 )                       |
| Net increase (decrease)                                    | \$(1,292 )   | \$2,154                        |

\* See discussions under “Ceded Premiums Written” for further information.

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## Net Investment Income, Equity in Earnings (Loss) of Unconsolidated Subsidiaries, Net Realized Investment Gains (Losses)

## Net Investment Income

Net investment income is primarily derived from the income earned by our fixed maturity securities and also includes income from our short-term and cash equivalent investments, dividend income from equity securities, earnings from other investments and increases in the cash surrender value of business owned life insurance contracts. Investment fees and expenses are deducted from investment income.

Net investment income by investment category was as follows:

| (\$ in thousands)             | Three Months Ended September 30 |          |                    | Nine Months Ended September 30 |           |                    |
|-------------------------------|---------------------------------|----------|--------------------|--------------------------------|-----------|--------------------|
|                               | 2012                            | 2011     | Change             | 2012                           | 2011      | Change             |
| Fixed maturities              | \$32,747                        | \$33,939 | \$(1,192 ) (3.5 %) | \$100,110                      | \$106,573 | \$(6,463 ) (6.1 %) |
| Equities                      | 1,907                           | 569      | 1,338 >100%        | 4,556                          | 985       | 3,571 >100%        |
| Short-term investments        | 51                              | 20       | 31 >100%           | 108                            | 93        | 15 16.1 %          |
| Other invested assets         | 39                              | 573      | (534 ) (93.2 %)    | 480                            | 2,137     | (1,657 ) (77.5 %)  |
| Business owned life insurance | 653                             | 635      | 18 2.8 %           | 1,571                          | 1,571     | — — %              |
| Investment expenses           | (1,487 )                        | (1,620 ) | 133 (8.2 %)        | (4,913 )                       | (4,786 )  | (127 ) 2.7 %       |
| Net investment income         | \$33,910                        | \$34,116 | \$(206 ) (0.6 %)   | \$101,912                      | \$106,573 | \$(4,661 ) (4.4 %) |

## Fixed Maturities

As compared to 2011, earnings from fixed maturity investments declined for both the three- and nine-month periods of 2012. Our average investment in fixed maturities decreased by approximately 4% and 2% for the 2012 three- and nine-month periods, respectively, principally because we reallocated funds to equity securities in order to improve overall investment performance. Yields for our fixed maturity portfolio were generally lower in 2012 because as securities have matured, paid down or been sold, we have reinvested at lower rates in order to maintain the asset quality and duration of our portfolio. Yields for 2012 also reflect lower income from Treasury Inflation-Protected Securities of \$0.7 million and \$1.6 million for the three- and nine-month periods, respectively. We have recently acquired some higher yielding fixed securities which mitigated other yield declines stabilizing the yield for the three-month period. Average yields for our fixed maturity securities during the three and nine months ended September 30, 2012 and 2011 were as follows:

|                                     | Three Months Ended September 30 |      | Nine Months Ended September 30 |      |
|-------------------------------------|---------------------------------|------|--------------------------------|------|
|                                     | 2012                            | 2011 | 2012                           | 2011 |
| Average income yield                | 3.9%                            | 3.9% | 3.9%                           | 4.1% |
| Average tax equivalent income yield | 4.5%                            | 4.4% | 4.5%                           | 4.6% |

## Equity in Earnings (Loss) of Unconsolidated Subsidiaries

Equity in earnings (loss) of unconsolidated subsidiaries is derived from our investment interests accounted for under the equity method. Results were as follows:

| (In thousands)   | Three Months Ended September 30 |            |         | Nine Months Ended September 30 |            |         |
|--|---------------------------------|------------|---------|--------------------------------|------------|---------|
|  | 2012                            | 2011       | Change  | 2012                           | 2011       | Change  |
| Investment LPs   | \$419                           | \$(297 )   | \$716   | \$1,189                        | \$(281 )   | \$1,470 |
| Business LLC interest                                    | —                               | (456 )     | 456     | (728 )                         | (1,866 )   | 1,138   |
| Tax credit partnerships                                  | (208 )                          | (1,511 )   | 1,303   | (4,543 )                       | (3,897 )   | (646 )  |
| Equity in earnings (loss) of unconsolidated subsidiaries | \$211                           | \$(2,264 ) | \$2,475 | \$(4,082 )                     | \$(6,044 ) | \$1,962 |

We hold interests in certain LPs that generate earnings from trading portfolios. The performance of the LPs is affected by the volatility of equity and credit markets.

Our business LLC interest is a non-controlling interest in an entity that began active business in 2011. We recognize quarterly our allocable portion of the operating results reported by the LLC. The entity was slower to produce positive operating returns than initially anticipated and losses recognized in 2012 fully eroded our initial investment.



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Our tax credit investments are designed to generate investment returns by providing tax benefits to fund investors in the form of project operating losses and tax credits. Our tax credit partnerships reduced our tax expenses by approximately \$2.5 million and \$7.6 million during the three and nine months ended September 30, 2012, respectively, while we recognized \$0.2 million and \$4.5 million of pre-tax amortization (\$0.1 million and \$3.0 million after tax) during the same respective periods on these investments noted in the table above. Pre-tax amortization is an estimate and is periodically re-estimated upon receipt of the investment partnerships' audited financial statements. The decline in pre-tax amortization recognized during the third quarter reflects the most current re-estimation.

**Non-GAAP Financial Measure – Tax Equivalent Investment Result**

We believe that to fully understand our investment returns it is important to consider the current tax benefits associated with certain investments; therefore, we impute a pro forma tax-equivalent investment result by adjusting the current tax benefit into the amount of investment income a taxable investment would need to produce to fairly compare to an investment with preferential tax treatment. We believe this better reflects the economics of our decision to invest in certain asset classes that are either taxed at lower rates and/or result in reductions to our current federal income tax expense.

| (In thousands)   | Three Months Ended<br>September 30 |          | Nine Months Ended<br>September 30 |           |
|--|------------------------------------|----------|-----------------------------------|-----------|
|  | 2012                               | 2011     | 2012                              | 2011      |
| Net investment income, as reported for GAAP  | \$33,910                           | \$34,116 | \$101,912                         | \$106,573 |
| Taxable equivalent adjustments, calculated using the 35% federal statutory tax rate: |                                    |          |                                   |           |
| State and municipal bonds  | 4,517                              | 4,658    | 13,807                            | 14,500    |
| BOLI   | 352                                | 342      | 846                               | 846       |
| Dividends received deduction   | 435                                | 182      | 916                               | 316       |
| Pro forma tax-equivalent net investment income                                       | 39,214                             | 39,298   | 117,481                           | 122,235   |
| Equity in earnings (loss) of unconsolidated subsidiaries, as reported for GAAP       | 211                                | (2,264)  | (4,082)                           | (6,044)   |
| Taxable equivalent adjustment, calculated using the 35% federal statutory tax rate:  |                                    |          |                                   |           |
| Tax credit partnerships  | 3,889                              | 1,777    | 11,750                            | 6,637     |
| Pro forma tax-equivalent equity in earnings (loss) of unconsolidated subsidiaries    | 4,100                              | (487)    | 7,668                             | 593       |
| Pro forma tax-equivalent investment results  | \$43,314                           | \$38,811 | \$125,149                         | \$122,828 |

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## Net Realized Investment Gains (Losses)

The following table provides detailed information regarding our net realized investment gains (losses).

| (In thousands)   | Three Months Ended |              | Nine Months Ended |             |
|--|--------------------|--------------|-------------------|-------------|
|  | September 30       |              | September 30      |             |
|  | 2012               | 2011         | 2012              | 2011        |
| Other-than-temporary impairment losses, total:                             |                    |              |                   |             |
| Residential mortgage-backed securities                                     | \$ (94 )           | \$ (13 )     | \$ (557 )         | \$ (782 )   |
| Corporate debt   | (48 )              | —            | (878 )            | —           |
| Other investments  | —                  | (1,376 )     | (131 )            | (3,509 )    |
| Portion recognized in (reclassified from) Other Comprehensive Income:      |                    |              |                   |             |
| Residential mortgage-backed securities                                     | —                  | (142 )       | (201 )            | (823 )      |
| Net impairment losses recognized in earnings                               | (142 )             | (1,531 )     | (1,767 )          | (5,114 )    |
| Gross realized gains, available-for-sale securities                        | 4,269              | 1,441        | 10,418            | 11,733      |
| Gross realized (losses), available-for-sale securities                     | (452 )             | (296 )       | (635 )            | (1,653 )    |
| Net realized gains (losses), short-term                                    | 6                  | —            | 6                 | —           |
| Net realized gains (losses), trading securities                            | 933                | (357 )       | 1,660             | 2,558       |
| Change in unrealized holding gains (losses), trading securities            | 7,874              | (11,702 )    | 12,779            | (13,043 )   |
| Decrease (increase) in the fair value of liabilities carried at fair value | (401 )             | 473          | (1,245 )          | (129 )      |
| Other  | 1,132              | —            | 1,132             | —           |
| Net realized investment gains (losses)                                     | \$ 13,219          | \$ (11,972 ) | \$ 22,348         | \$ (5,648 ) |

All impairments of debt securities recognized during the three- and nine-month periods of 2012 were credit-related.

We recognized impairments of \$0.1 million during the first quarter of 2012 and \$1.4 million and \$3.5 million for the 2011 three- and nine-month periods, respectively, related to an interest in an LLC classified as a part of Other investments which we accounted for using the cost method. The LLC announced in 2011 that it planned to convert to a publicly traded investment fund and we impaired the investment to the NAV reported by the fund. The conversion occurred during the second quarter of 2012.

We substantially increased the size of our trading portfolio over the previous year. Unrealized trading portfolio gains reflect higher average balances in our portfolio and an overall improvement in stock market yields.

Gains (losses) attributable to change in the fair value of liabilities were entirely attributable to our 2019 Note Payable and the related interest rate swap. We repaid both the Note and the Swap in July 2012. For more information, see Note 2 and Note 8 of the Notes to Condensed Consolidated Financial Statements.

## Other Income

The principal components of Other Income are typically commission and fee income from our agency operations, other fee revenues, rental income and other miscellaneous revenues. These revenues are not a principal source of income and often vary among periods. During the third quarter of 2011, we recognized other income of \$4.9 million related to a confidential settlement of litigation with a service provider.

## Losses and Loss Adjustment Expenses

The determination of calendar year losses involves the actuarial evaluation of incurred losses for the current accident year and the actuarial re-evaluation of incurred losses for prior accident years, including an evaluation of the reserve amounts required for losses in excess of policy limits.

Accident year refers to the accounting period in which the insured event becomes a liability of the insurer. For claims-made policies, which represent over 90% of the Company's business, the insured event generally becomes a liability when the event is first reported to the insurer. For occurrence policies the insured event becomes a liability when the event takes place. We believe that measuring losses on an accident year basis is the best measure of the underlying profitability of the premiums earned in that period, since it associates policy premiums earned with the estimate of the losses incurred related to those policy premiums.





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The following table summarizes calendar year net losses and net loss ratios for the three and nine months ended September 30, 2012 and 2011 by separating losses between the current accident year and all prior accident years.

| (\$ in millions)      | Net Losses                      |         |         |                                |         |          |
|-----------------------|---------------------------------|---------|---------|--------------------------------|---------|----------|
|                       | Three Months Ended September 30 |         |         | Nine Months Ended September 30 |         |          |
|                       | 2012                            | 2011    | Change  | 2012                           | 2011    | Change   |
| Current accident year | \$106.6                         | \$115.3 | \$(8.7) | \$332.4                        | \$340.3 | \$(7.9)  |
| Prior accident years  | (50.0)                          | (52.1)  | 2.1     | (157.5)                        | (142.3) | (15.2)   |
| Calendar year         | \$56.6                          | \$63.2  | \$(6.6) | \$174.9                        | \$198.0 | \$(23.1) |

  

|                       | Net Loss Ratios*                |          |          |                                |          |          |
|-----------------------|---------------------------------|----------|----------|--------------------------------|----------|----------|
|                       | Three Months Ended September 30 |          |          | Nine Months Ended September 30 |          |          |
|                       | 2012                            | 2011     | Change   | 2012                           | 2011     | Change   |
| Current accident year | 83.9                            | % 85.6   | % (1.7)  | 84.1                           | % 84.3   | % (0.2)  |
| Prior accident years  | (39.4)                          | %) (38.7 | %) (0.7) | (39.8)                         | %) (35.3 | %) (4.5) |
| Calendar year         | 44.5                            | % 46.9   | % (2.4)  | 44.3                           | % 49.0   | % (4.7)  |

\* Net losses as specified divided by net premiums earned.

Our current accident year net loss ratios for the three and nine months ended September 30, 2012 and 2011 compare as follows:

|  | Three Months Ended September 30 |        |         | Nine Months Ended September 30 |        |         |
|--|---------------------------------|--------|---------|--------------------------------|--------|---------|
|  | 2012                            | 2011   | Change  | 2012                           | 2011   | Change  |
| Current accident year net loss ratio, excluding other listed factors | 82.3                            | % 83.4 | % (1.1) | 82.9                           | % 82.9 | % —     |
| Effect attributable to:  |                                 |        |         |                                |        |         |
| Reduction in premiums owed under reinsurance arrangements            | —                               | —      | —       | (0.7                           | %) —   | (0.7)   |
| Commutation  | —                               | —      | —       | —                              | (0.2   | %) 0.2  |
| Tail coverages   | 1.6                             | % 2.2  | % (0.6) | 1.9                            | % 1.6  | % 0.3   |
| Current accident year net loss ratio, as reported                    | 83.9                            | % 85.6 | % (1.7) | 84.1                           | % 84.3 | % (0.2) |

Exclusive of the factors separately listed in the preceding table, the reduction in our current accident year net loss ratio for the 2012 three-month period was primarily due to changes in the mix of insured risks. Additionally, tail coverages decreased during the third quarter which lowered the ratio for the 2012 three-month period as we expect higher losses for tail coverages than for our other professional liability coverages. During the second quarter of 2012, we reduced our estimate of premiums owed under reinsurance arrangements (see “Net Premiums Earned”) which lowered our current accident year net loss ratio for the nine-month period, as the reduction increased net premiums earned but had no effect on net losses incurred. A commutation recorded in 2011 (see “Net Premiums Earned”) decreased our 2011 nine-month period current accident year net loss ratio; no commutation was recorded in 2012. Tail coverages increased the ratio for the 2012 nine-month period primarily due to increased premiums in the first quarter of 2012. During the three- and nine-month periods of both 2012 and 2011, we recognized favorable loss development, on a net basis, related to reserves previously established for prior accident years within our retained layers of coverage (\$1 million and below). We recognized favorable loss development of \$50.0 million and \$157.5 million for the 2012 three- and nine-month periods, respectively, primarily related to accident years 2004 through 2010. We recognized favorable loss development of \$52.1 million and \$142.3 million for the same respective periods of 2011, primarily related to accident years 2004 through 2009. A detailed discussion of factors influencing our recognition of loss development recognized is included in the Critical Accounting Estimates section of Item 2, under the caption “Reserve for Losses and Loss Adjustment Expenses.”

Assumptions used in establishing our reserve are regularly reviewed and updated by management as new data becomes available. Any adjustments necessary are reflected in the current operations. Due to the size of our reserve, even a small percentage adjustment to the assumptions can have a material effect on our results of operations for the

period in which the change is made, as was the case in 2011 and has been thus far in 2012.

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## Underwriting, Policy Acquisition and Operating Expenses

The table below provides a comparison of 2012 and 2011 underwriting, policy acquisition and operating expenses for the three and nine months ended September 30:

| (\$ in thousands)            | Three Months Ended September 30 |          |                    | Nine Months Ended September 30 |           |                  |
|------------------------------|---------------------------------|----------|--------------------|--------------------------------|-----------|------------------|
|                              | 2012                            | 2011     | Change             | 2012                           | 2011      | Change           |
| Insurance operation expenses | \$33,070                        | \$34,744 | \$(1,674 ) (4.8 %) | \$102,060                      | \$101,828 | \$232 0.2 %      |
| Agency expenses              | 210                             | 210      | — —                | 1,023                          | 1,706     | (683 ) (40.0 %)  |
|                              | \$33,280                        | \$34,954 | \$(1,674 ) (4.8 %) | \$103,083                      | \$103,534 | \$(451 ) (0.4 %) |

## Insurance Operation Expenses

Insurance operation expenses in 2012 as compared to the same periods in 2011 primarily reflects the net effect of the following:

We incurred transaction expenses related to our proposed merger with Medmarc of approximately \$0.6 million and \$0.7 million for the 2012 three- and nine-month periods, respectively. We anticipate additional Medmarc related expenses of approximately \$1.3 million, most of which will be incurred in the first quarter of 2013.

As discussed in Notes 1 and 5 of the Notes to Condensed Consolidated Financial Statements, we adopted, on a prospective basis, new FASB guidance related to the deferral of policy acquisition costs. The new guidance affects the timing, but not the amount of acquisition costs ultimately expensed, as the decrease in the expense deferral reduces amortization of policy acquisition costs by the same amount, recognized over the term of the associated successful policies. Our 2012 insurance operation expenses were increased by policy acquisition expenses that would have been deferred to later periods under previous accounting guidance of approximately \$1.0 million and \$3.2 million for the 2012 three- and nine-month periods, respectively. Amortization of policy acquisition costs for the 2012 three- and nine-month periods was lower by \$0.7 million and \$1.3 million, respectively, than would have been recognized under previous guidance.

Exclusive of the effect of the new FASB guidance, amortization of deferred policy acquisition costs decreased \$0.8 million for the 2012 three-month period and increased \$0.3 million for the 2012 nine-month period. Lower net premiums earned in 2012 reduced amortization for both the three- and the nine-month periods. The effect of lower earned premiums was offset for the three-month period and more than offset for the nine-month period by increases of \$0.2 million and \$1.5 million, respectively, related to the acquisition of APS in November 2010. Due to the application of GAAP purchase accounting rules, no asset for deferred policy acquisition costs was recognized as a part of the purchase price allocation of APS; consequently, amortization of deferred policy acquisition costs in 2011 was reduced.

Costs associated with the operations acquired from APS, primarily compensation costs and professional fees, were approximately \$1.4 million and \$3.7 million lower in the 2012 three- and nine-month periods, respectively, as compared to the same respective periods of 2011.

Compensation costs for the 2012 three-month period were comparable to the 2011 three-month period. For the 2012 nine-month period, higher stock compensation and bonus costs as well as additional costs incurred related to the enhancement of our customer service capabilities increased our expenses by approximately \$3.5 million. We relocated a number of positions in order to create a centralized customer service center.

Relocation benefits were provided to affected employees as well as termination benefits for employees unable to relocate.

Various other operating costs were collectively lower by approximately \$0.4 million and \$2.5 million for the 2012 three- and nine-month periods, respectively.

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## Underwriting Expense Ratio (the Expense Ratio)

|                            | Underwriting Expense Ratio *    |        |        |                                |        |        |
|----------------------------|---------------------------------|--------|--------|--------------------------------|--------|--------|
|                            | Three Months Ended September 30 |        |        | Nine Months Ended September 30 |        |        |
|                            | 2012                            | 2011   | Change | 2012                           | 2011   | Change |
| Underwriting expense ratio | 26.0                            | % 25.8 | % 0.2  | 25.8                           | % 25.2 | % 0.6  |

\* Our expense ratio computations exclude agency expenses as discussed below.

Our underwriting expense ratio for the 2012 three- and nine-month periods reflected increases of 1.4 percentage points and 0.6 percentage points, respectively, attributable to the 2012 decline in our net premiums earned, the effect of which was substantially offset by lower expenses during the 2012 three-month period.

## Agency expenses

We maintain limited agency operations that both generate premium revenues for our insurance subsidiaries and earn external commission and service fee revenues. Agency operations that are associated with the generation of premium revenues by our insurance subsidiaries are included in insurance operation expenses in the above table. Expenses of agency operations that are directly associated with external commission and service fee revenues are included in agency expenses in the above table. Agency expenses for 2011 included non-recurring expenses associated with the dissolution of certain agency operations.

## Interest Expense

Interest expense declined during the three and nine months ended September 30, 2012 as compared to the same respective periods in 2011, primarily because we repaid debt during the third quarter of 2012, as discussed in Liquidity and Capital Resources and Financial Condition. Interest expense by debt obligation is provided in the following table:

| (In thousands)                                   | Three Months Ended<br>September 30 |       |          | Nine Months Ended<br>September 30 |         |          |
|--|------------------------------------|-------|----------|-----------------------------------|---------|----------|
|  | 2012                               | 2011  | Change   | 2012                              | 2011    | Change   |
| Trust Preferred Securities due 2034              | \$129                              | \$240 | \$(111 ) | \$635                             | \$722   | \$(87 )  |
| Surplus Notes due May 2034                       | 78                                 | 127   | (49 )    | 342                               | 379     | (37 )    |
| 2019 Note Payable                                | 2                                  | 291   | (289 )   | 571                               | 867     | (296 )   |
| Revolving credit agreement fees and amortization | 141                                | 152   | (11 )    | 451                               | 287     | 164      |
| Other  | —                                  | 122   | (122 )   | 3                                 | 390     | (387 )   |
|  | \$350                              | \$932 | \$(582 ) | \$2,002                           | \$2,645 | \$(643 ) |

## Taxes

Factors affecting our effective tax rate include the following:

|                    | Three Months Ended<br>September 30 |         |    | Nine Months Ended<br>September 30 |         |    |
|--------------------|------------------------------------|---------|----|-----------------------------------|---------|----|
|                    | 2012                               | 2011    |    | 2012                              | 2011    |    |
| Statutory rate     | 35.0                               | % 35.0  | %  | 35.0                              | % 35.0  | %  |
| Tax-exempt income  | (3.8                               | %) (4.8 | %) | (4.9                              | %) (4.8 | %) |
| Tax credits        | (2.9                               | %) (1.8 | %) | (3.7                              | %) (2.1 | %) |
| Other              | (0.2                               | %) 2.1  | %  | 0.5                               | % 0.9   | %  |
| Effective tax rate | 28.1                               | % 30.5  | %  | 26.9                              | % 29.0  | %  |

Our effective tax rate decreased in 2012 as compared to 2011, primarily due to an increase in the expected tax benefit from tax credits transferred to us by our tax credit partnership investments, and, for the three-month period, the effect of a re-estimation of permanent tax differences in third quarter 2011. We recognized expected tax benefits of approximately \$2.5 million and \$7.6 million for the three and nine months ended September 30, 2012, respectively, related to the credits, compared to expected tax benefits of \$1.2 million and \$4.3 million for the 2011 three- and nine-month periods.



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## ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

We believe that we are principally exposed to three types of market risk related to our investment operations. These risks are interest rate risk, credit risk and equity price risk.

## Interest Rate Risk

Our fixed maturities portfolio is exposed to interest rate risk. Fluctuations in interest rates have a direct impact on the market valuation of these securities. As interest rates rise, market values of fixed income portfolios fall and vice versa. Certain of the securities are held in an unrealized loss position; we do not intend to sell and believe we will not be required to sell any of the debt securities held in an unrealized loss position before its anticipated recovery.

The following table summarizes estimated changes in the fair value of our available-for-sale fixed maturity securities for specific hypothetical changes in interest rates by asset class at September 30, 2012 and December 31, 2011. There are principally two factors that determine interest rates on a given security: market interest rates and credit spreads. As different asset classes can be affected in different ways by movements in those two factors, we have broken out our portfolio by asset class in the following table.

|  | Interest Rate Shift in Basis Points |         |         |         |         |
|--|-------------------------------------|---------|---------|---------|---------|
|  | September 30, 2012                  |         |         |         |         |
|  | (200)                               | (100)   | Current | 100     | 200     |
| Fair Value (in millions):                        |                                     |         |         |         |         |
| U.S. Treasury obligations                        | \$223                               | \$222   | \$219   | \$214   | \$209   |
| U.S. Government-sponsored enterprise obligations | 64                                  | 64      | 63      | 61      | 59      |
| State and municipal bonds                        | 1,267                               | 1,254   | 1,213   | 1,162   | 1,112   |
| Corporate debt                                   | 1,535                               | 1,525   | 1,477   | 1,416   | 1,358   |
| Asset-backed securities                          | 601                                 | 603     | 598     | 583     | 565     |
| All fixed maturity securities                    | \$3,690                             | \$3,668 | \$3,570 | \$3,436 | \$3,303 |
| Duration:  |                                     |         |         |         |         |
| U.S. Treasury obligations                        | 2.99                                | 2.96    | 2.90    | 2.83    | 2.75    |
| U.S. Government-sponsored enterprise obligations | 3.07                                | 3.06    | 2.92    | 2.86    | 2.85    |
| State and municipal bonds                        | 3.88                                | 4.04    | 4.19    | 4.30    | 4.39    |
| Corporate debt                                   | 4.25                                | 4.28    | 4.27    | 4.20    | 4.12    |
| Asset-backed securities                          | 2.01                                | 1.89    | 2.16    | 2.80    | 3.52    |
| All fixed maturity securities                    | 3.66                                | 3.70    | 3.78    | 3.89    | 4.00    |
|  |                                     |         |         |         |         |
|  | December 31, 2011                   |         |         |         |         |
| Fair Value (in millions):                        |                                     |         |         |         |         |
| U.S. Treasury obligations                        | \$303                               | \$301   | \$284   | \$277   | \$270   |
| U.S. Government-sponsored enterprise obligations | 70                                  | 70      | 68      | 65      | 63      |
| State and municipal bonds                        | 1,301                               | 1,279   | 1,228   | 1,172   | 1,117   |
| Corporate debt                                   | 1,429                               | 1,413   | 1,368   | 1,314   | 1,263   |
| Asset-backed securities                          | 735                                 | 733     | 718     | 695     | 669     |
| All fixed maturity securities                    | \$3,838                             | \$3,796 | \$3,666 | \$3,523 | \$3,382 |
| Duration:  |                                     |         |         |         |         |
| U.S. Treasury obligations                        | 3.42                                | 3.39    | 3.33    | 4.00    | 3.95    |
| U.S. Government-sponsored enterprise obligations | 3.25                                | 3.26    | 3.43    | 3.62    | 3.69    |
| State and municipal bonds                        | 4.22                                | 4.44    | 4.58    | 4.69    | 4.76    |

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|                               |      |      |      |      |      |
|-------------------------------|------|------|------|------|------|
| Corporate debt                | 4.07 | 4.05 | 4.00 | 3.91 | 3.83 |
| Asset-backed securities       | 1.01 | 1.54 | 2.87 | 3.48 | 3.83 |
| All fixed maturity securities | 3.47 | 3.63 | 3.91 | 4.09 | 4.14 |

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Computations of prospective effects of hypothetical interest rate changes are based on numerous assumptions, including the maintenance of the existing level and composition of fixed income security assets, and should not be relied on as indicative of future results.

Certain shortcomings are inherent in the method of analysis presented in the computation of the fair value of fixed rate instruments. Actual values may differ from those projections presented should market conditions vary from assumptions used in the calculation of the fair value of individual securities, including non-parallel shifts in the term structure of interest rates and changing individual issuer credit spreads.

ProAssurance's cash and short-term investment portfolio at September 30, 2012 was on a cost basis which approximates its fair value. This portfolio lacks significant interest rate sensitivity due to its short duration.

**Credit Risk**

We have exposure to credit risk primarily as a holder of fixed income securities. We control this exposure by emphasizing investment grade credit quality in the fixed income securities we purchase.

As of September 30, 2012, 93% of our fixed maturity securities were rated investment grade as determined by Nationally Recognized Statistical Rating Organizations (NRSROs), such as A.M. Best, Fitch, Moody's and Standard & Poor's. We believe that this concentration in investment grade securities reduces our exposure to credit risk on our fixed income investments to an acceptable level. However, investment grade securities, in spite of their rating, can rapidly deteriorate and result in significant losses. Ratings published by the NRSROs are one of the tools used to evaluate the credit worthiness of our securities. The ratings reflect the subjective opinion of the rating agencies as to the credit worthiness of the securities, and therefore, we may be subject to additional credit exposure should the rating prove to be unreliable.

We held \$1.2 billion of municipal bonds at September 30, 2012. We require the bonds that we purchase to meet our credit criteria on a stand-alone basis. As of September 30, 2012, on a stand-alone basis, our municipal bonds had a weighted average rating of AA.

We also have exposure to credit risk related to our receivables from reinsurers. Our receivables from reinsurers (on both paid and unpaid losses) approximated \$241 million at September 30, 2012 and \$252 million at December 31, 2011. We monitor the credit risk associated with our reinsurers using publicly available financial and rating agency data.

**Equity Price Risk**

At September 30, 2012 the fair value of our investment in common stocks was \$184 million. These securities are subject to equity price risk, which is defined as the potential for loss in fair value due to a decline in equity prices. The weighted average beta of this group of securities was 0.88. Beta measures the price sensitivity of an equity security or group of equity securities to a change in the broader equity market, in this case the S&P 500 Index. If the value of the S&P 500 Index increased by 10%, the fair value of these securities would be expected to increase by 9% to \$200 million. Conversely, a 10% decrease in the S&P 500 Index would imply a decrease of 9% in the fair value of these securities to \$168 million. The selected hypothetical changes of plus or minus 10% do not reflect what could be considered the best or worst case scenarios and are used for illustrative purposes only.

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## ITEM 4. CONTROLS AND PROCEDURES.

The Chief Executive Officer and Chief Financial Officer of the Company participated in management's evaluation of our disclosure controls and procedures (as defined in SEC Rule 13a-15(e)) as of September 30, 2012. ProAssurance's disclosure controls and procedures are designed to reasonably assure that information required to be disclosed by us in reports we file or submit under the Exchange Act is accumulated and communicated to our management as appropriate to allow timely decisions regarding disclosure and is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures are effective.

## Changes in Internal Control over Financial Reporting

There have been no significant changes in our internal controls over financial reporting that have materially affected, or are reasonably likely to materially affect, those controls during the quarter.

## PART II. OTHER INFORMATION

## ITEM 1. LEGAL PROCEEDINGS.

See Note 7 of the Notes to Condensed Consolidated Financial Statements.

## ITEM 1A. RISK FACTORS.

There are no changes to the "Risk Factors" in Part 1, Item 1A of the 2011 Form 10-K.

## ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS.

(a) Not applicable.

(b) Not applicable.

(c) Information required by Item 703 of Regulation S-K.

| Period                 | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Approximate Dollar Value of Shares that May Yet Be Purchased Under the Plans or Programs * |
|------------------------|----------------------------------|------------------------------|--|--|
| July 1 - 31, 2012      | —                                | \$—                          | —  | \$135,083,102  |
| August 1 - 31, 2012    | —                                | \$—                          | —  | \$135,083,102  |
| September 1 - 30, 2012 | —                                | \$—                          | —  | \$135,083,102  |
| Total                  | —                                | \$—                          | —  |  |

\* In November 2010, the ProAssurance Board of Directors authorized \$200 million for the repurchase of common shares or the retirement of outstanding debt. This is ProAssurance's only plan for the repurchase of common shares, and the plan has no expiration date.

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ITEM 6. EXHIBITS

|         |  |
|---------|--|
| 10.1    | Amendment No. 1 to Revolving Credit Agreement between ProAssurance and U.S. Bank National Association, Wells Fargo Bank, National Association, Branch Banking and Trust Company, First Tennessee Bank, N.A., and JP Morgan Chase Bank N.A. |
| 31.1    | Certification of Principal Executive Officer of ProAssurance as required under SEC rule 13a-14(a).   |
| 31.2    | Certification of Principal Financial and Accounting Officer of ProAssurance as required under SEC rule 13a-14(a).  |
| 32.1    | Certification of Principal Executive Officer of ProAssurance as required under SEC Rule 13a-14(b) and Section 1350 of Chapter 63 of Title 18 of the United States Code, as amended (18 U.S.C. 1350).                                       |
| 32.2    | Certification of Principal Financial and Accounting Officer of ProAssurance as required under SEC Rule 13a-14(b) and Section 1350 of Chapter 63 of Title 18 of the United States Code, as amended (18 U.S.C. 1350).                        |
| 101.INS | XBRL Instance Document   |
| 101.SCH | XBRL Taxonomy Extension Schema Document  |
| 101.CAL | XBRL Taxonomy Extension Calculation Linkbase Document  |
| 101.DEF | XBRL Taxonomy Extension Definition Linkbase Document   |
| 101.LAB | XBRL Taxonomy Extension Labels Linkbase Document   |
| 101.PRE | XBRL Taxonomy Extension Presentation Linkbase Document   |

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SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

PROASSURANCE CORPORATION

November 6, 2012

/s/ Edward L. Rand, Jr.

Edward L. Rand, Jr.

Chief Financial and Accounting Officer

(Duly authorized officer and principal financial and accounting officer)