

FEDERATED NATIONAL HOLDING CO  
Form 10-Q  
November 14, 2012

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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549  
FORM 10-Q

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 0-2500111

Federated National Holding Company  
(Exact name of registrant as specified in its charter)

Florida  
(State or Other Jurisdiction of Incorporation or  
Organization)

65-0248866  
(IRS Employer Identification Number)

14050 N.W. 14th Street, Suite 180, Sunrise, Florida 33323  
(Address of principal executive offices) (Zip Code)

954-581-9993  
(Registrant's telephone number, including area code)

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 electronically submitted and posted on its corporate website, 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

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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.

Large accelerated filer  Accelerated filer  Non-accelerated filer  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

Indicate the number of shares outstanding of each of the issuer’s classes of common stock, as of the latest practicable date.

Common Stock, \$.01 par value –7,955,186 outstanding as of November 7, 2012

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FEDERATED NATIONAL HOLDING COMPANY

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## PART I: FINANCIAL INFORMATION

## Item 1 Financial Statements

FEDERATED NATIONAL HOLDING COMPANY  
CONSOLIDATED BALANCE SHEETS  
(UNAUDITED)

|  | Period Ending         |                      |
|--|-----------------------|----------------------|
|  | September<br>30, 2012 | December 31,<br>2011 |
| (Dollars in Thousands)   |                       |                      |
| <b>ASSETS</b>  |                       |                      |
| Investments  |                       |                      |
| Debt maturities, available for sale, at fair value   | \$ 116,506            | \$ 104,311           |
| Debt maturities, held to maturity, at amortized cost   | 7,455                 | 7,128                |
| Equity securities, available for sale, at fair value   | 21,070                | 18,028               |
| <b>Total investments</b>   | <b>145,031</b>        | <b>129,467</b>       |
| Cash and short term investments  | 10,935                | 15,205               |
| Prepaid reinsurance premiums   | 5,386                 | 8,339                |
| Premiums receivable, net of allowance for credit losses of \$64 and \$73, respectively                                     | 8,136                 | 5,616                |
| Reinsurance recoverable, net   | 2,205                 | 2,087                |
| Deferred policy acquisition costs  | 8,484                 | 7,718                |
| Deferred income taxes, net   | 4,482                 | 8,612                |
| Income taxes receivable  | 70                    | -                    |
| Property, plant and equipment, net   | 777                   | 842                  |
| Other assets   | 1,679                 | 2,094                |
| <b>Total assets</b>  | <b>\$ 187,185</b>     | <b>\$ 179,980</b>    |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>  |                       |                      |
| Unpaid losses and LAE  | \$ 51,177             | \$ 59,983            |
| Unearned premiums  | 58,916                | 47,933               |
| Premiums deposits and customer credit balances   | 2,055                 | 2,804                |
| Bank overdraft   | 6,226                 | 7,930                |
| Income taxes payable   | -                     | 77                   |
| Accounts payable and accrued expenses  | 3,321                 | 3,109                |
| <b>Total liabilities</b>   | <b>121,695</b>        | <b>121,836</b>       |
| Shareholders' equity:  |                       |                      |
| Common stock, \$0.01 par value. Authorized 25,000,000 shares; issued and outstanding 7,951,218 and 7,946,384, respectively | 80                    | 79                   |
| Preferred stock, \$0.01 par value. Authorized 1,000,000 shares; none issued or outstanding                                 | -                     | -                    |
| Additional paid-in capital   | 51,172                | 50,940               |
| Accumulated other comprehensive income   |                       |                      |
| Unrealized net gains on investments, available for sale  | 4,746                 | 877                  |

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|  |            |            |
|--|------------|------------|
| Total accumulated other comprehensive income | 4,746      | 877        |
| Retained earnings                            | 9,492      | 6,248      |
| Total shareholders' equity                   | 65,490     | 58,144     |
| Total liabilities and shareholders' equity   | \$ 187,185 | \$ 179,980 |

SEE ACCOMPANYING NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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FEDERATED NATIONAL HOLDING COMPANY  
CONSOLIDATED STATEMENTS OF OPERATIONS  
(UNAUDITED)

|  | Three Months Ended September 30,<br>2012                         |           | Nine Months Ended September 30,<br>2012                          |           |
|--|--|-----------|--|-----------|
|  | 2011   |           | 2011   |           |
|  | (Dollars in Thousands except EPS and<br>share and dividend data) |           | (Dollars in Thousands except EPS and<br>share and dividend data) |           |
| Revenue:   |  |           |  |           |
| Gross premiums written   | \$ 25,338  | \$ 17,654 | \$ 89,683  | \$ 72,800 |
| Gross premiums ceded   | (35,733 )  | (29,657 ) | (49,318 )  | (44,672 ) |
| Net premiums written   | (10,395 )  | (12,003 ) | 40,365   | 28,128    |
| Increase in prepaid reinsurance premiums                         | 22,797   | 18,001    | 13,218   | 7,367     |
| Decrease (increase) in unearned premiums                         | 2,686  | 6,894     | (10,983 )  | 201       |
| Net change in prepaid reinsurance premiums and unearned premiums | 25,483   | 24,895    | 2,235  | 7,568     |
| Net premiums earned  | 15,088   | 12,892    | 42,600   | 35,696    |
| Commission income  | 400  | 253       | 1,101  | 858       |
| Finance revenue  | 122  | 175       | 363  | 411       |
| Managing general agent fees                                      | 435  | 288       | 1,529  | 1,201     |
| Net investment income  | 953  | 1,031     | 2,849  | 3,054     |
| Net realized investment gains (losses)                           | 145  | 713       | (83 )  | 1,052     |
| Regulatory assessments recovered                                 | -  | -         | -  | 109       |
| Other income   | 118  | 842       | 468  | 1,113     |
| Total revenue  | 17,261   | 16,194    | 48,827   | 43,494    |
| Expenses:  |  |           |  |           |
| Losses and LAE   | 8,049  | 7,852     | 20,913   | 24,116    |
| Operating and underwriting expenses                              | 2,047  | 2,271     | 6,829  | 7,529     |
| Salaries and wages   | 2,079  | 1,973     | 6,285  | 6,062     |
| Policy acquisition costs - amortization                          | 3,983  | 3,556     | 9,712  | 9,534     |
| Total expenses   | 16,158   | 15,652    | 43,739   | 47,241    |
| Income (loss) before provision for income tax expense (benefit)  | 1,103  | 542       | 5,088  | (3,747 )  |

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|  |           |           |           |             |
|--|-----------|-----------|-----------|-------------|
| Provision for income tax expense (benefit)                     | 353       | 114       | 1,844     | (1,363 )    |
| Net income (loss)  | \$ 750    | \$ 428    | \$ 3,244  | \$ (2,384 ) |
| Net income (loss) per share - basic                            | \$ 0.09   | \$ 0.05   | \$ 0.40   | \$ (0.30 )  |
| Net income (loss) per share - diluted                          | \$ 0.09   | \$ 0.05   | \$ 0.40   | \$ (0.30 )  |
| Weighted average number of common shares outstanding - basic   | 7,948,716 | 7,946,384 | 7,947,459 | 7,946,384   |
| Weighted average number of common shares outstanding - diluted | 8,042,356 | 7,946,384 | 8,008,470 | 7,946,384   |
| Dividends paid per share                                       | \$ -      | \$ -      | \$ -      | \$ -        |

SEE ACCOMPANYING NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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FEDERATED NATIONAL HOLDING COMPANY  
 CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)  
 (UNAUDITED)

|   | Three Months Ended<br>September, |           | Nine Months Ended<br>September, |             |
|---|----------------------------------|-----------|---------------------------------|-------------|
|   | 2012                             | 2011      | 2012                            | 2011        |
|   | (Dollars in Thousands)           |           | (Dollars in Thousands)          |             |
|   | Pretax                           |           | Pretax                          |             |
| Net income (loss)   | \$ 750                           | \$ 428    | \$ 3,244                        | \$ (2,384 ) |
| Change in net unrealized gains (losses) on<br>investments available for sale          | 3,180                            | (1,353 )  | 6,203                           | (140 )      |
| Comprehensive income (loss) before tax  | 3,930                            | (925 )    | 9,447                           | (2,524 )    |
| Income tax (expense) benefit related to items of<br>other comprehensive income (loss) | (1,196 )                         | 509       | (2,334 )                        | 53          |
| Comprehensive income (loss)   | \$ 2,734                         | \$ (416 ) | \$ 7,113                        | \$ (2,471 ) |

SEE ACCOMPANYING NOTES TO CONSOLIDATED FINANCIAL STATEMENTS



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FEDERATED NATIONAL HOLDING COMPANY  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
(UNAUDITED)

|  | Nine Months Ended September<br>30, |             |
|--|------------------------------------|-------------|
|  | 2012                               | 2011        |
|  | (Dollars in Thousands)             |             |
| Cash flow from operating activities:   |                                    |             |
| Net income (loss)  | \$ 3,244                           | \$ (2,384 ) |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: |                                    |             |
| Amortization of investment premium discount, net   | 1,035                              | 932         |
| Depreciation and amortization of property plant and equipment, net                       | 146                                | 132         |
| Net realized investment losses (gains)   | 83                                 | (1,052 )    |
| Non-cash impairment recognition  | 44                                 | -           |
| (Recovery) provision for credit losses, net  | (12 )                              | 17          |
| Provision (recovery) for uncollectible premiums receivable                               | 9                                  | (19 )       |
| Non-cash compensation  | 140                                | 149         |
| Changes in operating assets and liabilities:   |                                    |             |
| Premiums receivable  | (2,530 )                           | 476         |
| Prepaid reinsurance premiums   | 2,952                              | 6,387       |
| Reinsurance recoverable, net   | (118 )                             | 4,317       |
| Income taxes recoverable   | (70 )                              | 113         |
| Deferred income tax expense, net of other comprehensive income                           | 1,796                              | (1,500 )    |
| Policy acquisition costs, net of amortization  | (766 )                             | 187         |
| Other assets   | 427                                | (112 )      |
| Unpaid losses and LAE  | (8,805 )                           | (4,370 )    |
| Unearned premiums  | 10,983                             | (201 )      |
| Premium deposits and customer credit balances  | (749 )                             | 238         |
| Funds held under reinsurance treaties  | -                                  | 2,590       |
| Income taxes payable   | (77 )                              | -           |
| Bank overdraft   | (1,702 )                           | 130         |
| Accounts payable and accrued expenses  | 211                                | (1,043 )    |
| Net cash provided by operating activities  | 6,241                              | 4,987       |
| Cash flow used by investing activities:  |                                    |             |
| Proceeds from sale of investment securities  | 60,711                             | 70,582      |
| Purchases of investment securities available for sale                                    | (71,234 )                          | (76,739 )   |
| Purchases of property and equipment  | (81 )                              | 7           |
| Net cash used by investing activities  | (10,604 )                          | (6,150 )    |
| Cash flow provided by financing activities:  |                                    |             |
| Exercised stock options  | 16                                 | -           |
| Tax benefit related to non-cash compensation   | 77                                 | 68          |
| Net cash provided by financing activities  | 93                                 | 68          |
| Net decrease in cash and short term investments  | (4,270 )                           | (1,095 )    |
| Cash and short term investments at beginning of period                                   | 15,205                             | 16,206      |
| Cash and short term investments at end of period   | \$ 10,935                          | \$ 15,111   |

SEE ACCOMPANYING NOTES TO CONSOLIDATED FINANCIAL STATEMENTS



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FEDERATED NATIONAL HOLDING COMPANY  
 CONSOLIDATED STATEMENTS OF CASH FLOWS  
 (UNAUDITED)

|   | Nine Months Ended September<br>30, |      |
|---|------------------------------------|------|
| (continued)                                       | 2012                               | 2011 |
|   | (Dollars in Thousands)             |      |
| Supplemental disclosure of cash flow information: |                                    |      |
| Cash paid during the period for:                  |                                    |      |
| Interest  | \$ -                               | \$ - |
| Income taxes                                      | \$ 165                             | \$ - |
| Non-cash investing and finance activities:        |                                    |      |
| Accrued dividends payable                         | \$ -                               | \$ - |

SEE ACCOMPANYING NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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Federated National Holding Company

Notes to Condensed Consolidated Financial Statements

(1) Organization and Business

In this Quarterly Report on Form 10-Q, “FNHC” and the terms “Company”, “we”, “us” and “our” refer to Federated National Holding Company and its subsidiaries, unless the context indicates otherwise. We changed our name on September 11, 2012, pursuant to approval received at our annual shareholders’ meeting, from 21st Century Holding Company so that our parent company and other subsidiary companies names are consistent with our primary insurance subsidiary and the name under which we have been writing insurance for more than 20 years.

FNHC is an insurance holding company that controls substantially all steps in the insurance underwriting, distribution and claims processes through our subsidiaries and our contractual relationships with our independent agents and general agents.

We are authorized to underwrite, and/or place through our wholly owned subsidiaries, homeowners’ multi-peril (“homeowners”), commercial general liability, personal and commercial automobile, allied lines and various other lines of insurance in Florida and various other states. We market and distribute our own and third-party insurers’ products and our other services through a network of independent agents. We also utilize a select number of general agents for the same purpose.

Our primary insurance subsidiary is Federated National Insurance Company (“FNIC”). FNIC is licensed as an admitted carrier in Florida. An admitted carrier is an insurance company that has received a license from the state insurance regulator for authority to write specific lines of insurance in that state. Through contractual relationships with a network of approximately 3,000 independent agents, of which approximately 600 actively sell and service our products, FNIC is authorized to underwrite homeowners’, commercial general liability, fire, allied lines and personal and commercial automobile insurance in Florida. FNIC is also licensed as an admitted carrier in Alabama, Louisiana, Georgia and Texas, and underwrites commercial general liability insurance in those states and personal automobile insurance in Georgia.

FNIC operated as a non-admitted carrier in Arkansas, California, Kentucky, Maryland, Missouri, Nevada, Oklahoma, South Carolina, Tennessee and Virginia, and could underwrite commercial general liability insurance in all of these states. A non-admitted carrier, sometimes referred to as a “excess and surplus lines” carrier, is permitted to do business in a state and, although it is strictly regulated to protect policyholders from a variety of illegal and unethical practices, including fraud, non-admitted carriers are subject to considerably less regulation with respect to policy rates and forms. Non-admitted carriers are not required to financially contribute to and benefit from the state guarantee fund, which is used to pay for losses if an insurance carrier becomes insolvent or unable to pay the losses due their policyholders.

In January 2011, we merged FNIC and our other wholly owned insurance subsidiary, American Vehicle Insurance Company (“American Vehicle”), with FNIC continuing the operations of both entities. As part of its approval of the merger between FNIC and American Vehicle, the Florida Office of Insurance Regulation (“Florida OIR”), the Company, FNIC and American Vehicle entered into a consent order with the Florida OIR dated January 25, 2011 (the “Consent Order”) pursuant to which the Company and the resulting company in the merger (the “Merged Company”) have agreed to the following:

- The Merged Company retained the following licenses: (010) Fire, (020) Allied Lines, (040) Homeowners Multi Peril, (050) Commercial Multi Peril, (090) Inland Marine, (170) Other Liability, (192) Private Passenger Auto Liability, (194) Commercial Auto Liability, (211) Private Passenger Auto Physical Damage and (212) Commercial

Auto Physical Damage.

- The Merged Company will not write commercial multi peril policy premium without prior approval from the Florida OIR. The Merged Company has no commercial multi peril policy premium in force.
- The Merged Company surrendered its surety license. The Merged Company has no surety policy premium in force.

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Federated National Holding Company

Notes to Condensed Consolidated Financial Statements

- The Merged Company will not write new commercial habitation condominium associations without prior approval from the Florida OIR. The current commercial habitation book of business is approximately \$0.2 million of policy premium.
- The Merged Company agreed to reduce the total number of its homeowners' policies in Miami-Dade, Broward and Palm Beach counties (the "Tri-County Area") to 40% of its entire homeowners' book by December 31, 2011 and limit its new homeowners' policies in the Tri-County Area to \$500,000 of new policy premium per month. The 40% was achieved through the increased writing of property located outside of the Tri-County Area, the non-renewal of certain policies located within the Tri-County Area, and limiting the writing of new property located within the Tri-County Area. As of September 30, 2012, the Company had approximately 22.8% of its homeowners' policies located within Tri-County Area.
- The managing general agency fees payable by the Merged Company to Federated National Underwriters, Inc. ("FNU") formerly known as Assurance Managing General Agents, Inc., a wholly owned subsidiary of the Company, which were traditionally 6% of gross written premium, were reduced and will not exceed 4% without prior approval from the Florida OIR. The Merged Company has lowered the fee to 3% of gross written to further support the FNIC results of operations. This will have no impact on the Company's consolidated financial results.
- The claims service fees payable by the Merged Company to Federated National Adjusting, Inc. ("FNA") formerly known as Superior Adjusting, Inc., were reduced from the traditional 4.5% of gross earned premium to 3.6% of gross earned premium. This will have no impact on the Company's consolidated financial results.
- The Company provided the Florida OIR with a plan of operation and has agreed to provide certain reports to the Florida OIR on a monthly basis, and agreed to obtain the Florida OIR's approval prior to making any changes to the officers of the Merged Company during the first year following the effective date of the Merger.

The merger of FNIC and American Vehicle will be an ongoing transition, many aspects of which will take effect over time. References to the companies contained herein are intended to be references to the operations of the newly formed FNIC following the January 2011 merger. References to the historical activities of American Vehicle are appropriately identified throughout this document.

During the three months ended September 30, 2012, 81.1%, 9.4%, 6.2% and 3.3% of the premiums we underwrote were for homeowners', commercial general liability, federal flood, and automobile insurance, respectively. During the three months ended September 30, 2011, 76.8%, 13.3%, 7.1% and 2.8% of the premiums we underwrote were for homeowners', commercial general liability, federal flood, and personal automobile insurance, respectively.

During the nine months ended September 30, 2012, 84.6%, 8.2%, 4.6% and 2.6% of the premiums we underwrote were for homeowners', commercial general liability, federal flood, and automobile insurance, respectively. During the nine months ended September 30, 2011, 80.4%, 11.0%, 4.8% and 3.8% of the premiums we underwrote were for homeowners', commercial general liability, federal flood, and personal automobile insurance, respectively.

Our business, results of operations and financial condition are subject to fluctuations due to a variety of factors. Abnormally high severity or frequency of claims in any period could have a material adverse effect on us. When our estimated liabilities for unpaid losses and loss adjustment expenses ("LAE") are less than the actuarially determined amounts, we increase the expense in the current period. Conversely, when our estimated liabilities for unpaid losses and LAE are greater than the actuarially determined amounts, we decrease the expense in the current period.

We are focusing our marketing efforts on continuing to expand our distribution network while maintaining our commitment to long-term relationships. We market our products and services throughout Florida and in other states by establishing relationships with additional independent agents and general agents. There can be no assurance, however, that we will be able to obtain the required regulatory approvals to offer additional insurance products or expand into other states.

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Federated National Holding Company

Notes to Condensed Consolidated Financial Statements

FNU, a wholly owned subsidiary of the Company, acts as FNIC's exclusive managing general agent in Florida and is also licensed as a managing general agent in the States of Alabama, Georgia, Illinois, Louisiana, North Carolina, Mississippi, Missouri, New York, Nevada, South Carolina, Texas and Virginia. FNU has contracted with several unaffiliated insurance companies to sell commercial general liability, workers compensation, personal umbrella, inland marine and other various lines of insurance through FNU existing network of agents.

FNU earns commissions and fees for providing policy administration, marketing, accounting and analytical services, and for participating in the negotiation of reinsurance contracts. FNU earns a \$25 per policy fee, and traditionally a 6% commission fee from its affiliate, FNIC. During the fourth quarter of 2010, FNU, pursuant to the Consent Order as discussed above, reduced its fee, to earn amounts varying between 2% and 4%, which we anticipate will return to 6% at an unknown future date with approval from the Florida OIR. A formal agreement reflecting this fee modification was executed during January 2011.

We internally process claims made by our insureds through our wholly owned claims adjusting company, FNA. Our agents have no authority to settle claims or otherwise exercise control over the claims process. Furthermore, we believe that the retention of independent adjusters, in addition to the employment of salaried claims personnel, results in reduced ultimate loss payments, lower LAE and improved customer service for our claimants and policyholders. We also employ an in-house legal department to cost-effectively manage claims-related litigation and to monitor our claims handling practices for efficiency and regulatory compliance.

Until June 2011, our wholly owned subsidiary, Federated Premium Finance, Inc. ("Federated Premium"), offered premium financing to our own and third-party insureds. Premium financing has been marketed through our distribution network of general agents and independent agents.

Insure-Link, Inc. ("Insure-Link") was formed in March 2008 to serve as an independent insurance agency. The insurance agency markets direct to the public to provide a variety of insurance products and services to individual clients, as well as business clients, by offering a full line of insurance products including, but not limited to, homeowners', flood, personal and commercial automobile, commercial general liability and workers' compensation insurance through their agency appointments with over fifty different carriers. Insure-Link intends to expand its business through marketing and by acquiring other insurance agencies. There were no other agency relationships with affiliated captive or franchised agents during 2011 or the nine months ended September 30, 2012.

(2)Basis of Presentation

The accompanying unaudited condensed consolidated financial statements for the Company and its subsidiaries have been prepared in accordance with accounting principles generally accepted in the United States of America referred to as Generally Accepted Accounting Principles ("GAAP") for interim financial information, and the Securities and Exchange Commission ("SEC") rules for interim financial reporting. Certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to such rules and regulations. However, in the opinion of management, the accompanying financial statements reflect all normal recurring adjustments necessary to present fairly the Company's financial position as of September 30, 2012 and the results of operations and cash flows for the periods presented.

The results of operations for the interim periods presented are not necessarily indicative of the results of operations to be expected for any subsequent interim period or for the fiscal year ending December 31, 2012. The accompanying unaudited condensed consolidated financial statements and notes thereto should be read in conjunction with the



audited consolidated financial statements for the year ended December 31, 2011 included in the Company's Form 10-K, which was filed with the SEC on March 30, 2012.

In preparing the interim unaudited condensed consolidated financial statements, management was required to make certain estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, expenses and related disclosures at the financial reporting date and throughout the periods being reported upon. Certain of the estimates result from judgments that can be subjective and complex and consequently actual results may differ from these estimates.

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Federated National Holding Company

Notes to Condensed Consolidated Financial Statements

Material estimates that are particularly susceptible to significant change in the near-term relate to the determination of loss and LAE, ceded reinsurance balances payable, the recoverability of Deferred Policy Acquisition Costs (“DPAC”), the determination of federal income taxes, and the net realizable value of reinsurance recoverables. Although considerable variability is inherent in these estimates, management believes that the amounts provided are reasonable. These estimates are continually reviewed and adjusted as necessary. Such adjustments are reflected in current operations.

All significant intercompany balances and transactions have been eliminated. No reclassifications have been made to the prior-period balances to conform to the current-period presentation.

(3) Summary of Significant Accounting Policies and Practices

(A) Critical Accounting Policies

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions about future events that affect the amounts reported in the financial statements and accompanying notes. Future events and their effects cannot be determined with absolute certainty. Therefore, the determination of estimates requires the exercise of judgment. Actual results inevitably will differ from those estimates, and such differences may be material to the financial statements.

The most significant accounting estimates inherent in the preparation of our financial statements include estimates associated with management’s evaluation of the determination of (i) liability for unpaid losses and LAE, (ii) the amount and recoverability of amortization of DPAC, (iii) the valuation of investments and (iv) estimates for our reserves with respect to finance contracts, premiums receivable and deferred income taxes. Various assumptions and other factors underlie the determination of these significant estimates, which are described in greater detail in Footnote 2 of the Company’s audited consolidated financial statements for the fiscal year ended December 31, 2011, which we included in the Company’s Annual Report on Form 10-K which was filed with the SEC on March 30, 2012.

We believe that there were no significant changes in those critical accounting policies and estimates during the first nine months of fiscal 2012. Senior management has reviewed the development and selection of our critical accounting policies and estimates and their disclosure in this Form 10-Q with the Audit Committee of our Board of Directors.

The process of determining significant estimates is fact-specific and takes into account factors such as historical experience, current and expected economic conditions, and in the case of unpaid losses and LAE, an actuarial valuation. Management regularly reevaluates these significant factors and makes adjustments where facts and circumstances dictate. In selecting the best estimate, we utilize various actuarial methodologies. Each of these methodologies is designed to forecast the number of claims we will be called upon to pay and the amounts we will pay on average to settle those claims. In arriving at our best estimate, our actuaries consider the likely predictive value of the various loss development methodologies employed in light of underwriting practices, premium rate changes and claim settlement practices that may have occurred, and weight the credibility of each methodology. Our actuarial methodologies take into account various factors, including, but not limited to, paid losses, liability estimates for reported losses, paid allocated LAE, salvage and other recoveries received, reported claim counts, open claim counts and counts for claims closed with and without payment for loss.

Accounting for loss contingencies pursuant to Financial Accounting Standards Board (“FASB”) issued guidance involves the existence of a condition, situation or set of circumstances involving uncertainty as to possible loss that

will ultimately be resolved when one or more future event(s) occur or fail to occur. Additionally, accounting for a loss contingency requires management to assess each event as probable, reasonably possible or remote. Probable is defined as the future event or events are likely to occur. Reasonably possible is defined as the chance of the future event or events occurring is more than remote but less than probable, while remote is defined as the chance of the future event or events occurring is slight. An estimated loss in connection with a loss contingency shall be recorded by a charge to current operations if both of the following conditions are met: First, the amount can be reasonably estimated, and second, the information available prior to issuance of the financial statements indicates that it is probable that a liability has been incurred at the date of the financial statements. It is implicit in this condition that it is probable that one or more future events will occur confirming the fact of the loss or incurrence of a liability.

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We are required to review the contractual terms of all our reinsurance purchases to ensure compliance with FASB issued guidance. The guidance establishes the conditions required for a contract with a reinsurer to be accounted for as reinsurance and prescribes accounting and reporting standards for those contracts. Contracts that do not result in the reasonable possibility that the reinsurer may realize a significant loss from the insurance risk assumed generally do not meet the conditions for reinsurance accounting and must be accounted for as deposits. The guidance also requires us to disclose the nature, purpose and effect of reinsurance transactions, including the premium amounts associated with reinsurance assumed and ceded. It also requires disclosure of concentrations of credit risk associated with reinsurance receivables and prepaid reinsurance premiums.

FASB issued guidance addresses accounting and reporting for (a) investments in equity securities that have readily determinable fair values and (b) all investments in debt securities. The guidance requires that these securities be classified into one of three categories: Held-to-maturity, Trading, or Available-for-sale securities.

Investments classified as held-to-maturity include debt securities wherein the Company's intent and ability are to hold the investment until maturity. The accounting treatment for held-to-maturity investments is to carry them at amortized cost without consideration to unrealized gains or losses.

Investments classified as trading securities include debt and equity securities bought and held primarily for the sale in the near term. The accounting treatment for trading securities is to carry them at fair value with unrealized holding gains and losses included in current period operations.

Investments classified as available-for-sale include debt and equity securities that are not classified as held-to-maturity or as trading security investments. The accounting treatment for available-for-sale securities is to carry them at fair value with unrealized holding gains and losses excluded from earnings and reported as a separate component of shareholders' equity, namely "Other Comprehensive Income" and the components of other comprehensive income are presented in a statement separate from and consecutive with the statement of operations.

A decline in the fair value of an available-for-sale security below cost that is deemed other-than temporary results in a charge to income, resulting in the establishment of a new cost basis for the security.

Premiums and discounts are amortized or accreted, respectively, over the life of the related debt security as an adjustment to yield using a method that approximates the effective interest method. Dividends and interest income are recognized when earned. Realized gains and losses are included in earnings and are derived using the specific-identification method for determining the cost of securities sold.

Financial instruments, which potentially expose us to concentrations of credit risk, consist primarily of investments, premiums receivable, amounts due from reinsurers on paid and unpaid losses and finance contracts. We have not experienced significant losses related to premiums receivable from individual policyholders or groups of policyholders in a particular industry or geographic area. We believe no credit risk beyond the amounts provided for collection losses is inherent in our premiums receivable or finance contracts. In order to reduce credit risk for amounts due from reinsurers, we seek to do business with financially sound reinsurance companies and regularly review the financial strength of all reinsurers used. Additionally, our credit risk in connection with our reinsurers is mitigated by the establishment of irrevocable clean letters of credit in favor of FNIC.

The fair value of our investments is estimated based on prices published by financial services or quotations received from securities dealers and is reflective of the interest rate environment that existed as of the close of business on September 30, 2012 and December 31, 2011. Changes in interest rates subsequent to September 30, 2012 and

December 31, 2011 may affect the fair value of our investments.

The carrying amounts for the following financial instrument categories approximate their fair values at September 30, 2012 and December 31, 2011 because of their short-term nature: cash and short term investments, premiums receivable, finance contracts, due from reinsurers, revolving credit outstanding, bank overdraft, accounts payable and accrued expenses.

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(B) Impact of New Accounting Pronouncements

In July 2012, the FASB issued Accounting Standard Update (“ASU”) No. 2012-02: Intangibles – Goodwill and Other (Topic 350): Testing Indefinite-Lived Intangible Assets for Impairment. The objective of the amendments in this ASU is to reduce the cost and complexity of performing an impairment test for indefinite-lived intangible assets by simplifying how an entity tests those assets for impairment and to improve consistency in impairment testing guidance among long-lived asset categories. The amendments permit an entity first to assess qualitative factors to determine whether it is more likely than not that an indefinite-lived intangible asset is impaired as a basis for determining whether it is necessary to perform the quantitative impairment test in accordance with Subtopic 350-30. The more-likely-than-not threshold is defined as having a likelihood of more than 50 percent. Upon adoption, these amendments are effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012; early adoption is permitted. The adoption of these amendments did not have a material impact on our financial condition, results of operations or cash flows.

In June 2011, the FASB issued ASU No. 2011-05: Comprehensive Income (Topic 220): Presentation of Comprehensive Income. The guidance in this ASU is intended to increase the prominence of items reported in other comprehensive income in the financial statements by presenting the total of comprehensive income, the components of net income and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. This ASU eliminates the option to present the components of other comprehensive income as part of the statement of changes in stockholders' equity. The guidance in this ASU does not change the items that must be reported in other comprehensive income or when an item of other comprehensive income must be reclassified to net income. Upon adoption, this update is to be applied retrospectively and is effective during interim and annual periods beginning after December 15, 2011. Early adoption is permitted. The adoption of this ASU did not have a material impact on our financial condition, results of operations or cash flows.

In December 2011, the FASB issued ASU No. 2011-12: Comprehensive Income (Topic 220): Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05. The guidance defers certain provisions contained in ASU No. 2011-05 requiring the requirement to present components of reclassifications of other comprehensive income on the face of the income statement or in the notes to the financial statements. However, this deferral does not impact the other requirements contained in the new standard on comprehensive income as described above. This ASU is effective during interim and annual periods beginning after December 15, 2011. The adoption of this ASU did not have a material impact on our financial condition, results of operations or cash flows.

In September 2011, the FASB issued ASU No. 2011-08: Intangibles – Goodwill and Other (Topic 350): Testing Goodwill for Impairment, which amends ASC Topic 350, Intangibles-Goodwill and Other. The guidance in this ASU permits an entity to first assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount as a basis for determining whether it is necessary to perform the two-step goodwill impairment test described in ASC Topic 350. Under the amendments in this ASU, an entity is not required to calculate the fair value of a reporting unit unless the entity determines that it is more likely than not that its fair value is less than its carrying amount. The amendments are effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011. Early adoption is permitted, including for annual and interim goodwill impairment tests performed as of a date before September 15, 2011, if an entity’s financial statements for the most recent annual or interim period have not yet been issued or, for nonpublic entities, have not yet been made available for issuance. The adoption of this ASU did not have a material impact on our financial condition,

results of operations or cash flows.

In December 2011, the FASB issued ASU No. 2011-11: Balance Sheet (Topic 210): Disclosures about Offsetting Assets and Liabilities, which requires new disclosure requirements mandating that entities disclose both gross and net information about instruments and transactions eligible for offset in the statement of financial position as well as instruments and transactions subject to an agreement similar to a master netting arrangement. In addition, the standard requires disclosure of collateral received and posted in connection with master netting agreements or similar arrangements. This ASU is effective for annual reporting periods beginning on or after January 1, 2013, and interim periods within those annual periods. The adoption of this ASU will not have a material impact on our financial condition, results of operations or cash flows.

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In October 2010, the FASB issued ASU No. 2010-26: Financial Services – Insurance (Topic 944): Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts, a consensus of FASB Emerging Issues Task Force. The amendments in this update modify the definition of the types of costs incurred by insurance entities that can be capitalized in the acquisition of new and renewal contracts. The amendments in this update specify that the costs must be based on successful efforts (that is, acquiring a new or renewal contract). The amendments also specify that advertising costs should be included as deferred acquisition costs under certain circumstances. The amendments in this update are effective for fiscal years, and interim period within those fiscal years, beginning after December 15, 2011. The amendments in this update should be applied prospectively upon adoption. Retrospective application to all prior periods presented upon the date of adoption also is permitted. The adoption of this ASU did not have a material impact on the Company’s consolidated financial statements.

Other recent accounting pronouncements issued by FASB, the American Institute of Certified Public Accountants (“AICPA”), and the SEC did not or are not believed by management to have a material impact on the Company’s present or future financial statements.

(C) Stock Options

Pursuant to FASB issued guidance, compensation cost recognized during the nine months ended September 30, 2012 includes compensation cost for all share-based payments granted subsequent to January 1, 2006, based on the grant date fair value estimated in accordance with the guidance.

(D) Earnings (Loss) per Share

Basic earnings (loss) per share (“Basic EPS”) is computed by dividing net income (loss) by the weighted average number of common shares outstanding during the period presented. Diluted earnings (loss) per share (“Diluted EPS”) is computed by dividing net income by the weighted average number of shares of common stock and common stock equivalents outstanding during the period presented; outstanding warrants and stock options are considered common stock equivalents and are included in the calculation using the treasury stock method.

(E) Reclassifications

No reclassification of the 2011 financial statements was necessary to conform to the 2012 presentation.

(4) Commitments and Contingencies

Management has a responsibility to continually measure and monitor its commitments and its contingencies. The nature of the Company’s commitments and contingencies can be grouped into three major categories: insured claim activity, assessment related activities and operational matters.

(A) Insured Claim Activity

We are involved in claims and legal actions arising in the ordinary course of business. The amount of liability for these claims and lawsuits is uncertain. Revisions to our estimates are based on our analysis of subsequent information that we receive regarding various factors, including: (i) per claim information; (ii) company and industry historical loss experience; (iii) legislative enactments, judicial decisions, legal developments in the awarding of damages; and (iv) trends in general economic conditions, including the effects of inflation. Management revises its estimates based



on the results of its analysis. This process assumes that experience, adjusted for the effects of current developments and anticipated trends, is an appropriate basis for estimating the ultimate settlement of all claims. There is no precise method for subsequently evaluating the impact of any specific factor on the adequacy of the reserves, because the eventual redundancy or deficiency is affected by multiple factors. In the opinion of management, the ultimate disposition of these matters may have a material adverse effect on our consolidated financial position, results of operations, or liquidity.

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The Company's subsidiaries are, from time to time, named as defendants in various lawsuits incidental to their insurance operations. Legal actions relating to claims made in the ordinary course of seeking indemnification for a loss covered by the insurance policy are considered by the Company in establishing loss and LAE reserves.

The Company also faces, in the ordinary course of business, lawsuits that seek damages beyond policy limits. The Company continually evaluates potential liabilities and reserves for litigation of these types using the criteria established by FASB issued guidance. Under this guidance, reserves for a loss are recorded if the likelihood of occurrence is probable and the amount can be reasonably estimated. If a loss, while not probable, is judged to be reasonably possible, management will make an estimate of a possible range of loss or state that an estimate cannot be made. Management considers each legal action using this guidance and records reserves for losses as warranted.

(B) Assessment Related Activity

We operate in a regulatory environment where certain entities and organizations have the authority to require us to participate in assessments. Currently these entities and organizations include, but are not limited to, Florida Insurance Guaranty Association ("FIGA"), Citizens Property Insurance Corporation ("Citizens"), Florida Hurricane Catastrophe Fund ("FHCF") and Florida Joint Underwriters Insurance Association ("JUA"). As a direct premium writer in the state of Florida, we are required to participate in certain insurer solvency associations under Florida Statutes Section 631.57(3) (a), administered by FIGA.

Related to statutory accounting, in October 2010, the National Association of Insurance Commissioners ("NAIC") issued substantive revisions in Statement of Statutory Accounting Principles ("SSAP") No. 35 Revised ("SSAP No. 35R"), Guaranty Fund and Other Assessments. For statutory accounting, SSAP No. 35R, effective January 1, 2011, requires assessments that could be recouped through future premium surcharges to be expensed and not be recognized as an asset. The impact is there might be an effect on statutory policyholder surplus once the liability for the assessments is recognized. The adoption of SSAP No. 35R rule will not have a material effect on our 2012 operations.

FNIC is also required to participate in an insurance apportionment plan under Florida Statutes Section 627.351, which is referred to as a JUA Plan. The JUA Plan provides for the equitable apportionment of any profits realized, or losses and expenses incurred, among participating automobile insurers. In the event of an underwriting deficit incurred by the JUA Plan which is not recovered through the policyholders in the JUA Plan, such deficit shall be recovered from the companies participating in the JUA Plan in the proportion that the net direct written premiums of each such member during the preceding calendar year bear to the aggregate net direct premiums written in this state by all members of the JUA Plan. FNIC was not assessed by the JUA Plan during 2012 or 2011. Future assessments by this association are undeterminable at this time.

(C) Operational Matters

The Company's consolidated federal and state income tax returns for 2009-2011 are open for review by the Internal Revenue Service ("IRS") and various state taxing authorities. The 2005 and 2006 income tax returns and net operating loss carry-back from tax year 2009 have been reviewed by the Joint Committee on Taxation. The Joint Committee on Taxation completed its consideration in September 2011 and took no exception to the conclusions reached by the IRS regarding the net operating loss carry-back from tax year 2009.

The Company has recorded a net deferred tax asset of \$4.5 million and \$8.6 million as of September 30, 2012 and December 31, 2011, respectively. Realization of net deferred tax asset is dependent on generating sufficient taxable income in future periods. Management believes that it is more likely than not that the deferred tax assets will be realized and as such no valuation allowance has been recorded against the net deferred tax asset. Management considers the scheduled reversal of deferred tax liabilities, projected future taxable income and tax planning strategies in making this assessment. At September 30, 2012, based upon the level of historical taxable income and projections for future taxable income over the periods in which the deferred tax assets are deductible, management believes it is more likely than not that the Company will realize the benefits of these deductible differences. When assessing the need for valuation allowances, the Company considers future taxable income and ongoing prudent and feasible tax planning strategies. Should a change in circumstances lead to a change in judgment about the realizability of deferred tax assets in future years, the Company would record valuation allowances as deemed appropriate in the period that the change in circumstances occurs, along with a corresponding increase or charge to net income. The resolution of tax reserves and changes in valuation allowances could be material to the Company's results of operations for any period, but is not expected to be material to the Company's financial position.

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Relative to the Company's commitments stemming from operational matters, on or about March 1, 2006 we sold our interest in the building that housed our operations in Lauderdale Lakes through December 16, 2011, to an unrelated party. As part of this transaction, we agreed to lease the same facilities for a five-year term. We amended the lease agreement and the note receivable on September 1, 2010. As part of the amendment, we discounted the note receivable and have discontinued the interest on the note. In consideration, we paid a reduced lease payment for the remainder of the lease. Our lease for this office space expired in December 2011.

Our executive offices are now located at 14050 N.W. 14th Street, Suite 180, Sunrise, Florida 33323 in an 18,500 square foot office facility. All of our operations are consolidated within this facility. We believe that the facilities are well maintained, in substantial compliance with environmental laws and regulations, and adequately covered by insurance. We also believe that these leased facilities are not unique and could be replaced, if necessary, at the end of the lease term. Our lease for this office space will expire in May 2017.

The expected future payments in connection with this lease are as follows.

| Fiscal Year | Payments<br>(Dollars in<br>Thousands) |
|-------------|---------------------------------------|
| 2012        | 91                                    |
| 2013        | 373                                   |
| 2014        | 380                                   |
| 2015        | 388                                   |
| 2016        | 395                                   |
| 2017        | 151                                   |
| Total       | \$ 1,778                              |

The Company is not currently involved in any material legal actions arising from the ordinary course of business that are not related to the insured claims activity.

## (5) Investments

Total investments increased \$15.5 million, or 12.0%, to \$145.0 million as of September 30, 2012, compared with \$129.5 million as of December 31, 2011.

We account for our investment securities consistent with FASB issued guidance that requires our securities be classified into one of three categories: (i) held-to-maturity, (ii) trading securities or (iii) available-for-sale.

Investments classified as held-to-maturity include debt securities where the Company's intent and ability are to hold the investment until maturity and are carried at amortized cost without consideration to unrealized gains or losses. Investments classified as trading securities include debt and equity securities bought and held primarily for sale in the near term and are carried at fair value with unrealized holding gains and losses included in current period operations. Investments classified as available-for-sale include debt and equity securities that are not classified as held-to-maturity or as trading security investments and are carried at fair value with unrealized holding gains and losses excluded from earnings and reported as a separate component of shareholders' equity, namely "Other Comprehensive Income."

The debt and equity securities that are available-for-sale and carried at fair value represent 95% of total investments as of September 30, 2012, compared with 94% as of December 31, 2011.

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We did not hold any trading investment securities during the nine months ended September 30, 2012.

The FASB issued guidance also addresses the determination as to when an investment is considered impaired, whether that impairment is other-than-temporary, and the measurement of an impairment loss. The Company's policy for the valuation of temporarily impaired securities is to determine impairment based on the analysis of the following factors.

- rating downgrade or other credit event (e.g., failure to pay interest when due);
- length of time and the extent to which the fair value has been less than amortized cost;
- financial condition and near term prospects of the issuer, including any specific events which may influence the operations of the issuer such as changes in technology or discontinuance of a business segment;
  - prospects for the issuer's industry segment;
- intent and ability of the Company to retain the investment for a period of time sufficient to allow for anticipated recovery in market value;
  - historical volatility of the fair value of the security.

Pursuant to FASB issued guidance, the Company records the unrealized losses, net of estimated income taxes, that are associated with that part of our portfolio classified as available-for-sale through the shareholders' equity account titled "Other Comprehensive Income". Management periodically reviews the individual investments that comprise our portfolio in order to determine whether a decline in fair value below our cost either is other-than temporarily or permanently impaired. Factors used in such consideration include, but are not limited to, the extent and length of time over which the market value has been less than cost, the financial condition and near-term prospects of the issuer and our ability and intent to keep the investment for a period sufficient to allow for an anticipated recovery in market value.

In reaching a conclusion that a security is either other-than-temporarily or permanently impaired we consider such factors as the timeliness and completeness of expected dividends, principal and interest payments, ratings from nationally recognized statistical rating organizations such as Standard and Poor's ("S&P") and Moody's Investors Service, Inc. ("Moody's"), as well as information released via the general media channels. In connection with this process, we have not charged net realized losses to operations during the three months ended September 30, 2012; in connection with this process we have charged \$44,000 of net realized investment losses to operations during the nine months ended September 30, 2012.

As of September 30, 2012 and December 31, 2011, respectively, all of our securities are in good standing and not impaired as defined by FASB issued guidance, except as noted above.

As of September 30, 2012 and December 31, 2011, approximately 86% of our investment portfolio was in debt instruments and 14% was in equity instruments. As of September 30, 2012, 64% of our debt portfolio was in diverse industries and 36% is in United States government bonds. As of September 30, 2012, approximately 87% of our equity holdings were in equities related to diverse industries and 13% were in mutual funds. As of December 31, 2011, 61% of our debt portfolio was in diverse industries and 39% is in United States government bonds. As of December 31, 2011, approximately 83% of our equity holdings were in equities related to diverse industries and 17%

were in mutual funds.

As of September 30, 2012 and December 31, 2011, we have classified \$7.5 million and \$7.1 million, respectively, of our bond portfolio as held-to-maturity. We only classify bonds as held-to-maturity to support securitization of credit requirements. Fully funded trust agreements used for such purposes totaled \$4.6 million as of September 30, 2012 and December 31, 2011.

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During the three and nine months ended September 30, 2012 and 2011, respectively, we did not re-classify any of our bond portfolio between available-for-sale and held-to-maturity.

## (A) Debt and Equity Securities

The following table summarizes, by type, our investments as of September 30, 2012 and December 31, 2011.

|  | September 30, 2012 |                  | December 31, 2011 |                  |  |
|--|--------------------|------------------|-------------------|------------------|--|
|  | Carrying Amount    | Percent of Total | Carrying Amount   | Percent of Total |  |
| (Dollars in Thousands)                               |                    |                  |                   |                  |  |
| Debt securities, at market:                          |                    |                  |                   |                  |  |
| United States government obligations and authorities | \$37,928           | 26.15 %          | \$37,217          | 28.75 %          |  |
| Obligations of states and political subdivisions     | 3,467              | 2.39 %           | 2,303             | 1.77 %           |  |
| Corporate  | 72,836             | 50.22 %          | 63,268            | 48.87 %          |  |
| International  | 2,275              | 1.57 %           | 1,523             | 1.18 %           |  |
|  | 116,506            | 80.33 %          | 104,311           | 80.57 %          |  |
| Debt securities, at amortized cost:                  |                    |                  |                   |                  |  |
| Corporate  | 1,328              | 0.92 %           | 962               | 0.74 %           |  |
| United States government obligations and authorities | 6,127              | 4.22 %           | 6,166             | 4.76 %           |  |
|  | 7,455              | 5.14 %           | 7,128             | 5.50 %           |  |
| Total debt securities                                | 123,961            | 85.47 %          | 111,439           | 86.07 %          |  |
| Equity securities, at market:                        |                    |                  |                   |                  |  |
| Total investments                                    | \$145,031          | 100.00 %         | \$129,467         | 100.00 %         |  |

The following table shows the realized gains for debt and equity securities for the three months ended September 30, 2012 and 2011.

|                                   | Three Months Ended September 30, |                    |                |                    |
|-----------------------------------|----------------------------------|--------------------|----------------|--------------------|
|                                   | 2012                             |                    | 2011           |                    |
|                                   | Gains (Losses)                   | Fair Value at Sale | Gains (Losses) | Fair Value at Sale |
| (Dollars in Thousands)            |                                  |                    |                |                    |
| Debt securities                   | \$410                            | \$ 9,716           | \$620          | \$ 10,177          |
| Equity securities                 | 145                              | 1,349              | 273            | 1,502              |
| Total realized gains              | 555                              | 11,065             | 893            | 11,679             |
| Debt securities                   | (56 )                            | 1,637              | (10 )          | 213                |
| Equity securities                 | (354 )                           | 682                | (170 )         | 492                |
| Total realized losses             | (410 )                           | 2,319              | (180 )         | 705                |
| Net realized gains on investments | \$145                            | \$ 13,384          | \$713          | \$ 12,384          |





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The following table shows the realized (losses) gains for debt and equity securities for the nine months ended September 30, 2012 and 2011.

|  | Nine Months Ended September 30, |                        |                   |                       |
|--|---------------------------------|------------------------|-------------------|-----------------------|
|  | Gains<br>(Losses)               | Fair Value<br>at Sale  | Gains<br>(Losses) | Fair Value<br>at Sale |
|  |                                 | 2012                   |                   | 2011                  |
|  |                                 | (Dollars in Thousands) |                   |                       |
| Debt securities                            | \$958                           | \$ 27,760              | \$1,045           | \$ 39,630             |
| Equity securities                          | 805                             | 5,437                  | 1,010             | 5,751                 |
| Total realized gains                       | 1,763                           | 33,197                 | 2,055             | 45,381                |
| Debt securities                            | (371 )                          | 11,050                 | (442 )            | 14,046                |
| Equity securities                          | (1,475 )                        | 6,073                  | (561 )            | 3,019                 |
| Total realized losses                      | (1,846 )                        | 17,123                 | (1,003 )          | 17,065                |
| Net realized (losses) gains on investments | \$(83 )                         | \$ 50,320              | \$1,052           | \$ 62,446             |

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A summary of the amortized cost, estimated fair value and gross unrealized gains and losses of debt and equity securities at September 30, 2012 and December 31, 2011 is as follows.

|  | Amortized<br>Cost      | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Estimated<br>Fair Value |
|--|------------------------|------------------------------|-------------------------------|-------------------------|
|  | (Dollars in Thousands) |                              |                               |                         |
| September 30, 2012                                   |                        |                              |                               |                         |
| Debt Securities - Available-For-Sale:                |                        |                              |                               |                         |
| United States government obligations and authorities | \$36,721               | \$ 1,229                     | \$ 22                         | \$ 37,928               |
| Obligations of states and political subdivisions     | 3,294                  | 174                          | 1                             | 3,467                   |
| Corporate  | 68,622                 | 4,227                        | 13                            | 72,836                  |
| International  | 2,187                  | 89                           | 1                             | 2,275                   |
|  | \$110,824              | \$ 5,719                     | \$ 37                         | \$ 116,506              |
| Debt Securities - Held-To-Maturity:                  |                        |                              |                               |                         |
| United States government obligations and authorities | \$6,127                | \$ 182                       | \$ 1                          | \$ 6,308                |
| Corporate  | 1,328                  | 75                           | -                             | 1,403                   |
|  | \$7,455                | \$ 257                       | \$ 1                          | \$ 7,711                |
| Equity securities - common stocks                    | \$19,142               | \$ 2,581                     | \$ 653                        | \$ 21,070               |
| December 31, 2011                                    |                        |                              |                               |                         |
| Debt Securities - Available-For-Sale:                |                        |                              |                               |                         |
| United States government obligations and authorities | \$36,558               | \$ 686                       | \$ 27                         | \$ 37,217               |
| Obligations of states and political subdivisions     | 2,165                  | 138                          | -                             | 2,303                   |
| Corporate  | 61,724                 | 1,934                        | 390                           | 63,268                  |
| International  | 1,519                  | 9                            | 5                             | 1,523                   |
|  | \$101,966              | \$ 2,767                     | \$ 422                        | \$ 104,311              |
| Debt Securities - Held-To-Maturity:                  |                        |                              |                               |                         |
| United States government obligations and authorities | \$6,166                | \$ 249                       | \$ -                          | \$ 6,415                |
| Corporate  | 962                    | 39                           | 1                             | 1,000                   |
|  | \$7,128                | \$ 288                       | \$ 1                          | \$ 7,415                |
| Equity securities - common stocks                    | \$18,966               | \$ 1,057                     | \$ 1,995                      | \$ 18,028               |

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The table below reflects our unrealized investment losses by investment class, aged for length of time in a continuous unrealized loss position as of September 30, 2012.

|  | Unrealized<br>Losses   | Less than 12<br>months | 12 months or<br>longer |
|--|------------------------|------------------------|------------------------|
|  | (Dollars in Thousands) |                        |                        |
| Debt securities:                                     |                        |                        |                        |
| United States government obligations and authorities | \$22                   | \$ 22                  | \$ -                   |
| Obligations of states and political subdivisions     | 1                      | 1                      | -                      |
| Corporate  | 13                     | 7                      | 6                      |
| International  | 1                      | 1                      | -                      |
|  | 37                     | 31                     | 6                      |
| Equity securities:                                   |                        |                        |                        |
| Common stocks  | 653                    | 440                    | 213                    |
| Total debt and equity securities                     | \$690                  | \$ 471                 | \$ 219                 |

The table below reflects our unrealized investment losses by investment class, aged for length of time in a continuous unrealized loss position as of December 31, 2011.

|  | Unrealized<br>(Losses) | Less than 12<br>months | 12 months or<br>longer |
|--|------------------------|------------------------|------------------------|
|  | (Dollars in Thousands) |                        |                        |
| Debt securities:                                     |                        |                        |                        |
| United States government obligations and authorities | \$27                   | \$ 27                  | \$ -                   |
| Obligations of states and political subdivisions     | -                      | -                      | -                      |
| Corporate  | 390                    | 390                    | -                      |
| International  | 4                      | 4                      | -                      |
|  | 421                    | 421                    | -                      |
| Equity securities:                                   |                        |                        |                        |
| Common stocks  | 1,996                  | 1,620                  | 376                    |
| Total debt and equity securities                     | \$2,417                | \$ 2,041               | \$ 376                 |

Below is a summary of debt securities at September 30, 2012 and December 31, 2011, by contractual or expected maturity periods. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

|                                  | September 30, 2012     |                         | December 31, 2011 |                         |
|----------------------------------|------------------------|-------------------------|-------------------|-------------------------|
|                                  | Amortized<br>Cost      | Estimated<br>Fair Value | Amortized<br>Cost | Estimated<br>Fair Value |
|                                  | (Dollars in Thousands) |                         |                   |                         |
| Due in one year or less          | \$7,222                | \$ 7,308                | \$8,284           | \$ 8,376                |
| Due after one through five years | 55,689                 | 57,837                  | 47,294            | 48,314                  |

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|                                  |           |            |           |            |
|----------------------------------|-----------|------------|-----------|------------|
| Due after five through ten years | 36,812    | 39,219     | 36,525    | 37,448     |
| Due after ten years              | 18,556    | 19,853     | 16,991    | 17,588     |
| Total                            | \$118,279 | \$ 124,217 | \$109,094 | \$ 111,726 |

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## Federated National Holding Company

## Notes to Condensed Consolidated Financial Statements

United States Treasury notes with a book value of \$2,178,935 and \$63,725, maturing in 2012 and 2016, respectively, were on deposit with the Florida OIR as of September 30, 2012, as required by law for FNIC, and are included with other investments held until maturity.

The table below sets forth investment results for the three months ended September 30, 2012 and 2011.

|                                       | Three Months Ended September<br>30, |                 |
|---------------------------------------|-------------------------------------|-----------------|
|                                       | 2012                                | 2011            |
|                                       | (Dollars in Thousands)              |                 |
| Interest on debt securities           | \$ 839                              | \$ 950          |
| Dividends on equity securities        | 113                                 | 80              |
| Interest on cash and cash equivalents | 1                                   | 1               |
| <b>Total investment income</b>        | <b>\$ 953</b>                       | <b>\$ 1,031</b> |
| <b>Net realized gains</b>             | <b>\$ 145</b>                       | <b>\$ 713</b>   |

Proceeds from sales, pay downs and maturities of debt securities and proceeds from sales of equity securities during the three months ended September 30, 2012 and 2011, were approximately \$17.9 million and \$15.0 million, respectively.

The table below sets forth investment results for the nine months ended September 30, 2012 and 2011.

|                                       | Nine Months Ended September<br>30, |                 |
|---------------------------------------|------------------------------------|-----------------|
|                                       | 2012                               | 2011            |
|                                       | (Dollars in Thousands)             |                 |
| Interest on debt securities           | \$ 2,563                           | \$ 2,805        |
| Dividends on equity securities        | 279                                | 246             |
| Interest on cash and cash equivalents | 7                                  | 3               |
| <b>Total investment income</b>        | <b>\$ 2,849</b>                    | <b>\$ 3,054</b> |
| <b>Net realized (losses) gains</b>    | <b>\$ (83 )</b>                    | <b>\$ 1,052</b> |

Proceeds from sales, pay downs and maturities of debt securities and proceeds from sales of equity securities during the nine months ended September 30, 2012 and 2011, were approximately \$60.7 million and \$70.6 million, respectively.

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Notes to Condensed Consolidated Financial Statements

The table below sets forth a summary of net realized and unrealized investment gains during the three months ended September 30, 2012 and 2011.

|                      | Three Months Ended September 30, |          |
|----------------------|----------------------------------|----------|
|                      | 2012                             | 2011     |
|                      | (Dollars in Thousands)           |          |
| Net realized gains   |                                  |          |
| Debt securities      | \$ 354                           | \$ 610   |
| Equity securities    | (209 )                           | 103      |
| Total                | \$ 145                           | \$ 713   |
| Net unrealized gains |                                  |          |
| Debt securities      | \$ 5,682                         | \$ 3,877 |
| Equity securities    | 1,928                            | (3,183 ) |
| Total                | \$ 7,610                         | \$ 694   |

The table below sets forth a summary of net realized and unrealized investment (losses) gains during the nine months ended September 30, 2012 and 2011.

|                             | Nine Months Ended September 30, |          |
|-----------------------------|---------------------------------|----------|
|                             | 2012                            | 2011     |
|                             | (Dollars in Thousands)          |          |
| Net realized (losses) gains |                                 |          |
| Debt securities             | \$ 587                          | \$ 603   |
| Equity securities           | (670 )                          | 449      |
| Total                       | \$ (83 )                        | \$ 1,052 |
| Net unrealized gains        |                                 |          |
| Debt securities             | \$ 5,682                        | \$ 5,070 |
| Equity securities           | 1,928                           | (2,328 ) |
| Total                       | \$ 7,610                        | \$ 2,742 |

## (6)Fair Value Disclosure

In April 2009, the FASB issued accounting guidance that if an entity determines that either the volume and/or level of activity for an investment security has significantly decreased (from normal conditions for that investment security) or price quotations or observable inputs are not associated with orderly transactions, increased analysis and management judgment will be required to estimate fair value. This guidance was effective for interim and annual periods ending after June 15, 2009, with early adoption permitted. This guidance was applied prospectively. The adoption of this guidance did not have an impact on the Company's financial statements or condition.

In October 2008, the FASB issued accounting guidance to clarify the application of GAAP in determining fair value of financial instruments in a market that is not active. The guidance was effective upon issuance, including prior periods for which financial statements had not been issued. Our adoption of this guidance does not have a material effect on our financial position, results of operations, cash flows or disclosures.



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## Federated National Holding Company

## Notes to Condensed Consolidated Financial Statements

In September 2006, FASB issued accounting guidance that defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for an asset or liability in an orderly transaction between market participants on the measurement date. This guidance also establishes a fair value hierarchy that requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The guidance also categorizes assets and liabilities at fair value into one of three different levels depending on the observation of the inputs employed in the measurement, as follows.

Level 1 — inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets. A quoted price for an identical asset or liability in an active market provides the most reliable fair value measurement because it is directly observable to the market.

Level 2 — inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs are observable for an asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.

Level 3 — inputs to the valuation methodology are unobservable and significant to the fair value measurement.

Securities available for sale: The fair value of securities available for sale is determined by obtaining quoted prices on nationally recognized security exchanges.

Assets measured at fair value on a recurring basis as of September 30, 2012, presented in accordance with this guidance, are as follows.

|  |                        | As of September 30, 2012 |         |           |  |
|--|------------------------|--------------------------|---------|-----------|--|
|  | Level 1                | Level 2                  | Level 3 | Total     |  |
|  | (Dollars in Thousands) |                          |         |           |  |
| Debt securities:                                     |                        |                          |         |           |  |
| United States government obligations and authorities | \$-                    | \$37,928                 | \$-     | \$37,928  |  |
| Obligations of states and political subdivisions     | -                      | 3,467                    | -       | 3,467     |  |
| Corporate  | 72,836                 | -                        | -       | 72,836    |  |
| International  | -                      | 2,275                    | -       | 2,275     |  |
|  | 72,836                 | 43,670                   | -       | 116,506   |  |
| Equity securities:                                   |                        |                          |         |           |  |
| Common stocks  | 21,070                 | -                        | -       | 21,070    |  |
|  | 21,070                 | -                        | -       | 21,070    |  |
| Total debt and equity securities                     | \$93,906               | \$43,670                 | \$-     | \$137,576 |  |

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## Federated National Holding Company

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Assets measured at fair value on a recurring basis as of December 31, 2011, presented in accordance with this guidance, are as follows.

|  | Level 1  | As of December 31, 2011<br>Level 2      Level 3<br>(Dollars in Thousands) |     | Total     |
|--|----------|---|-----|-----------|
| Debt securities:                                     |          |   |     |           |
| United States government obligations and authorities | \$-      | \$37,217  | \$- | \$37,217  |
| Obligations of states and political subdivisions     | -        | 2,303   | -   | 2,303     |
| Corporate  | 63,268   | -   | -   | 63,268    |
| International  | -        | 1,523   | -   | 1,523     |
|  | 63,268   | 41,043  | -   | 104,311   |
| Equity securities:                                   |          |   |     |           |
| Common stocks  | 18,028   | -   | -   | 18,028    |
|  | 18,028   | -   | -   | 18,028    |
| Total debt and equity securities                     | \$81,296 | \$41,043  | \$- | \$122,339 |

## (7)Reinsurance Agreements

Financing risk generally involves a combination of risk retention and risk transfer techniques. “Retention”, similar to a deductible, involves financing losses by funds internally generated. “Transfer” involves the existence of a contractual arrangement designed to shift financial responsibility to another party in exchange for premium. Secondary to the primary risk-transfer agreements we use reinsurance agreements to transfer a portion of the risks insured under our policies to other companies through the purchase of reinsurance. We utilize reinsurance to reduce exposure to catastrophic and non-catastrophic risks and to help manage the cost of capital. Reinsurance techniques are designed to lessen earnings volatility, improve shareholder return, and to support the required statutory surplus requirements. We also use reinsurance to realize an arbitrage of premium rates, benefit from the availability of our reinsurers’ expertise, and benefit from the management of a profitable portfolio of insureds by way of enhanced analytical capacities. Our primary property line that is subject to catastrophic reinsurance is Homeowners Multiple Peril. FNIC cedes these risks to domestic and foreign reinsurance participants from Bermuda and Europe as well as to the FHCF.

In addition to reinsurance agreements, we also from time to time enter into retro-cessionary reinsurance agreements; each designed to shift financial responsibility based on predefined conditions. Generally, there are three separate kinds of reinsurance structures – quota share, excess of loss, and facultative, each considered either proportional or non-proportional. Our reinsurance structures are maintained to protect our insurance subsidiary against the severity of losses on individual claims or unusually serious occurrences in which the frequency and or the severity of claims produce an aggregate extraordinary loss from catastrophic events.

Although reinsurance does not discharge us from our primary obligation to pay for losses insured under the policies we issue, reinsurance does make the assuming reinsurer liable to the insurance subsidiary for the reinsured portion of the risk. A credit risk exposure exists with respect to ceded losses to the extent that any reinsurer is unable or unwilling to meet the obligations assumed under the reinsurance contracts. The collectability of reinsurance is subject to the solvency of the reinsurers, interpretation of contract language and other factors. A reinsurer’s insolvency or inability to make payments under the terms of a reinsurance contract could have a material adverse effect on our

results of operations and financial condition. Our reinsurance structure has significant risks, including the fact that the FHCF may not be able to raise sufficient money to pay its claims or impair its ability to pay its claims in a timely manner. This could result in significant financial, legal and operational challenges to all property and casualty companies associated with FHCF, including our company.

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The availability and costs associated with the acquisition of reinsurance will vary year to year. These fluctuations, which can be significant, are not subject to our control and may limit our ability to purchase adequate coverage. For example, FHCF continues to restrict its reinsurance capacity and is expected to continue constricting capacity for future seasons. This gradual restriction is requiring us to replace that capacity with more expensive private market reinsurance. Our reinsurance program is subject to approval by the Florida OIR and review by Demotech, Inc. (“Demotech”). The recovery of increased reinsurance costs through rate action is not immediate and cannot be presumed and is subject to Florida OIR approval.

For the 2012–2013 hurricane season, the excess of loss and FHCF treaties insured the property lines for approximately \$328.3 million of aggregate catastrophic losses and LAE with a maximum single event coverage totaling approximately \$246.5 million, with the Company retaining the first \$8.0 million of losses and LAE for each event. The reinsurance program includes coverage purchased from the private market, which affords optional reinstatement premium protection that provides coverage beyond the first event, along with any remaining coverage from the FHCF. Coverage afforded by the FHCF totals approximately \$144.7 million, or 44.1% of the \$328.3 million of aggregate catastrophic losses and LAE. The FHCF affords coverage for the entire season, subject to maximum payouts, without regard to any particular insurable event.

The estimated cost to the Company for the excess of loss reinsurance products for the 2012-2013 hurricane season, inclusive of approximately \$9.6 million payable to the FHCF and the prepaid automatic premium reinstatement protection, is approximately \$41.6 million.

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## Federated National Holding Company

## Notes to Condensed Consolidated Financial Statements

The 2012-2013 private reinsurance companies and their respective A.M. Best Company (“A.M. Best”) and S&P ratings are listed in the table as follows.

| Reinsurer   | A.M. Best Rating | S&P Rating |
|---|------------------|------------|
| <b>UNITED STATES</b>  |                  |            |
| American Agricultural Insurance Company   | A-               | NR         |
| Everest Reinsurance Company   | A+               | A+         |
| Houston Casualty Company, (UK Branch)   | A+ *             | AA         |
| Munich Reinsurance America, Inc.  | A+               | AA-        |
| Odyssey Reinsurance Company   | A                | A-         |
| <b>BERMUDA</b>  |                  |            |
| ACE Tempest Reinsurance Limited   | A+ *             | AA-        |
| Arch Reinsurance Limited  | A+ *             | A+         |
| Ariel Reinsurance Bermuda Limited for and on<br>Behalf of Ariel Syndicate 1910 (ARE)                | A- *             | NR         |
| DaVinci Reinsurance Limited   | A *              | A+         |
| JC Re Limited (Juniperus & fka Actua Re<br>Limited)   | NR *             | ** NR      |
| Montpelier Reinsurance Limited  | A-               | A-         |
| Nephila (via Allianz Risk Transfer AG,<br>Bermuda Branch)   | NR               | AA-        |
| Platinum Underwriters Bermuda Limited   | A *              | A-         |
| Renaissance Reinsurance Limited   | A+ *             | AA-        |
| <b>UNITED KINGDOM</b>   |                  |            |
| Amlin Syndicate No. 2001 (AML)  | A                | A+         |
| Ariel Syndicate No. 1910 (ARE)  | A *              | A+         |
| ARK Syndicate No. 3902 (NOA)  | A                | A+         |
| Barbican Syndication No. 1955 (BAR)   | A                | A+         |
| Kiln Syndicate No. 510 (KLN)  | A                | A+         |
| Liberty Syndicates Services Limited Paris, for and on Behalf of<br>Lloyd's Syndicate No. 4472 (LIB) | NR               | A+         |
| MAP Underwriting Syndicate No. 2791<br>(Parallel) (MAP)   | A                | A+         |
| Novae Syndicate No. 2007 (NVA)  | A                | A+         |
| Tokio Marine Kiln Syndicate No. 1880 (TMK)  | A                | A+         |
| Torus Syndicate No. 1301 (TUL)  | A                | A+         |
| <b>EUROPE</b>   |                  |            |
| Amlin Bermuda (Branch of Amlin AG)  | A                | A          |
| Flagstone Reassurance Suisse SA   | A-               | NR         |
| SCOR Global P&C Zurich Branch   | A                | A          |

\* Reinstatement Premium Protection Program  
Participants

\*\* Participant will fund a trust agreement for their exposure with cash and U.S. Government obligations of American institutions at fair market value.

For the 2011–2012 hurricane season, the excess of loss and FHCF treaties insured the property lines for approximately \$298.0 million of aggregate catastrophic losses and LAE with a maximum single event coverage totaling approximately \$226.0 million, with the Company retaining the first \$7.0 million of losses and LAE for each event. The reinsurance program included coverage purchased from the private market, which affords optional reinstatement premium protection that provides coverage beyond the first event, along with any remaining coverage from the FHCF. Coverage afforded by the FHCF totals approximately \$154.1 million, or 51.7% of the \$298.0 million of aggregate catastrophic losses and LAE. The FHCF affords coverage for the entire season, subject to maximum payouts, without regard to any particular insurable event.

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## Federated National Holding Company

## Notes to Condensed Consolidated Financial Statements

The estimated cost to the Company for the excess of loss reinsurance products for the 2011-2012 hurricane season, inclusive of approximately \$11.7 million payable to the FHCF and the prepaid automatic premium reinstatement protection, was approximately \$39.7 million.

The 2011-2012 private reinsurance companies and their respective A.M. Best and S&P ratings are listed in the table as follows.

| Reinsurer   | A.M. Best Rating | S&P Rating |
|---|------------------|------------|
| <b>UNITED STATES</b>  |                  |            |
| American Agricultural Insurance Company   | A-               | NR         |
| Everest Reinsurance Company   | A+               | A+         |
| Houston Casualty Company, (UK Branch)   | A+               | AA         |
| Munich Reinsurance America, Inc.  | A+               | AA-        |
| Odyssey Reinsurance Company   | A                | A-         |
| QBE Reinsurance Corporation   | A                | A+         |
| <b>BERMUDA</b>  |                  |            |
| ACE Tempest Reinsurance Limited   | A+ *             | A+         |
| Arch Reinsurance Limited  | A                | A+         |
| Ariel Reinsurance Company Limited, Bermuda  | A- *             | A-         |
| DaVinci Reinsurance Limited   | A *              | A+         |
| D.E. Shaw Re (Bermuda) Limited  | NR               | ** NR      |
| JC Re Ltd (Juniperus & fka Actua Re Limited)  | NR *             | ** NR      |
| Montpelier Reinsurance Limited  | A-               | A-         |
| Renaissance Reinsurance Limited   | A+ *             | AA-        |
| Torus Insurance (Bermuda) Limited   | A- *             | NR         |
| <b>UNITED KINGDOM</b>   |                  |            |
| Amlin Syndicate No. 2001 (AML)  | A *              | A+         |
| Antares Syndicate No. 1274 (AUL)  | A                | A+         |
| Arrow Syndicate No. 1910 (ARW)  | A *              | A+         |
| Broadgate Syndicate No. 1301 (BGT)  | A                | A+         |
| Liberty Syndicates Services Limited Paris, for and on Behalf of<br>Lloyd's Syndicate No. 4472 (LIB) | A                | A+         |
| MAP Underwriting Syndicate No. 2791 (MAP)   | A *              | A+         |
| Novae Syndicate No. 2007 (NVA)  | A                | A+         |
| <b>EUROPE</b>   |                  |            |
| Amlin Bermuda ( Branch of Amlin AG)   | A                | A          |
| Flagstone Reassurance Suisse SA   | A-               | NR         |
| Lansforsakringar Sak Forsakringsaktiebolag (publ)   | NR-5             | A          |
| SCOR Global P&C Zurich Branch   | A                | A          |

\* Reinstatement Premium Protection Program Participants

\*\* Participant will fund a trust agreement for their exposure with cash and U.S. Government obligations of American institutions at fair market value.



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Notes to Condensed Consolidated Financial Statements

Annually, the cost and amounts of reinsurance are based on management's analysis of FNIC's exposure to catastrophic risk as of June 30 and estimated to September 30. Our data is then subjected to actual exposure level analysis as of September 30. This analysis of our exposure level in relation to the total exposures to the FHCF and excess of loss treaties may produce changes in limits and reinsurance premiums as a result of the reconciliation of estimated to actual exposure level. The September 30, 2012 change to total limits was an increase of \$2.1 billion of total insured value or 12.6% and the change to reinsurance premiums was an increase of \$2.4 million or 3.0%. The September 30, 2011 change to total limits was an increase of \$63.1 million of probable maximum loss or 0.5% and the change to reinsurance premiums was an increase of \$3.7 million or 8.7%. These adjustments are amortized over the remaining underlying policy term. The September 30, 2011 change to total limits was an increase of \$172.2 million of total insured value or 1.4 % and the change to reinsurance premiums was an increase of \$0.5 million or 1.1%.

To date, we have made no claims asserted against our reinsurers in connection with the 2012–2013 and 2011–2012 excess of loss and FHCF treaties.

The quota share retrocessionaire reinsurance agreements require FNIC to securitize credit, regulatory and business risk. Fully funded trust agreements totaled \$4.7 million as of September 30, 2012 and December 31, 2011.

We are selective in choosing reinsurers and consider numerous factors, the most important of which are the financial stability of the reinsurer, their history of responding to claims and their overall reputation. In an effort to minimize our exposure to the insolvency of a reinsurer, we evaluate the acceptability and review the financial condition of the reinsurer at least annually.

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## (8)Unpaid losses and LAE

The liability for unpaid losses and LAE is determined on an individual-case basis for all incidents reported. The liability also includes amounts for unallocated expenses, anticipated future claim development and Incurred but Not Yet Reported (“IBNR”).

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

|                               | Nine<br>Months<br>Ended<br>September<br>30,<br>2012 | Year Ended<br>December 31,<br>2011 |
|-------------------------------|---|------------------------------------|
|                               | (Dollars in Thousands)                              |                                    |
| Balance at January 1          | \$59,983  | \$ 66,529                          |
| Less reinsurance recoverables | (2,088 )  | (6,810 )                           |
| Net balance at January 1      | \$57,895  | \$ 59,719                          |
| Incurred related to           |   |                                    |
| Current year                  | \$22,551  | \$ 31,893                          |
| Prior years                   | (1,638 )  | (997 )                             |
| Total incurred                | \$20,913  | \$ 30,896                          |
| Paid related to               |   |                                    |
| Current year                  | \$10,149  | \$ 13,672                          |
| Prior years                   | 19,687  | 19,048                             |
| Total paid                    | \$29,836  | \$ 32,720                          |
| Net balance at period end     | \$48,972  | \$ 57,895                          |
| Plus reinsurance recoverables | 2,205   | 2,088                              |
| Balance at period end         | \$51,177  | \$ 59,983                          |

Based upon consultations with our independent actuarial consultants, we believe that the liability for unpaid losses and LAE is adequate to cover all claims and related expenses which may arise from incidents reported.

As a result of our review of liability for losses and LAE, which includes a re-evaluation of the adequacy of reserve levels for prior year’s claims, we decreased the liability for losses and LAE for claims occurring in prior years by \$1.6 million for the nine months ended September 30, 2012 and \$1.0 million for the year ended December 31, 2011.

We continue to revise our estimates of the ultimate financial impact of claims made resulting from past storms. The revisions to our estimates are based on our analysis of subsequent information that we receive regarding various factors, including: (i) per claim information; (ii) Company and industry historical loss experience; (iii) legislative enactments, judicial decisions, legal developments in the awarding of damages, and (iv) trends in general economic conditions, including the effects of inflation.



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## Federated National Holding Company

## Notes to Condensed Consolidated Financial Statements

## (9) Stock Compensation Plans

In April 2012, our Board of Directors adopted, and in September 2012 our shareholders approved, the Company's 2012 Stock Incentive Plan (the "2012 Plan"). The 2012 Plan permits the issuance of up to 1,000,000 shares of our common stock, subject to adjustment as provided for in the 2012 Plan, in connection with the grant of a variety of equity incentive awards, such as incentive stock options, non-qualified stock options, stock appreciation rights, dividend equivalent rights, restricted stock, restricted stock units, and performance shares. Officers, directors and executive, managerial, administrative and professional employees of the Company and its subsidiaries are eligible to participate in the 2012 Plan. Awards may be granted singly, in combination, or in tandem. As of the date of this report, no awards have been granted under the 2012 Plan. The 2012 Plan will expire on April 5, 2022.

Our prior stock option plans, adopted in 1998 and 2002, have expired. A total of 817,800 options granted under those plans remain outstanding, as follows:

|              | Range of<br>Exercise Price | Outstanding at<br>September 30, 2012 | Weighted Average<br>Contractual<br>Periods in Years |
|--------------|----------------------------|--------------------------------------|---|
| 1998<br>Plan | \$8.67 - \$16.59           | 78,500                               | 0.97  |
| 2002<br>Plan | \$2.45 - \$18.21           | 739,300                              | 6.11  |

FASB issued guidance requires that when valuing an employee stock option under the Black-Scholes option pricing model, the fair value be based on the option's expected term and expected volatility rather than the contractual term. The estimate of the fair value on the grant date should reflect the assumptions marketplace participants now use on the date of the measurement (i.e. grant date). During 2011, management changed the expected term in the Black-Scholes option pricing model from four years to two years for new options granted. Management believes that share price volatility over the last two years is more indicative of future share price volatility. The change has had an immaterial impact on the financial statements.

Activity in our stock option plans for the period from January 1, 2010 to September 30, 2012 is summarized below.

|                                | 1998 Plan           |  | 2002 Plan           |  |
|--------------------------------|---------------------|--|---------------------|--|
|                                | Number of<br>Shares | Weighted<br>Average<br>Option<br>Exercise<br>Price | Number of<br>Shares | Weighted<br>Average<br>Option<br>Exercise<br>Price |
| Outstanding at January 1, 2010 | 124,599             | \$15.88  | 736,951             | \$12.03  |
| Granted                        | -                   | \$-  | 109,500             | \$3.59   |
| Exercised                      | -                   | \$-  | -                   | \$-  |
| Cancelled                      | (34,849 )           | \$23.74  | (271,651 )          | \$14.78  |
| Outstanding at January 1, 2011 | 89,750              | \$12.83  | 574,800             | \$9.12   |
| Granted                        | -                   | \$-  | 179,000             | \$2.45   |
| Exercised                      | -                   | \$-  | -                   | \$-  |
| Cancelled                      | -                   | \$-  | (129,100 )          | \$14.29  |

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|                                   |           |         |           |         |
|-----------------------------------|-----------|---------|-----------|---------|
| Outstanding at January 1, 2012    | 89,750    | \$12.83 | 624,700   | \$6.15  |
| Granted                           | -         | \$-     | 181,500   | \$4.40  |
| Exercised                         | -         | \$-     | (4,834 )  | \$3.29  |
| Cancelled                         | (11,250 ) | \$13.54 | (62,066 ) | \$13.59 |
| Outstanding at September 30, 2012 | 78,500    | \$12.73 | 739,300   | \$5.11  |

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Options outstanding as of September 30, 2012 are exercisable as follows.

| Options Exercisable at:   | 1998 Plan        |  | 2002 Plan        |  |
|---------------------------|------------------|--|------------------|--|
|                           | Number of Shares | Weighted Average Option Exercise Price | Number of Shares | Weighted Average Option Exercise Price |
| September 30, 2012        | 70,800           | \$ 12.73                               | 335,461          | \$ 5.11                                |
| December 31, 2012         | 7,000            | \$ 12.73                               | 8,434            | \$ 5.11                                |
| December 31, 2013         | 700              | \$ 12.73                               | 167,724          | \$ 5.11                                |
| December 31, 2014         | -                | \$ -                                   | 148,381          | \$ 5.11                                |
| December 31, 2015         | -                | \$ -                                   | 79,300           | \$ 5.11                                |
| December 31, 2016         | -                | \$ -                                   | -                | \$ -                                   |
| Thereafter                | -                | \$ -                                   | -                | \$ -                                   |
| Total options exercisable | 78,500           |  | 739,300          |  |

Prior to January 1, 2006, we accounted for the plans under the recognition and measurement provisions of stock-based compensation using the intrinsic value method prescribed by the APB and related Interpretation, as permitted by FASB issued guidance. Under these provisions, no stock-based employee compensation cost was recognized in the Statement of Operations as all options granted under those plans had an exercise price equal to or less than the market value of the underlying common stock on the date of grant.

Upon the exercise of options, the Company issues authorized shares.

Effective January 1, 2006, the Company adopted the fair value recognition provisions of FASB issued guidance using the modified-prospective-transition method. Under that transition method, compensation costs recognized during 2012 and 2011 include the following.

- Compensation cost for all share-based payments granted prior to, but not yet vested as of January 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of FASB issued guidance, and
- Compensation cost for all share-based payments granted subsequent to January 1, 2006, based on the grant-date fair-value estimated in accordance with the provisions of FASB issued guidance. Results for prior periods have not been restated, as they are not required to be by the pronouncement.

As a result of adopting FASB issued guidance on January 1, 2006, the Company's income from continuing operations before provision for income tax expense and net income for the three months ended September 30, 2012 are lower by approximately \$73,000 and \$45,000, respectively, than if it had continued to account for share-based compensation under APB guidance.

As a result of adopting FASB issued guidance on January 1, 2006, the Company's income from continuing operations before provision for income tax expense and net income for the three months ended September 30, 2011 are lower by approximately \$61,000 and \$38,000, respectively, than if it had continued to account for share-based compensation under APB guidance.

As a result of adopting FASB issued guidance on January 1, 2006, the Company's income from continuing operations before provision for income tax expense and net income for the nine months ended September 30, 2012 are lower by approximately \$201,000 and \$125,000, respectively, than if it had continued to account for share-based compensation under APB guidance.

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## Federated National Holding Company

## Notes to Condensed Consolidated Financial Statements

As a result of adopting FASB issued guidance on January 1, 2006, the Company's loss from continuing operations before provision for income tax benefit and net loss for the nine months ended September 30, 2011 are higher by approximately \$178,000 and \$111,000, respectively, than if it had continued to account for share-based compensation under APB guidance.

Basic and diluted earnings per share for the three months ended September 30, 2012 would have been \$0.10, if the Company had not adopted FASB issued guidance, compared with reported basic and diluted earnings per share of \$0.09.

Basic and diluted earnings per share for the three months ended September 30, 2011 would have remained unchanged at \$0.5, if the Company had not adopted FASB issued guidance, compared with reported basic and diluted earnings per share of \$0.5.

Basic and diluted earnings per share for the nine months ended September 30, 2012 would have been \$0.42, if the Company had not adopted FASB issued guidance, compared with reported basic and diluted earnings per share of \$0.40.

Basic loss per share for the nine months ended September 30, 2011 would have been \$0.29, if the Company had not adopted FASB issued guidance, compared with reported basic loss per share of \$0.30. Diluted earnings per share are not computed on a reported loss.

Because the change in income taxes receivable includes the effect of excess tax benefits, those excess tax benefits also must be shown as a separate operating cash outflow so that operating cash flows exclude the effect of excess tax benefits. FASB issued guidance requires the cash flows resulting from the tax benefits resulting from tax deductions in excess of the compensation cost recognized for those options (excess tax benefits) to be classified as financing cash flows.

There were no options granted during the three months ended September 30, 2012, as compared with 178,000 during the three months ended September 30, 2011. There were 181,500 options granted during the three months ended June 30, 2012, as compared with none during the three months ended June 30, 2011. There were no options granted during the three months ended March 31, 2012 or 2011.

The fair value of options granted is estimated on the date of grant using the following assumptions.

|                          | September 30, 2012 | September 30, 2011 |
|--------------------------|--------------------|--------------------|
| Dividend yield           | N/A                | N/A                |
| Expected volatility      | 39.79%             | 39.08%             |
| Risk-free interest rate  | 0.28%              | 0.20%              |
| Expected life (in years) | 4.45               | 4.35               |

## (10) Stockholders' Equity

## Capital Stock

The Company's authorized capital consists of 1,000,000 shares of preferred stock, par value \$0.01 per share, and 25,000,000 shares of common stock, par value \$0.01 per share. As of September 30, 2012, there were no preferred



shares issued or outstanding and there were 7,951,218 shares of common stock outstanding.

(11)Subsequent Events

There were no subsequent events.

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General information about Federated National Holding Company can be found at [www.myFNIC.com](http://www.myFNIC.com); however, the information that can be accessed through our web site is not part of our report. We make our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to these reports filed or furnished pursuant to Section 13 or 15(d) of the Securities and Exchange Act of 1934 available free of charge on our web site, as soon as reasonably practicable after they are electronically filed with the SEC.

Item 2

Management's Discussion and Analysis of Financial Condition and Results of Operations

You should read the following discussion in conjunction with our condensed consolidated financial statements and related notes and information included under this Item 2 and elsewhere in this Quarterly Report on Form 10-Q and in our Annual Report on Form 10-K filed with the Securities and Exchange Commission ("SEC") on March 30, 2012 ("Form 10-K"). Unless the context requires otherwise, as used in this Form 10-Q, the terms "FNHC" "Company," "we," "us" and "our," refers to Federated National Holding Company and its subsidiaries. We changed our name on September 11, 2012, pursuant to approval received at our annual shareholders' meeting, from 21st Century Holding Company so that our parent company and other subsidiary companies names are consistent with our primary insurance subsidiary and the name under which we have been writing insurance for more than 20 years.

Forward-Looking Statements

Statements in this Quarterly Report on Form 10-Q for the three months ended September 30, 2012 ("Form 10-Q") or in documents that are incorporated by reference that are not historical fact are forward-looking statements that are subject to certain risks and uncertainties that could cause actual events and results to differ materially from those discussed herein. Without limiting the generality of the foregoing, words such as "may," "will," "expect," "believe," "anticipate," "intend," "could," "would," "estimate," or "continue" or the negative other variations thereof or comparative terminology are intended to identify forward-looking statements. The risks and uncertainties include, without limitation, uncertainties related to estimates, assumptions and projections relating to unpaid losses and loss adjustment expenses and other accounting policies, losses from the nine hurricanes that occurred in fiscal years 2005 and 2004 and in other estimates, assumptions and projections contained in this Form 10-Q; inflation and other changes in economic conditions (including changes in interest rates and financial markets); the impact of new regulations adopted in Florida which affect the property and casualty insurance market; the costs of reinsurance, assessments charged by various governmental agencies; pricing competition and other initiatives by competitors; our ability to obtain regulatory approval for requested rate changes and the timing thereof; legislative and regulatory developments; the outcome of various litigation matters pending against us, including the terms of any settlements; risks related to the nature of our business; dependence on investment income and the composition of our investment portfolio; the adequacy of our liability for loss and loss adjustment expense; insurance agents; claims experience; ratings by industry services; catastrophe losses; reliance on key personnel; weather conditions (including the severity and frequency of storms, hurricanes, tornadoes and hail); changes in driving patterns and loss trends; acts of war and terrorist activities; court decisions and trends in litigation and health care and auto repair costs; and other matters described from time to time by us in this report, and in our other filings with the SEC, including the Company's Form 10-K.

You are cautioned not to place reliance on these forward-looking statements, which are valid only as of the date they were made. The Company undertakes no obligation to update or revise any forward-looking statements to reflect new information or the occurrence of unanticipated events or otherwise. In addition, readers should be aware that

Generally Accepted Accounting Principles (“GAAP”) prescribes when a company may reserve for particular risks, including litigation exposures. Accordingly, results for a given reporting period could be significantly affected when a reserve is established for a major contingency. Reported results may therefore appear to be volatile in certain accounting periods.

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Overview

FNHC is an insurance holding company that controls substantially all steps in the insurance underwriting, distribution and claims processes through our subsidiaries and our contractual relationships with our independent agents and general agents.

We are authorized to underwrite, and/or place through our wholly owned subsidiaries, homeowners' multi-peril ("homeowners"), commercial general liability, personal and commercial automobile, allied lines and various other lines of insurance in Florida and various other states. We market and distribute our own and third-party insurers' products and our other services through a network of independent agents. We also utilize a select number of general agents for the same purpose.

Our primary insurance subsidiary is Federated National Insurance Company ("FNIC"). FNIC is licensed as an admitted carrier in Florida. An admitted carrier is an insurance company that has received a license from the state insurance regulator for authority to write specific lines of insurance in that state. Through contractual relationships with a network of approximately 3,000 independent agents, of which approximately 600 actively sell and service our products, FNIC is authorized to underwrite homeowners', commercial general liability, fire, allied lines and personal and commercial automobile insurance in Florida. FNIC is also licensed as an admitted carrier in Alabama, Louisiana, Georgia and Texas, and underwrites commercial general liability insurance in those states and personal automobile insurance in Georgia.

FNIC operated as a non-admitted carrier in Arkansas, California, Kentucky, Maryland, Missouri, Nevada, Oklahoma, South Carolina, Tennessee and Virginia, and could underwrite commercial general liability insurance in all of these states. A non-admitted carrier, sometimes referred to as a "excess and surplus lines" carrier, is permitted to do business in a state and, although it is strictly regulated to protect policyholders from a variety of illegal and unethical practices, including fraud, non-admitted carriers are subject to considerably less regulation with respect to policy rates and forms. Non-admitted carriers are not required to financially contribute to and benefit from the state guarantee fund, which is used to pay for losses if an insurance carrier becomes insolvent or unable to pay the losses due their policyholders.

Our executive offices are located at 14050 N.W. 14th Street, Suite 180, Sunrise, Florida 33323 and our telephone number is (954) 581-9993.

Merger of FNIC and American Vehicle

In January 2011, we merged FNIC and our other wholly owned insurance subsidiary, American Vehicle Insurance Company ("American Vehicle"), with FNIC, continuing the operations of both entities. In connection with this merger, the Company, FNIC and American Vehicle entered into a consent order with the Florida Office of Insurance Regulation ("Florida OIR") pursuant to which we agreed to certain restrictions on our business operations. See Footnote "(1) Organization and Business". References to the historical activities of American Vehicle are appropriately identified throughout this document.

Our Subsidiaries

During the three months ended September 30, 2012, 81.1%, 9.4%, 6.2% and 3.3% of the premiums we underwrote were for homeowners', commercial general liability, federal flood, and automobile insurance, respectively. During the

three months ended September 30, 2011, 76.8%, 13.3%, 7.1% and 2.8% of the premiums we underwrote were for homeowners', commercial general liability, federal flood, and personal automobile insurance, respectively.

During the nine months ended September 30, 2012, 84.6%, 8.2%, 4.6% and 2.6% of the premiums we underwrote were for homeowners', commercial general liability, federal flood, and automobile insurance, respectively. During the nine months ended September 30, 2011, 80.4%, 11.0%, 4.8% and 3.8% of the premiums we underwrote were for homeowners', commercial general liability, federal flood, and personal automobile insurance, respectively.

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Our business, results of operations and financial condition are subject to fluctuations due to a variety of factors. Abnormally high severity or frequency of claims in any period could have a material adverse effect on us. When our estimated liabilities for unpaid losses and loss adjustment expenses ("LAE") are less than the actuarially determined amounts, we increase the expense in the current period. Conversely, when our estimated liabilities for unpaid losses and LAE are greater than the actuarially determined amounts, we decrease the expense in the current period.

We are focusing our marketing efforts on continuing to expand our distribution network while maintaining our commitment to long-term relationships. We market our products and services throughout Florida and in other states by establishing relationships with additional independent agents and general agents. There can be no assurance, however, that we will be able to obtain the required regulatory approvals to offer additional insurance products or expand into other states.

Federated National Underwriters, Inc. ("FNU") formerly known as Assurance Managing General Agents, Inc., a wholly owned subsidiary of the Company, acts as FNIC's exclusive managing general agent in Florida and is also licensed as a managing general agent in the States of Alabama, Georgia, Illinois, Louisiana, North Carolina, Mississippi, Missouri, New York, Nevada, South Carolina, Texas and Virginia. FNU has contracted with several unaffiliated insurance companies to sell commercial general liability, workers compensation, personal umbrella, inland marine and other various lines of insurance through FNU existing network of agents.

FNU earns commissions and fees for providing policy administration, marketing, accounting and analytical services, and for participating in the negotiation of reinsurance contracts. FNU earns a \$25 per policy fee, and traditionally a 6% commission fee from its affiliate, FNIC. During the fourth quarter of 2010, FNU, pursuant to the Consent Order as discussed above, reduced its fee, to earn amounts varying between 2% and 4%, which we anticipate will return to 6% at an unknown future date with approval from the Florida OIR. A formal agreement reflecting this fee modification was executed during January 2011.

We internally process claims made by our insureds through our wholly owned claims adjusting company, Federated National Adjusting, Inc. ("FNA") formerly known as Superior Adjusting, Inc. Our agents have no authority to settle claims or otherwise exercise control over the claims process. Furthermore, we believe that the retention of independent adjusters, in addition to the employment of salaried claims personnel, results in reduced ultimate loss payments, lower LAE and improved customer service for our claimants and policyholders. We also employ an in-house legal department to cost-effectively manage claims-related litigation and to monitor our claims handling practices for efficiency and regulatory compliance.

Until June 2011, our wholly owned subsidiary, Federated Premium Finance, Inc. ("Federated Premium"), offered premium financing to our own and third-party insureds. Premium financing has been marketed through our distribution network of general agents and independent agents.

Insure-Link, Inc. ("Insure-Link") was formed in March 2008 to serve as an independent insurance agency. The insurance agency markets direct to the public to provide a variety of insurance products and services to individual clients, as well as business clients, by offering a full line of insurance products including, but not limited to, homeowners', flood, personal and commercial automobile, commercial general liability and workers' compensation insurance through their agency appointments with over fifty different carriers. Insure-Link intends to expand its business through marketing and by acquiring other insurance agencies. There were no other agency relationships with affiliated captive or franchised agents during 2011 or the nine months ended September 30, 2012.

Insurance Markets in Which We Operate

We operate in highly competitive markets and face competition from national, regional and residual market insurance companies in the homeowners', commercial general liability, and automobile markets. Our competitors include companies that market their products through agents, as well as companies that sell insurance directly to their customers. Large national writers may have certain competitive advantages over agency writers, including increased name recognition, increased loyalty of their customer base and reduced policy acquisition costs. We compete based on underwriting criteria, our distribution network and superior service to our agents and insureds. Although our pricing is inevitably influenced to some degree by that of our competitors, we believe that it is generally not in our best interest to compete solely on price.

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In Florida, more than 200 companies are authorized to underwrite homeowners' insurance. Several of our competitors include Citizens Property Insurance Corporation ("Citizens"), Universal Property and Casualty Insurance Company and St. Johns Insurance Company. In Florida, more than one dozen companies compete with us in the commercial general liability insurance market.

Significant competition also emerged because of fundamental changes made to the property and casualty insurance business in Florida, in recent years, which resulted in a multi-pronged approach to address the cost of residential property insurance in Florida. First, the law increased the capacity of reinsurance that stabilized the reinsurance market to the benefit of the insurance companies writing properties lines in Florida. Secondly, the law provided for rate relief to all policyholders. The law also authorized the state-owned insurance company, Citizens, which is free of many of the restraints on private carriers such as surplus, ratios, income taxes and reinsurance expense, to reduce its premium rates and begin competing against private insurers in the residential property insurance market and expands the authority of Citizens to write commercial insurance.

Critical Accounting Policies

See Note 3, "Summary of Significant Accounting Policies" in the Notes to the Company's condensed consolidated financial statements for the quarter ended September 30, 2012 included in Item 1 of this Quarterly Report on Form 10-Q for a discussion of the Company's critical accounting policies.

New Accounting Pronouncements

See Note 3, "Summary of Significant Accounting Policies" in the Notes to the Company's condensed consolidated financial statements for the quarter ended September 30, 2012 included in Item 1 of this Quarterly Report on Form 10-Q for a discussion of recent accounting pronouncements and their effect, if any, on the Company.

Analysis of Financial Condition

As of September 30, 2012 Compared with December 31, 2011

Total Investments

Total investments increased \$15.5 million, or 12.0%, to \$145.0 million as of September 30, 2012, compared with \$129.5 million as of December 31, 2011.

We account for our investment securities consistent with FASB issued guidance that requires our securities be classified into one of three categories: (i) held-to-maturity, (ii) trading securities or (iii) available-for-sale.

Investments classified as held-to-maturity include debt securities where the Company's intent and ability are to hold the investment until maturity and are carried at amortized cost without consideration to unrealized gains or losses. Investments classified as trading securities include debt and equity securities bought and held primarily for sale in the near term and are carried at fair value with unrealized holding gains and losses included in current period operations. Investments classified as available-for-sale include debt and equity securities that are not classified as held-to-maturity or as trading security investments and are carried at fair value with unrealized holding gains and losses excluded from earnings and reported as a separate component of shareholders' equity, namely "Other Comprehensive Income."



The debt and equity securities that are available-for-sale and carried at fair value represent 95% of total investments as of September 30, 2012, compared with 94% as of December 31, 2011.

We did not hold any trading investment securities during the nine months ended September 30, 2012.

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Below is a summary of net unrealized gains and losses as of September 30, 2012 and December 31, 2011, by category.

|  | Unrealized Gains and (Losses) |                      |
|--|-------------------------------|----------------------|
|  | September<br>30, 2012         | December 31,<br>2011 |
|  | (Dollars in Thousands)        |                      |
| Debt securities:                                     |                               |                      |
| United States government obligations and authorities | \$ 1,207                      | \$ 659               |
| Obligations of states and political subdivisions     | 173                           | 138                  |
| Corporate  | 4,214                         | 1,543                |
| International  | 88                            | 5                    |
|  | 5,682                         | 2,345                |
| Equity securities:                                   |                               |                      |
| Common stocks  | 1,928                         | (939)                |
| Total debt and equity securities                     | \$ 7,610                      | \$ 1,406             |

The net unrealized gain of \$7.6 million is inclusive of \$0.7 million of unrealized losses. The \$0.7 million of unrealized losses are primarily from equity securities.

The \$0.7 million of unrealized losses from equity securities are from common stocks and mutual funds held in diverse industries as of September 30, 2012. The Company evaluated the near-term prospects in relation to the severity and duration of the impairment. Based on this evaluation and the Company's ability and intent to hold these investments for a reasonable period of time sufficient for a forecasted recovery of fair value, the Company does not consider these investments to be other-than-temporarily impaired at September 30, 2012.

The FASB issued guidance also addresses the determination as to when an investment is considered impaired, whether that impairment is other-than-temporary, and the measurement of an impairment loss. The Company's policy for the valuation of temporarily impaired securities is to determine impairment based on the analysis of the following factors.

- rating downgrade or other credit event (e.g., failure to pay interest when due);
- length of time and the extent to which the fair value has been less than amortized cost;
- financial condition and near term prospects of the issuer, including any specific events which may influence the operations of the issuer such as changes in technology or discontinuance of a business segment;
  - prospects for the issuer's industry segment;
- intent and ability of the Company to retain the investment for a period of time sufficient to allow for anticipated recovery in market value;
  - historical volatility of the fair value of the security.

Pursuant to FASB issued guidance, the Company records the unrealized losses, net of estimated income taxes, that are associated with that part of our portfolio classified as available-for-sale through the shareholders' equity account titled "Other Comprehensive Income". Management periodically reviews the individual investments that comprise our portfolio in order to determine whether a decline in fair value below our cost either is other-than temporarily or permanently impaired. Factors used in such consideration include, but are not limited to, the extent and length of time over which the market value has been less than cost, the financial condition and near-term prospects of the issuer and our ability and intent to keep the investment for a period sufficient to allow for an anticipated recovery in market value.

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In reaching a conclusion that a security is either other-than-temporarily or permanently impaired we consider such factors as the timeliness and completeness of expected dividends, principal and interest payments, ratings from nationally recognized statistical rating organizations such as Standard and Poor's ("S&P") and Moody's Investors Service, Inc. ("Moody's"), as well as information released via the general media channels. In connection with this process, we have not charged net realized losses to operations during the three months ended September 30, 2012; in connection with this process we have charged \$44,000 of net realized investment losses to operations during the nine months ended September 30, 2012.

As of September 30, 2012 and December 31, 2011, respectively, all of our securities are in good standing and not impaired as defined by FASB issued guidance, except as noted above.

As of September 30, 2012 and December 31, 2011, approximately 86% of our investment portfolio was in debt instruments and 14% was in equity instruments. As of September 30, 2012, 64% of our debt portfolio was in diverse industries and 36% is in United States government bonds. As of September 30, 2012, approximately 87% of our equity holdings were in equities related to diverse industries and 13% were in mutual funds. As of December 31, 2011, 61% of our debt portfolio was in diverse industries and 39% is in United States government bonds. As of December 31, 2011, approximately 83% of our equity holdings were in equities related to diverse industries and 17% were in mutual funds.

As of September 30, 2012 and December 31, 2011, we have classified \$7.5 million and \$7.1 million, respectively, of our bond portfolio as held-to-maturity. We only classify bonds as held-to-maturity to support securitization of credit requirements. Fully funded trust agreements used for such purposes totaled \$4.7 million as of September 30, 2012 and \$4.6 million as of December 31, 2011.

During the three and nine months ended September 30, 2012 and 2011, respectively, we did not re-classify any of our bond portfolio between available-for-sale and held-to-maturity.

The following table summarizes, by type, our investments as of September 30, 2012 and December 31, 2011.

|  | September 30, 2012     |                     | December 31, 2011 |                    |                     |
|--|------------------------|---------------------|-------------------|--------------------|---------------------|
|  | Carrying<br>Amount     | Percent<br>of Total |                   | Carrying<br>Amount | Percent<br>of Total |
|  | (Dollars in Thousands) |                     |                   |                    |                     |
| Debt securities, at market:                          |                        |                     |                   |                    |                     |
| United States government obligations and authorities | \$37,928               | 26.15               | %                 | \$37,217           | 28.75               |
| Obligations of states and political subdivisions     | 3,467                  | 2.39                | %                 | 2,303              | 1.77                |
| Corporate  | 72,836                 | 50.22               | %                 | 63,268             | 48.87               |
| International  | 2,275                  | 1.57                | %                 | 1,523              | 1.18                |
|  | 116,506                | 80.33               | %                 | 104,311            | 80.57               |
| Debt securities, at amortized cost:                  |                        |                     |                   |                    |                     |
| Corporate  | 1,328                  | 0.92                | %                 | 962                | 0.74                |
| United States government obligations and authorities | 6,127                  | 4.22                | %                 | 6,166              | 4.76                |
|  | 7,455                  | 5.14                | %                 | 7,128              | 5.50                |
| Total debt securities                                | 123,961                | 85.47               | %                 | 111,439            | 86.07               |
| Equity securities, at market:                        | 21,070                 | 14.53               | %                 | 18,028             | 13.93               |

|                   |           |        |   |           |        |   |
|-------------------|-----------|--------|---|-----------|--------|---|
| Total investments | \$145,031 | 100.00 | % | \$129,467 | 100.00 | % |
|-------------------|-----------|--------|---|-----------|--------|---|

Cash and Short-Term Investments

Cash and short-term investments, which include cash, certificates of deposits, and money market accounts, decreased \$4.3 million, or 28.1%, to \$10.9 million as of September 30, 2012, compared with \$15.2 million as of December 31, 2011. Cash and short-term investments decreased primarily due to the purchase of securities and the payment of reinsurance.

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Prepaid Reinsurance Premiums

Prepaid reinsurance premiums decreased \$2.9 million, or 35.4%, to \$5.4 million as of September 30, 2012, compared with \$8.3 million as of December 31, 2011. The change is due to \$16.1 million of ceded premiums, net of payments to reinsurers, offset by \$13.2 million amortization of prepaid reinsurance premiums associated with our reinsurance programs. We believe concentrations of credit risk associated with our prepaid reinsurance premiums are not significant.

Premiums Receivable, Net of Allowance for Credit Losses

Premiums receivable, net of allowance for credit losses, increased \$2.5 million, or 44.9%, to \$8.1 million as of September 30, 2012, compared with \$5.6 million as of December 31, 2011. Our homeowners' insurance premiums receivable increased \$2.0 million, or 51.3%, to \$5.7 million as of September 30, 2012, compared with \$3.7 million as of December 31, 2011. Our commercial general liability insurance premiums receivable decreased \$0.3 million, or 21.1%, to \$0.9 million as of September 30, 2012, compared with \$1.2 million as of December 31, 2011. Premiums receivable in connection with our automobile line of business increased \$0.8 million, or 109.9%, to \$1.6 million as of September 30, 2012, compared with \$0.8 million as of December 31, 2011. Our allowance for credit losses remained unchanged at \$0.1 million as of September 30, 2012, compared with \$0.1 million as of December 31, 2011.

Reinsurance Recoverable, Net

Reinsurance recoverable, net, increased \$0.1 million, or 5.6%, to \$2.2 million as of September 30, 2012, compared with \$2.1 million as of December 31, 2011. The change is due to the payment patterns by our reinsurers, as influenced by catastrophe related claims. All amounts are current and deemed collectable. We believe concentrations of credit risk associated with our reinsurance recoverables, net, are not significant.

Deferred Policy Acquisition Costs ("DPAC")

DPAC increased \$0.8 million, or 9.9%, to \$8.5 million as of September 30, 2012, compared with \$7.7 million as of December 31, 2011. The change is due primarily to the increase in unearned premiums.

Deferred Income Taxes, Net

Deferred income taxes, net, decreased \$4.1 million, or 48.0%, to \$4.5 million as of September 30, 2012, compared with \$8.6 million as of December 31, 2011. Deferred income taxes, net, is comprised of approximately \$6.7 million and \$10.6 million of deferred tax assets, net of approximately \$2.2 million and \$2.0 million of deferred tax liabilities as of September 30, 2012 and December 31, 2011. The change in the net deferred tax asset is primarily due to the decrease in the deferred tax assets related to our available-for-sale portfolio, discount on liability for unpaid losses and net operating loss carry forward.

Other Assets

Other assets decreased \$0.4 million, or 19.8%, to \$1.7 million as of September 30, 2012, compared with \$2.1 million as of December 31, 2011. Major components of other assets are shown in the following table; the accrued interest income receivable is primarily investment related.

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September      December 31,  
30, 2012      2011  
(Dollars in Thousands)

|                                    |         |          |
|------------------------------------|---------|----------|
| Accrued interest income receivable | \$984   | \$ 1,130 |
| Deposits                           | 148     | 185      |
| Prepaid expenses                   | 381     | 432      |
| Other                              | 166     | 347      |
| Total                              | \$1,679 | \$ 2,094 |

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## Unpaid Losses and LAE

Unpaid losses and LAE decreased \$8.8 million, or 14.7%, to \$51.2 million as of September 30, 2012, compared with \$60.0 million as of December 31, 2011. The composition of unpaid losses and LAE by product line is as follows.

|                              | September 30, 2012     |          |          | December 31, 2011      |          |          |
|------------------------------|------------------------|----------|----------|------------------------|----------|----------|
|                              | Case                   | Bulk     | Total    | Case                   | Bulk     | Total    |
|                              | (Dollars in Thousands) |          |          | (Dollars in Thousands) |          |          |
| Homeowners'                  | \$8,674                | \$7,237  | \$15,911 | \$8,795                | \$10,652 | \$19,447 |
| Commercial General Liability | 4,114                  | 22,315   | 26,429   | 4,225                  | 27,717   | 31,942   |
| Automobile                   | 3,673                  | 5,164    | 8,837    | 3,533                  | 5,061    | 8,594    |
| Total                        | \$16,461               | \$34,716 | \$51,177 | \$16,553               | \$43,430 | \$59,983 |

Please See "Results of Operations - Three Months Ended September 30, 2012 Compared with Three Months Ended September 30, 2011 - Losses and LAE" for a description of the factors that affect unpaid losses and LAE and management's revised processes to its estimates based on the results of its analysis of the Company's claim and loss history and expectations.

## Unearned Premium

Unearned premiums increased \$11.0 million, or 22.9%, to \$58.9 million as of September 30, 2012, compared with \$47.9 million as of December 31, 2011. The change was due to a \$10.1 million increase in unearned homeowners' insurance premiums, a \$0.6 million increase in unearned flood insurance premiums, a \$0.2 million increase in unearned commercial general liability premiums, and a \$0.1 million increase in unearned automobile insurance premiums. Generally, as is in this case, an increase in unearned premium directly relates to an increase in written premium on a rolling twelve-month basis. Competition could negatively affect our unearned premium.

## Premium Deposits and Customer Credit Balances

Premium deposits and customer credit balances decreased \$0.7 million, or 26.7%, to \$2.1 million as of September 30, 2012, compared with \$2.8 million as of December 31, 2011. Premium deposits are monies received on policies not yet in-force as of September 30, 2012.

## Bank Overdraft

Bank overdraft decreased \$1.7 million, or 21.5 %, to \$6.2 million as of September 30, 2012, compared with \$7.9 million as of December 31, 2011. The bank overdraft relates primarily to losses and LAE disbursements paid but not presented for payment by the policyholder or vendor. The change relates to the timing of presentation of claims checks to the issuing bank.

## Accounts Payable and Accrued Expenses

Accounts payable and accrued expenses increased \$0.2 million, or 6.8%, to \$3.3 million as of September 30, 2012, compared with \$3.1 million as of December 31, 2011. The change from prior year is primarily due an increase in premium taxes payable.





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## Results of Operations

Three Months Ended September 30, 2012 Compared with Three Months Ended September 30, 2011

Effective January 26, 2011, FNIC merged with and into American Vehicle, and the resulting entity changed its name to "Federated National Insurance Company".

## Gross Premiums Written

Gross premiums written increased \$7.6 million, or 43.5%, to \$25.3 million for the three months ended September 30, 2012, compared with \$17.7 million for the three months ended September 30, 2011. The following table denotes gross premiums written by major product line.

|                              | Three Months Ended September 30, |            |      |          |            |
|------------------------------|----------------------------------|------------|------|----------|------------|
|                              | 2012                             |            | 2011 |          |            |
|                              | (Dollars in Thousands)           |            |      |          |            |
|                              | Amount                           | Percentage |      | Amount   | Percentage |
| Homeowners'                  | \$20,564                         | 81.16 %    |      | \$13,555 | 76.78 %    |
| Commercial General Liability | 2,377                            | 9.38 %     |      | 2,352    | 13.32 %    |
| Federal Flood                | 1,559                            | 6.15 %     |      | 1,260    | 7.14 %     |
| Automobile                   | 838                              | 3.31 %     |      | 487      | 2.76 %     |
| Gross written premiums       | \$25,338                         | 100.00 %   |      | \$17,654 | 100.00 %   |

The Company's increase in the sale of homeowners' policies by \$7.0 million, or 51.7%, to \$20.6 million for the three months ended September 30, 2012, compared with \$13.6 million for the three months ended September 30, 2011, is gross of reinsurance costs and net of Florida's mandated homeowners' wind mitigation discounts. Our number of in-force homeowners' policies increased by approximately 4,700 or 9.0%, to approximately 57,600 as of September 30, 2012, compared with approximately 52,900 as of September 30, 2011. This increase is due to increased marketing efforts and a change in our underwriting process.

We continue to offer premium discounts for wind mitigation efforts by policyholders, as required by Florida law. These discounts have had a significant effect on both written and earned premium. During the three months ended September 30, 2012 and 2011, the change to the cumulative wind mitigation credits afforded our policyholders totaled 6.3 million and \$1.8 million, respectively. As of September 30, 2012, 70.5% of our in-force homeowners' policyholders were receiving wind mitigation credits totaling approximately \$52.2 million (a 34.8% reduction of in-force premium), while 62.0% of our in-force homeowners' policyholders were receiving wind mitigation credits totaling approximately \$28.1 million, (a 26.8% reduction of in-force premium), as of September 30, 2011.

We are required to report write-your-own flood premiums on a direct and 100% ceded basis.

The Company's sale of commercial general liability policies remained unchanged at \$2.4 million for the three months ended September 30, 2012, compared with \$2.4 million for the three months ended September 30, 2011.

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The following table sets forth the amounts and percentages of our gross premiums written in connection with our commercial general liability program by state.

| State     | Three Months Ended September 30, |            |   |         |            |   |
|-----------|----------------------------------|------------|---|---------|------------|---|
|           | 2012                             |            |   | 2011    |            |   |
|           | Amount                           | Percentage |   | Amount  | Percentage |   |
|           | (Dollars in Thousands)           |            |   |         |            |   |
| Alabama   | \$8                              | 0.34       | % | \$6     | 0.26       | % |
| Florida   | 2,184                            | 91.88      | % | 1,999   | 84.99      | % |
| Louisiana | 72                               | 3.03       | % | 226     | 9.61       | % |
| Texas     | 113                              | 4.75       | % | 121     | 5.14       | % |
| Total     | \$2,377                          | 100.00     | % | \$2,352 | 100.00     | % |

The Company's sale of auto insurance policies increased \$0.3 million, or 72.0%, to \$0.8 million for the three months ended September 30, 2012, compared with \$0.5 million for the three months ended September 30, 2011.

We are currently rated by Demotech, Inc. ("Demotech") as "A" ("Exceptional"), which is the third of seven ratings, and defined as "Regardless of the severity of a general economic downturn or deterioration in the insurance cycle, insurers earning a Financial Stability Rating ("FSR") of "A" possess "Exceptional" financial stability related to maintaining surplus as regards to policyholders". Demotech's ratings are based upon factors of concern to agents, reinsurers and policyholders and are not primarily directed toward the protection of investors. Our Demotech rating could be jeopardized by factors including adverse development and various surplus related ratio exceptions.

The withdrawal of our ratings could limit or prevent us from writing or renewing desirable insurance policies, from competing with insurers who have higher ratings, from obtaining adequate reinsurance, or from borrowing on a line of credit. The withdrawal of our ratings could have a material adverse effect on the Company's results of operations and financial position because the Company's insurance products might no longer be acceptable to the secondary marketplace and mortgage lenders. Furthermore, a withdrawal of our ratings could prevent independent agents from selling and servicing our insurance products.

#### Gross Premiums Ceded

Gross premiums ceded increased \$6.0 million, or 20.5%, to \$35.7 million for the three months ended September 30, 2012, compared with \$29.7 million for the three months ended September 30, 2011. Gross premiums ceded relating to our homeowners', write-your-own flood, commercial general liability and automobile programs totaled \$33.6 million, \$1.6 million, \$0.1 million and \$0.4 million for the three months ended September 30, 2012, respectively. Gross premiums ceded relating to our homeowners', write-your-own flood and automobile programs totaled \$28.0 million, \$1.3 million and \$0.4 million for the three months ended September 30, 2011, respectively.

#### Increase in Prepaid Reinsurance Premiums

The increase in prepaid reinsurance premiums was \$22.8 million for the three months ended September 30, 2012, compared with an \$18.0 million increase for the three months ended September 30, 2011. The increased charge to written premium is associated with the timing of our reinsurance payments measured against the term of the underlying reinsurance policies.

#### Decrease in Unearned Premiums

The decrease in unearned premiums was \$2.7 million for the three months ended September 30, 2012, compared with \$6.9 million for the three months ended September 30, 2011. The decreased benefit to written premium was due to a \$3.0 million decrease in unearned homeowners' insurance premiums, a \$0.3 million increase in unearned flood premiums, a less than \$0.1 million decrease in unearned commercial general liability premiums, and a \$0.1 million increase in unearned automobile premiums during the three months ended September 30, 2012. These changes are a result of differences in written premium volume during this period as compared with the same period last year. See "Gross Premiums Written" above.

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## Net Premiums Earned

Net premiums earned increased \$2.2 million, or 17.0%, to \$15.1 million for the three months ended September 30, 2012, compared with \$12.9 million for the three months ended September 30, 2011. The following table denotes net premiums earned by product line.

|                              | Three Months Ended September 30, |            | 2012   |            | 2011   |            |
|------------------------------|----------------------------------|------------|--------|------------|--------|------------|
|                              | Amount                           | Percentage | Amount | Percentage | Amount | Percentage |
| (Dollars in Thousands)       |                                  |            |        |            |        |            |
| Homeowners'                  | \$12,558                         | 83.24      | %      | \$9,773    | 75.81  | %          |
| Commercial General Liability | 2,292                            | 15.19      | %      | 2,607      | 20.22  | %          |
| Automobile                   | 238                              | 1.57       | %      | 512        | 3.97   | %          |
| Net premiums earned          | \$15,088                         | 100.00     | %      | \$12,892   | 100.00 | %          |

The \$2.8 million increase in homeowners' net premiums earned is due to a \$7.0 million increase in gross written premium, a \$5.7 million increase in gross premiums ceded and a \$1.5 million increase in the net change to prepaid reinsurance premiums and unearned premium.

The \$0.3 million decrease in commercial general liability net premiums earned is a result of a corresponding decrease to unearned premium, while the \$0.3 million decrease in automobile net premiums earned is a result of a corresponding decrease in gross written premium.

## Commission Income

Commission income increased \$0.1 million, or 57.7%, to \$0.4 million for the three months ended September 30, 2012, compared with \$0.3 million for the three months ended September 30, 2011. The primary sources of our commission income are our managing general agent services, write-your-own flood premiums and our independent insurance agency, Insure-Link.

## Net Investment Income

Net investment income remained unchanged at \$1.0 million for the three months ended September 30, 2012, compared with \$1.0 million for the three months ended September 30, 2011.

Our investment yields, net and gross of investment expenses, excluding equities and including cash, were 2.4% and 2.7%, respectively, for the three months ended September 30, 2012. Our investment yield, net and gross of investment expenses, excluding equities and including cash, were 2.8% and 3.1%, respectively, for the three months ended September 30, 2011.

Our investment yield, net and gross of investment expenses measured against debt securities, excluding equities and cash, were 2.5% and 2.8%, respectively, for the three months ended September 30, 2012. Our investment yield, net and gross of investment expenses measured against debt securities, excluding equities and cash, were 3.1% and 3.4%, respectively, for the three months ended September 30, 2011.

See also “Analysis of Financial Condition as of September 30, 2012 Compared with December 31, 2011 – Investments” for a further discussion on our investment portfolio.

#### Net Realized Investment Gains

Net realized investment gains totaled \$0.1 million for the three months ended September 30, 2012, compared with \$0.7 million during the three months ended September 30, 2011.

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FASB has issued guidance regarding when an investment is considered impaired, whether that impairment is other-than temporary, and the measurement of an impairment loss. Management periodically reviews the individual investments that comprise our portfolio in order to determine whether a decline in fair value below our cost is either other-than temporarily or permanently impaired. During the three months ended September 30, 2012 and September 30, 2011 respectively, pursuant to guidelines prescribed in FASB issued guidance, we did not mark any investments to market value pursuant to guidelines prescribed in FASB issued guidance.

The table below depicts the net realized investment gains by investment category during the three months ended September 30, 2012 and 2011.

|  | Three Months Ended September<br>30, |               |
|--|-------------------------------------|---------------|
|  | 2012                                | 2011          |
|  | (Dollars in Thousands)              |               |
| <b>Realized gains:</b>                   |                                     |               |
| Debt securities                          | \$ 410                              | \$ 620        |
| Equity securities                        | 145                                 | 273           |
| <b>Total realized gains</b>              | <b>555</b>                          | <b>893</b>    |
| <b>Realized losses:</b>                  |                                     |               |
| Debt securities                          | (56 )                               | (10 )         |
| Equity securities                        | (354 )                              | (170 )        |
| <b>Total realized losses</b>             | <b>(410 )</b>                       | <b>(180 )</b> |
| <b>Net realized gains on investments</b> | <b>\$ 145</b>                       | <b>\$ 713</b> |

#### Losses and LAE

Losses and LAE, our most significant expense, represent actual payments made and changes in estimated future payments to be made to or on behalf of our policyholders, including expenses required to settle claims and losses. We revise our estimates based on the results of analysis of estimated future payments to be made. This process assumes that experience, adjusted for the effects of current developments and anticipated trends, is an appropriate basis for predicting future events.

Losses and LAE increased by \$0.1 million, or 2.5%, to \$8.0 million for the three months ended September 30, 2012, compared with \$7.9 million for the three months ended September 30, 2011. The overall change includes a \$1.2 million increase in our homeowners' program, a \$0.5 million decrease in our commercial general liability program and a \$0.6 million decrease in connection with our automobile program.

We continue to revise our estimates of the ultimate financial impact of claims made resulting from past storms. The revisions to our estimates are based on our analysis of subsequent information that we receive regarding various factors, including: (i) per claim information; (ii) Company and industry historical loss experience; (iii) legislative enactments, judicial decisions, legal developments in the awarding of damages, and (iv) trends in general economic conditions, including the effects of inflation.

The composition of unpaid losses and LAE by product line is as follows.

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|                              | September 30, 2012     |          |          | December 31, 2011      |          |          |
|------------------------------|------------------------|----------|----------|------------------------|----------|----------|
|                              | Case                   | Bulk     | Total    | Case                   | Bulk     | Total    |
|                              | (Dollars in Thousands) |          |          | (Dollars in Thousands) |          |          |
| Homeowners'                  | \$8,674                | \$7,237  | \$15,911 | \$8,795                | \$10,652 | \$19,447 |
| Commercial General Liability | 4,114                  | 22,315   | 26,429   | 4,225                  | 27,717   | 31,942   |
| Automobile                   | 3,673                  | 5,164    | 8,837    | 3,533                  | 5,061    | 8,594    |
| Total                        | \$16,461               | \$34,716 | \$51,177 | \$16,553               | \$43,430 | \$59,983 |



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Factors that affect unpaid losses and LAE include the estimates made on a claim-by-claim basis known as “case reserves” coupled with bulk estimates known as Incurred but Not Yet Reported (“IBNR”). Periodic estimates by management of the ultimate costs required to settle all claim files are based on the Company’s analysis of historical data and estimations of the impact of numerous factors such as (i) per claim information; (ii) Company and industry historical loss experience; (iii) legislative enactments, judicial decisions, legal developments in the awarding of damages, and changes in political attitudes; and (iv) trends in general economic conditions, including the effects of inflation. Other factors influencing the unpaid loss and LAE balance include improved underwriting processes and claim settling techniques.

Management revises its estimates based on the results of its analysis. This process assumes that experience, adjusted for the effects of current developments and anticipated trends, is an appropriate basis for estimating the ultimate settlement of all claims. There is no precise method for subsequently evaluating the impact of any specific factor on the adequacy of the reserves, because the eventual redundancy or deficiency is affected by multiple factors. Because of our process, reserves were decreased by approximately \$1.8 million during the three months ended September 30, 2012. This overall change includes a \$1.6 million decrease in reserves for our homeowners’ program, a \$0.5 million decrease in reserves for our commercial general liability program and a \$0.3 million increase in reserves for our automobile program.

In accordance with GAAP and as discussed above, our loss ratio is computed as losses and LAE divided by net premiums earned. A lower loss ratio generally results in higher operating income. Our loss ratio for the three months ended September 30, 2012 was 53.4% compared with 60.9% for the same period in 2011. The favorable decrease to our loss ratio is due to the \$0.1 million increase in losses and LAE measured against the \$2.2 million increase in net premium earned during the three months ended September 30, 2012 as compared with the same period in 2011.

The table below reflects the loss ratios by product line.

|                              | Three Months Ended September<br>30, |   |        |   |
|------------------------------|-------------------------------------|---|--------|---|
|                              | 2012                                |   | 2011   |   |
| Homeowners'                  | 48.18                               | % | 48.12  | % |
| Commercial General Liability | 59.50                               | % | 71.60  | % |
| Automobile                   | 267.01                              | % | 250.47 | % |
| All lines                    | 53.35                               | % | 60.91  | % |

#### Operating and Underwriting Expenses

Operating and underwriting expenses decreased \$0.3 million, or 9.9%, to \$2.0 million for the three months ended September 30, 2012, compared with \$2.3 million for the three months ended September 30, 2011. The decrease includes the reduction of professional accounting, actuarial and consulting service fees.

#### Salaries and Wages

Salaries and wages increased \$0.1 million, or 5.3%, to \$2.1 million for the three months ended September 30, 2012, compared with \$2.0 million for the three months ended September 30, 2011. The charge to operations for stock-based compensation, in accordance with FASB guidance, was approximately \$73,000 during the three months ended September 30, 2012 compared with approximately \$61,000 for the three months ended September 30, 2011.

Policy Acquisition Costs - Amortization

Policy acquisition costs - amortization, increased \$0.4 million, or 12.0%, to \$4.0 million for the three months ended September 30, 2012, compared with \$3.6 million for the three months ended September 30, 2011, which corresponds to the increase in net premiums earned during this same period.

Policy acquisition costs - amortization, consists of the actual policy acquisition costs, including commissions, payroll and premium taxes, less commissions earned on reinsurance ceded and policy fees earned.

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## Provision for Income Tax Expense

The provision for income tax expense was \$0.4 million for the three months ended September 30, 2012, compared with a \$0.1 million for the three months ended September 30, 2011. The effective rate for income taxes was 32.0% for the three months ended September 30, 2012, compared with 21.0% for the three months ended September 30, 2011. There were significant favorable permanent differences for the three months ended September 30, 2011 compared with the three months ended September 30, 2012, which resulted in a lower effective tax rate.

## Net Income

As a result of the foregoing, the Company's net income for the three months ended September 30, 2012 was \$0.8 million compared with \$0.4 million for the three months ended September 30, 2011.

## Results of Operations

Nine Months Ended September 30, 2012 Compared with Nine Months Ended September 30, 2011

Effective January 26, 2011, FNIC merged with and into American Vehicle, and the resulting entity changed its name to "Federated National Insurance Company".

## Gross Premiums Written

Gross premiums written increased \$16.9 million, or 23.2%, to \$89.7 million for the nine months ended September 30, 2012, compared with \$72.8 million for the nine months ended September 30, 2011. The following table denotes gross premiums written by major product line.

|                              | Nine Months Ended September 30, |            | 2012                   |            | 2011   |            |
|------------------------------|---------------------------------|------------|------------------------|------------|--------|------------|
|                              |                                 |            | (Dollars in Thousands) |            |        |            |
|                              | Amount                          | Percentage | Amount                 | Percentage | Amount | Percentage |
| Homeowners'                  | \$75,933                        | 84.67 %    | \$58,517               | 80.39 %    |        |            |
| Commercial General Liability | 7,330                           | 8.17 %     | 7,967                  | 10.94 %    |        |            |
| Federal Flood                | 4,090                           | 4.56 %     | 3,519                  | 4.83 %     |        |            |
| Automobile                   | 2,330                           | 2.60 %     | 2,797                  | 3.84 %     |        |            |
| Gross written premiums       | \$89,683                        | 100.00 %   | \$72,800               | 100.00 %   |        |            |

The Company's increase in the sale of homeowners' policies by \$17.4 million, or 29.8%, to \$75.9 million for the nine months ended September 30, 2012, compared with \$58.5 million for the nine months ended September 30, 2011, is gross of reinsurance costs and net of Florida's mandated homeowners' wind mitigation discounts. Our number of in-force homeowners' policies increased by approximately 13,800, or 31.5%, to approximately 57,600 as of September 30, 2012, as compared with approximately 43,800 as of December 31, 2011. This increase is due to increased marketing efforts and a change in our underwriting process.

We continue to offer premium discounts for wind mitigation efforts by policyholders, as required by Florida law. These discounts have had a significant effect on both written and earned premium. During the nine months ended September 30, 2012 and 2011, the change to the cumulative wind mitigation credits afforded our policyholders totaled

\$20.7 million and \$0.8 million, respectively. As of September 30, 2012, 70.5% of our in-force homeowners' policyholders were receiving wind mitigation credits totaling approximately \$52.2 million (a 34.8% reduction of in-force premium), while 62.0% of our in-force homeowners' policyholders were receiving wind mitigation credits totaling approximately \$28.1 million, (a 26.8% reduction of in-force premium), as of September 30, 2011.

We are required to report write-your-own flood premiums on a direct and 100% ceded basis.

The Company's sale of commercial general liability policies decreased by \$0.7 million, or 8.0%, to \$7.3 million for the nine months ended September 30, 2012, compared with \$8.0 million for the nine months ended September 30, 2011. The primary factor for this decrease has been the slowdown in the economy, which had a dramatic impact on the artisan contractor portfolio written by FNIC. Additional factors include improvements to our underwriting standards and our decision to restrict underwriting authority within specific commercial general liability classes and geographic areas.

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The following table sets forth the amounts and percentages of our gross premiums written in connection with our commercial general liability program by state.

| State      | Nine Months Ended      |            | 2011    |            |
|------------|------------------------|------------|---------|------------|
|            | 2012                   |            | 2011    |            |
|            | Amount                 | Percentage | Amount  | Percentage |
|            | (Dollars in Thousands) |            |         |            |
| Alabama    | \$41                   | 0.56 %     | \$33    | 0.41 %     |
| California | -                      | 0.00 %     | 5       | 0.06 %     |
| Florida    | 6,798                  | 92.74 %    | 6,767   | 84.94 %    |
| Louisiana  | 170                    | 2.32 %     | 745     | 9.35 %     |
| Oklahoma   | -                      | 0.00 %     | 2       | 0.03 %     |
| Texas      | 321                    | 4.38 %     | 415     | 5.21 %     |
| Total      | \$7,330                | 100.00 %   | \$7,967 | 100.00 %   |

The Company's sale of auto insurance policies decreased \$0.5 million, or 16.7%, to \$2.3 million for the nine months ended September 30, 2012, compared with \$2.8 million for the nine months ended September 30, 2011. The decrease is due to the Company's decision to not write new commercial automobile insurance policies during the current period.

We are currently rated by Demotech as "A" ("Exceptional"), which is the third of seven ratings, and defined as "Regardless of the severity of a general economic downturn or deterioration in the insurance cycle, insurers earning a FSR of "A" possess "Exceptional" financial stability related to maintaining surplus as regards to policyholders". Demotech's ratings are based upon factors of concern to agents, reinsurers and policyholders and are not primarily directed toward the protection of investors. Our Demotech rating could be jeopardized by factors including adverse development and various surplus related ratio exceptions.

The withdrawal of our ratings could limit or prevent us from writing or renewing desirable insurance policies, from competing with insurers who have higher ratings, from obtaining adequate reinsurance, or from borrowing on a line of credit. The withdrawal of our ratings could have a material adverse effect on the Company's results of operations and financial position because the Company's insurance products might no longer be acceptable to the secondary marketplace and mortgage lenders. Furthermore, a withdrawal of our ratings could prevent independent agents from selling and servicing our insurance products.

#### Gross Premiums Ceded

Gross premiums ceded increased \$4.6 million, or 10.4%, to \$49.3 million for the nine months ended September 30, 2012, compared with \$44.7 million for the nine months ended September 30, 2011. Gross premiums ceded relating to our homeowners', write-your-own flood, commercial general liability and automobile programs totaled \$43.2 million, \$4.1 million, \$0.4 million and \$1.6 million for the nine months ended September 30, 2012, respectively. Gross premiums ceded relating to our homeowners', write-your-own flood and automobile programs totaled \$40.0 million, \$3.5 million and \$1.2 million for the nine months ended September 30, 2011, respectively.

#### Increase in Prepaid Reinsurance Premiums

The increase in prepaid reinsurance premiums was \$13.2 million for the nine months ended September 30, 2012, compared with a \$7.4 million increase for the nine months ended September 30, 2011. The increased benefit to written premium is primarily associated with the timing of our homeowners' reinsurance payments measured against the term of the underlying reinsurance policies.

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**(Increase) Decrease in Unearned Premiums**

The increase in unearned premiums was \$11.0 million for the nine months ended September 30, 2012, compared with a \$0.2 million decrease for the nine months ended September 30, 2011. The increased charge to written premium was due to a \$10.1 million increase in unearned homeowners' insurance premiums, a \$0.6 million increase in unearned flood premiums, a \$0.2 million increase in unearned commercial general liability premiums, and a \$0.1 million increase in unearned automobile premiums during the nine months ended September 30, 2012. These changes are a result of differences in written premium volume during this period as compared with the same period last year. See "Gross Premiums Written" above.

**Net Premiums Earned**

Net premiums earned increased \$6.9 million, or 19.3%, to \$42.6 million for the nine months ended September 30, 2012, compared with \$35.7 million for the nine months ended September 30, 2011. The following table denotes net premiums earned by product line.

|                              | Nine Months Ended September 30, |            | 2011   |            |        |   |
|------------------------------|---------------------------------|------------|--------|------------|--------|---|
|                              | 2012                            | 2011       | Amount | Percentage |        |   |
|                              | Amount                          | Percentage | Amount | Percentage |        |   |
|                              | (Dollars in Thousands)          |            |        |            |        |   |
| Homeowners'                  | \$35,104                        | 82.40      | %      | \$26,169   | 73.31  | % |
| Commercial General Liability | 6,916                           | 16.24      | %      | 8,055      | 22.57  | % |
| Automobile                   | 580                             | 1.36       | %      | 1,472      | 4.12   | % |
| Net premiums earned          | \$42,600                        | 100.00     | %      | \$35,696   | 100.00 | % |

The \$8.9 million increase in homeowners' net premiums earned is due to a \$17.4 million increase in gross written premium, a \$3.2 million increase in gross premiums ceded and a \$5.3 million decrease in the net change to prepaid reinsurance premiums and unearned premium.

The \$1.2 million decrease in commercial general liability net premiums earned is a result of a \$0.7 million decrease in gross written premium, a \$0.4 million increase in gross premiums ceded and a \$0.1 million decrease in the net change to unearned premium.

The \$0.9 million decrease in automobile net premiums earned is a result of a \$0.5 million decrease in gross written premium and a \$0.4 million increase in gross premiums ceded.

**Commission Income**

Commission income increased \$0.2 million, or 28.2%, to \$1.1 million for the nine months ended September 30, 2012, compared with \$0.9 million for the nine months ended September 30, 2011. The primary sources of our commission income are our managing general agent services, write-your-own flood premiums and our independent insurance agency, Insure-Link.

**Net Investment Income**

Net investment income decreased \$0.3 million, or 6.7%, to \$2.8 million for the nine months ended September 30, 2012, compared with \$3.1 million for the nine months ended September 30, 2011.

Our investment yields, net and gross of investment expenses, excluding equities and including cash, were 2.5% and 2.7%, respectively, for the nine months ended September 30, 2012. Our investment yields, net and gross of investment expenses, excluding equities and including cash, were 2.9% and 3.1%, respectively, for the nine months ended September 30, 2011.



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Our investment yield, net and gross of investment expenses measured against debt securities, excluding equities and cash, were 2.8% and 2.9%, respectively, for the nine months ended September 30, 2012. Our investment yield, net and gross of investment expenses measured against debt securities, excluding equities and cash, were 3.2% and 3.4%, respectively, for the nine months ended September 30, 2011.

See also "Analysis of Financial Condition as of September 30, 2012 Compared with December 31, 2011 – Investments" for a further discussion on our investment portfolio.

#### Net Realized Investment (Losses) Gains

Net realized investment losses were \$0.1 million for the nine months ended September 30, 2012, compared with net realized gains of \$1.1 million for the nine months ended September 30, 2011.

FASB has issued guidance regarding when an investment is considered impaired, whether that impairment is other-than temporary, and the measurement of an impairment loss. Management periodically reviews the individual investments that comprise our portfolio in order to determine whether a decline in fair value below our cost is either other-than temporarily or permanently impaired. During the nine months ended September 30, 2012, pursuant to guidelines prescribed in FASB issued guidance, we have charged to operations realized investment losses of approximately \$44,000, while during the same period in 2011 we did not mark any investments to market value pursuant to guidelines prescribed in FASB issued guidance.

The table below depicts the net realized investment (losses) gains by investment category during the nine months ended September 30, 2012 and 2011.

|  | Nine Months Ended September<br>30, |          |
|--|------------------------------------|----------|
|  | 2012                               | 2011     |
|  | (Dollars in Thousands)             |          |
| Realized gains:                            |                                    |          |
| Debt securities                            | \$ 958                             | \$ 1,045 |
| Equity securities                          | 805                                | 1,010    |
| Total realized gains                       | 1,763                              | 2,055    |
| Realized losses:                           |                                    |          |
| Debt securities                            | (371 )                             | (442 )   |
| Equity securities                          | (1,475 )                           | (561 )   |
| Total realized losses                      | (1,846 )                           | (1,003 ) |
| Net realized (losses) gains on investments | \$ (83 )                           | \$ 1,052 |

#### Losses and LAE

Losses and LAE, our most significant expense, represent actual payments made and changes in estimated future payments to be made to or on behalf of our policyholders, including expenses required to settle claims and losses. We revise our estimates based on the results of analysis of estimated future payments to be made. This process assumes that experience, adjusted for the effects of current developments and anticipated trends, is an appropriate basis for predicting future events.

Losses and LAE decreased by \$3.2 million, or 13.3%, to \$20.9 million for the nine months ended September 30, 2012, compared with \$24.1 million for the nine months ended September 30, 2011. This is due primarily to a reassessment of our losses by line and increased underwriting procedures to manage our risks. The overall change includes a \$3.2 million increase in our homeowners' program, a \$4.7 million decrease in our commercial general liability program and a \$1.7 million decrease in connection with our automobile program. During the nine months ended September 30, 2012, we reallocated approximately \$2.7 million of IBNR reserves from commercial liability to private property lines. An estimated \$1.4 million of bulk reserves from private passenger automobile were released during this period.

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Federated National Holding Company  
Management's Discussion and Analysis of Financial Condition and Results of Operations

We continue to revise our estimates of the ultimate financial impact of claims made resulting from past storms. The revisions to our estimates are based on our analysis of subsequent information that we receive regarding various factors, including: (i) per claim information; (ii) Company and industry historical loss experience; (iii) legislative enactments, judicial decisions, legal developments in the awarding of damages, and (iv) trends in general economic conditions, including the effects of inflation.

The composition of unpaid losses and LAE by product line is as follows.

|                              | September 30, 2012     |          |          | December 31, 2011      |          |          |
|------------------------------|------------------------|----------|----------|------------------------|----------|----------|
|                              | Case                   | Bulk     | Total    | Case                   | Bulk     | Total    |
|                              | (Dollars in Thousands) |          |          | (Dollars in Thousands) |          |          |
| Homeowners'                  | \$8,674                | \$7,237  | \$15,911 | \$8,795                | \$10,652 | \$19,447 |
| Commercial General Liability | 4,114                  | 22,315   | 26,429   | 4,225                  | 27,717   | 31,942   |
| Automobile                   | 3,673                  | 5,164    | 8,837    | 3,533                  | 5,061    | 8,594    |
| Total                        | \$16,461               | \$34,716 | \$51,177 | \$16,553               | \$43,430 | \$59,983 |

Factors that affect unpaid losses and LAE include the estimates made on a claim-by-claim basis known as "case reserves" coupled with bulk estimates known as IBNR. Periodic estimates by management of the ultimate costs required to settle all claim files are based on the Company's analysis of historical data and estimations of the impact of numerous factors such as (i) per claim information; (ii) Company and industry historical loss experience; (iii) legislative enactments, judicial decisions, legal developments in the awarding of damages, and changes in political attitudes; and (iv) trends in general economic conditions, including the effects of inflation. Other factors influencing the unpaid loss and LAE balance include our claim severity for both the property and liability lines that do not appear to be materializing as planned, as well as improved underwriting processes and claim settling techniques.

Management revises its estimates based on the results of its analysis. This process assumes that experience, adjusted for the effects of current developments and anticipated trends, is an appropriate basis for estimating the ultimate settlement of all claims. There is no precise method for subsequently evaluating the impact of any specific factor on the adequacy of the reserves, because the eventual redundancy or deficiency is affected by multiple factors. Because of our process, reserves were decreased by approximately \$8.8 million during the nine months ended September 30, 2012. This overall change includes a \$3.5 million decrease in reserves for our homeowners' program, a \$5.5 million decrease in reserves for our commercial general liability program and a \$0.2 million increase in reserves for our automobile program. During the nine months ended September 30, 2012, we reallocated approximately \$2.7 million of IBNR reserves from commercial liability to private property lines. An estimated \$1.4 million of bulk reserves from private passenger automobile were released during this period. Decreases for unpaid loss and LAE reserves are typically primarily attributable to our payment patterns in connection with the settlement of claims for loss and LAE.

In accordance with GAAP and as discussed above, our loss ratio is computed as losses and LAE divided by net premiums earned. A lower loss ratio generally results in higher operating income. Our loss ratio for the nine months ended September 30, 2012 was 49.1% compared with 67.6% for the same period in 2011. The favorable decrease to our loss ratio is due to the \$3.2 million decrease in losses and LAE measured against the \$6.9 million increase in net premium earned during the nine months ended September 30, 2012 as compared with the same period in 2011.

The table below reflects the loss ratios by product line.

|                              | Nine Months Ended September |   |             |   |
|------------------------------|-----------------------------|---|-------------|---|
|                              | 2012                        |   | 30,<br>2011 |   |
| Homeowners'                  | 52.48                       | % | 58.19       | % |
| Commercial General Liability | 20.50                       | % | 76.00       | % |
| Automobile                   | 185.03                      | % | 187.93      | % |
| All lines                    | 49.09                       | % | 67.57       | % |

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Operating and Underwriting Expenses

Operating and underwriting expenses decreased \$0.7 million, or 9.3%, to \$6.8 million for the nine months ended September 30, 2012, compared with \$7.5 million for the nine months ended September 30, 2011. The decrease includes the reduction of professional accounting and consulting service fees.

Salaries and Wages

Salaries and wages increased \$0.2 million, or 3.7%, to \$6.3 million for the nine months ended September 30, 2012, compared with \$6.1 million for the nine months ended September 30, 2011. The charge to operations for stock-based compensation, in accordance with FASB guidance, was approximately \$201,000 during the nine months ended September 30, 2012 compared with approximately \$178,000 for the nine months ended September 30, 2011.

Policy Acquisition Costs - Amortization

Policy acquisition costs - amortization, increased \$0.2 million, or 1.9%, to \$9.7 million for the nine months ended September 30, 2012, compared with \$9.5 million for the nine months ended September 30, 2011, which corresponds to the increase in net premiums earned during this same period.

Policy acquisition costs - amortization, consists of the actual policy acquisition costs, including commissions, payroll and premium taxes, less commissions earned on reinsurance ceded and policy fees earned.

Provision for Income Tax Expense (Benefit)

The provision for income tax expense was \$1.8 million for the nine months ended September 30, 2012, compared with a \$1.4 million provision for income tax benefit for the nine months ended September 30, 2011. The effective rate for income taxes was 36.2% for the nine months ended September 30, 2012, compared with 36.4% for the nine months ended September 30, 2011.

Net Income (Loss)

As a result of the foregoing, the Company's net income for the nine months ended September 30, 2012 was \$3.2 million compared with a \$2.4 million net loss for the nine months ended September 30, 2011.

Liquidity and Capital Resources

During the nine months ended September 30, 2012, our primary sources of capital included proceeds from the sale of investment securities, increased unearned premiums, decreased prepaid reinsurance premiums, decreased deferred income tax expense, amortization of investment premium discount, net, decreased other assets, increased accounts payable and accrued expenses, depreciation and amortization and non-cash compensation. Additional sources of capital included net realized investment losses, a tax benefit related to non-cash compensation, non-cash impairment recognition, exercised stock options and an increased provision for uncollectible premiums receivable.

During the nine months ended September 30, 2012 and 2011, operations provided net operating cash flow of \$6.2 million and \$5.0 million, respectively.

During the nine months ended September 30, 2012, operations generated \$21.1 million of gross cash flow, due to an \$11.0 million increase in unearned premiums, a \$3.0 million decrease in prepaid reinsurance premiums, a \$1.8 million decrease in deferred income tax expense, \$1.0 million of amortization of investment premium and a \$0.4 million decrease in other assets. Additional sources of cash included a \$0.2 million increase in accounts payable and accrued expenses, \$0.2 million depreciation and amortization, \$0.1 million non-cash compensation, \$0.1 million in net realized investment losses and less than \$0.1 million non-cash impairment recognition, all in conjunction with \$3.2 million of net income.

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During the nine months ended September 30, 2012, operations used \$14.8 million of gross cash flow, due to an \$8.8 million decrease in unpaid losses and LAE, a \$2.5 million increase in premiums receivable and a \$1.7 million decrease in bank overdraft. Additional uses of cash included a \$0.8 million increase in policy acquisition costs, net of amortization, a \$0.8 million decrease in premium deposits and customer credit balances, a \$0.1 million increase in reinsurance recoverable, net and a \$0.1 million decrease in income taxes payable.

During the nine months ended September 30, 2012 and 2011, net cash used by investing activities was \$10.6 million and \$6.2 million, respectively. Our available-for-sale investment portfolio is highly liquid as it consists entirely of readily marketable securities. During the nine months ended September 30, 2012, investing activities generated \$60.7 million and used \$71.3 million.

During the nine months ended September 30, 2012 and 2011, net financing activities provided \$0.1 million. In 2012, the source of cash in connection with financing activities was a \$0.1 million tax benefit related to non-cash compensation.

We offer direct billing in connection with our homeowners', commercial general liability and automobile programs. Direct billing is an agreement in which the insurance company accepts from the insured, as a receivable, a promise to pay the premium, as opposed to requiring the full amount of the policy at policy inception, either directly from the insured or from a premium finance company. The advantage of direct billing a policyholder by the insurance company is that we are not reliant on a credit facility, but remain able to charge and collect interest from the policyholder.

We believe that our current capital resources will be sufficient to meet currently anticipated working capital requirements. There can be no assurances, however, that such will be the case.

As of September 30, 2012, we did not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as "structured finance" or "special purpose" entities, which were established for the purpose of facilitating off-balance-sheet arrangements or other contractually narrow or limited purposes. As such, management believes that we currently are not exposed to any financing, liquidity, market or credit risks that could arise if we had engaged in transactions of that type requiring disclosure herein.

#### Impact of Inflation and Changing Prices

The consolidated financial statements and related data presented herein have been prepared in accordance with GAAP, which requires the measurement of financial position and operating results in terms of historical dollars without considering changes in the relative purchasing power of money over time due to inflation. Our primary assets and liabilities are monetary in nature. As a result, interest rates have a more significant impact on performance than the effects of general levels of inflation. Interest rates do not necessarily move in the same direction or with the same magnitude as the inflationary effect on the cost of paying losses and LAE.

Insurance premiums are established before we know the amount of losses and LAE and the extent to which inflation may affect such expenses. Consequently, we attempt to anticipate the future impact of inflation when establishing rate levels. While we attempt to charge adequate premiums, we may be limited in raising premium levels for competitive and regulatory reasons. Inflation also affects the market value of our investment portfolio and the investment rate of return. Any future economic changes that result in prolonged and increasing levels of inflation could cause increases in the dollar amount of incurred losses and LAE and thereby materially adversely affect future

liability requirements.

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Federated National Holding Company

Item 3

## Quantitative and Qualitative Disclosures about Market Risk

Our investment objective is to maximize total rate of return after federal income taxes while maintaining liquidity and minimizing risk. Our current investment policy limits investment in non-investment-grade debt securities (including high-yield bonds), and limits total investments in preferred stock, common stock and mortgage notes receivable. We also comply with applicable laws and regulations that further restrict the type, quality and concentration of our investments. In general, these laws and regulations permit investments, within specified limits and subject to certain qualifications, in federal, state and municipal obligations, corporate bonds, preferred and common equity securities and real estate mortgages.

Our investment policy is established by our Board's Investment Committee and is reviewed on a regular basis. Pursuant to this investment policy, as of September 30, 2012, approximately 86% of investments were in debt securities and cash and cash equivalents, which are considered to be either held until maturity or available for sale, based upon our estimates of required liquidity. Approximately 94% of the debt securities are considered available for sale and are marked to market. We may in the future consider additional debt securities to be held to maturity and carried at amortized cost. We do not use any swaps, options, futures or forward contracts to hedge or enhance our investment portfolio.

The following table summarizes, by type, our investments as of September 30, 2012 and December 31, 2011.

|  | September 30, 2012 |                  | December 31, 2011 |                  |  |
|--|--------------------|------------------|-------------------|------------------|--|
|  | Carrying Amount    | Percent of Total | Carrying Amount   | Percent of Total |  |
| (Dollars in Thousands)                               |                    |                  |                   |                  |  |
| Debt securities, at market:                          |                    |                  |                   |                  |  |
| United States government obligations and authorities | \$37,928           | 26.15 %          | \$37,217          | 28.75 %          |  |
| Obligations of states and political subdivisions     | 3,467              | 2.39 %           | 2,303             | 1.77 %           |  |
| Corporate  | 72,836             | 50.22 %          | 63,268            | 48.87 %          |  |
| International  | 2,275              | 1.57 %           | 1,523             | 1.18 %           |  |
|  | 116,506            | 80.33 %          | 104,311           | 80.57 %          |  |
| Debt securities, at amortized cost:                  |                    |                  |                   |                  |  |
| Corporate  | 1,328              | 0.92 %           | 962               | 0.74 %           |  |
| United States government obligations and authorities | 6,127              | 4.22 %           | 6,166             | 4.76 %           |  |
|  | 7,455              | 5.14 %           | 7,128             | 5.50 %           |  |
| Total debt securities                                | 123,961            | 85.47 %          | 111,439           | 86.07 %          |  |
| Equity securities, at market:                        |                    |                  |                   |                  |  |
|  | 21,070             | 14.53 %          | 18,028            | 13.93 %          |  |
| Total investments                                    | \$145,031          | 100.00 %         | \$129,467         | 100.00 %         |  |

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## Federated National Holding Company

Available-for-sale debt securities are carried on the balance sheet at market and held-to-maturity debt securities are carried on the balance sheet at amortized cost. As of September 30, 2012 and December 31, 2011, debt securities had the following quality ratings by S&P or, if not rated by S&P, by Moody's or Fitch.

|           | September 30, 2012     |                  | December 31, 2011 |                  |   |
|-----------|------------------------|------------------|-------------------|------------------|---|
|           | Carrying Amount        | Percent of Total | Carrying Amount   | Percent of Total |   |
|           | (Dollars in Thousands) |                  |                   |                  |   |
| AAA       | \$49,298               | 39.77            | % \$48,686        | 43.69            | % |
| AA        | 5,334                  | 4.30             | % 6,712           | 6.02             | % |
| A         | 29,662                 | 23.93            | % 31,960          | 28.68            | % |
| BBB       | 39,667                 | 32.00            | % 22,193          | 19.92            | % |
| Not rated | -                      | 0.00             | % 1,888           | 1.69             | % |
|           | \$123,961              | 100.00           | % \$111,439       | 100.00           | % |

The following table summarizes, by maturity, the debt securities as of September 30, 2012 and December 31, 2011.

|                        | September 30, 2012     |                  | December 31, 2011 |                  |   |
|------------------------|------------------------|------------------|-------------------|------------------|---|
|                        | Carrying Amount        | Percent of Total | Carrying Amount   | Percent of Total |   |
|                        | (Dollars in Thousands) |                  |                   |                  |   |
| Matures In:            |                        |                  |                   |                  |   |
| One year or less       | \$7,290                | 5.88             | % \$8,328         | 7.47             | % |
| One year to five years | 57,731                 | 46.57            | % 48,176          | 43.24            | % |
| Five years to 10 years | 39,134                 | 31.57            | % 37,380          | 33.54            | % |
| More than 10 years     | 19,806                 | 15.98            | % 17,555          | 15.75            | % |
| Total debt securities  | \$123,961              | 100.00           | % \$111,439       | 100.00           | % |

At September 30, 2012, the weighted average maturity of the debt portfolio was approximately 6.4 years.

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## Federated National Holding Company

The following table provides information about the financial instruments as of September 30, 2012 that are sensitive to changes in interest rates. The table presents principal cash flows and the related weighted average interest rate by expected maturity date based upon par values.

|  | 2012     | 2013     | 2014     | 2015      | 2016      | 2017     | Thereafter | Total      | Carrying Amount |
|--|----------|----------|----------|-----------|-----------|----------|------------|------------|-----------------|
| Principal amount by expected maturity:               |          |          |          |           |           |          |            |            |                 |
| United States government obligations and authorities | \$ 103   | \$ 1,653 | \$ 813   | \$ 50     | \$ 1,085  | \$ 868   | \$ 13,030  | \$ 17,602  | \$ 19,367       |
| Obligations of states and political subdivisions     | -        | 350      | -        | -         | -         | 350      | 2,450      | 3,150      | 3,467           |
| Corporate securities                                 | 1,548    | 3,146    | 5,079    | 5,191     | 7,411     | 6,832    | 31,096     | 60,303     | 68,605          |
| International securities                             | -        | -        | -        | -         | 790       | 1,248    | -          | 2,038      | 2,275           |
| Collateralized mortgage obligations                  | -        | 745      | 2,595    | 16,094    | 6,933     | -        | 1,327      | 27,694     | 30,247          |
| Equity securities, at market                         | -        | -        | -        | -         | -         | -        | -          | -          | 21,070          |
| All investments                                      | \$ 1,651 | \$ 5,894 | \$ 8,487 | \$ 21,335 | \$ 16,219 | \$ 9,298 | \$ 47,903  | \$ 110,787 | \$ 145,031      |
| Weighted average interest rate by expected maturity: |          |          |          |           |           |          |            |            |                 |
| United States government obligations and authorities | 4.50 %   | 3.54 %   | 1.18 %   | 0.25 %    | 1.92 %    | 0.80 %   | 2.57 %     | 2.47 %     |                 |
| Obligations of states and political subdivisions     | 0.00 %   | 2.04 %   | 0.00 %   | 0.00 %    | 0.00 %    | 1.65 %   | 4.27 %     | 3.73 %     |                 |
|  | 3.86 %   | 3.95 %   | 5.32 %   | 4.12 %    | 3.87 %    | 4.51 %   | 5.59 %     | 4.98 %     |                 |

|                                     |        |        |        |        |        |        |        |        |  |  |  |  |  |  |
|-------------------------------------|--------|--------|--------|--------|--------|--------|--------|--------|--|--|--|--|--|--|
| Corporate securities                |        |        |        |        |        |        |        |        |  |  |  |  |  |  |
| International securities            | 0.00 % | 0.00 % | 0.00 % | 0.00 % | 1.98 % | 4.82 % | 0.00 % | 3.72 % |  |  |  |  |  |  |
| Collateralized mortgage obligations | 0.00 % | 4.78 % | 4.11 % | 4.00 % | 5.03 % | 0.00 % | 3.00 % | 4.24 % |  |  |  |  |  |  |
| Equity securities, at market        | 0.00 % | 0.00 % | 0.00 % | 0.00 % | 0.00 % | 0.00 % | 0.00 % | 0.00 % |  |  |  |  |  |  |
| All investments                     | 3.90 % | 3.83 % | 4.55 % | 4.02 % | 4.14 % | 4.10 % | 4.63 % | 4.34 % |  |  |  |  |  |  |

#### Item 4

##### Controls and Procedures

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in the reports that we file or submit under the Securities Exchange Act is recorded, processed, summarized, and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosures.

Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of our disclosure controls and procedures as defined in Rules 13a-15(e) under the Securities Exchange Act of 1934, as of September 30, 2012. Based upon their evaluation, the Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures, as of September 30, 2012, were effective to provide reasonable assurance that information required to be disclosed by us in the reports filed or submitted by it under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and to provide reasonable assurance that information required to be disclosed by us in such reports is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

There were no changes during the first nine months of 2012 that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

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Federated National Holding Company

Part II: OTHER INFORMATION

Item 1

Legal Proceedings

See Item 1 of Part I, “Financial Statements – Note 4 – Commitments and Contingencies.”

Item 1A

Risk Factors

There have been no material changes from the risk factors previously disclosed in Item 1, Risk Factors, in the Company’s Form 10-K for the fiscal year ended December 31, 2011.

Additional Risk Factors

The risks described in this Quarterly Report on Form 10-Q and in our Annual Report on Form 10-K for the fiscal year ended December 31, 2011 are not the only risks facing our Company. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results.

Item 2

Unregistered Sales of Equity Securities and Use of Proceeds

(a) None

(b) None

(c) None

Item 3

Defaults upon Senior Securities

None

Item 4

Mine Safety Disclosures

Item 5

Other Information

(a) None

(b) None

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Federated National Holding Company

Item 6

Exhibits

|              |  |
|--------------|--|
| 3.1          | Amended and Restated Articles of Incorporation, as amended *   |
| 10.1         | Excess Catastrophe Reinsurance Contract, effective July 1, 2012, between Federated National Insurance Company and subscribing reinsurers. *                |
| 10.2         | Reinstatement Premium Protection Reinsurance Contract, effective July 1, 2012, between Federated National Insurance Company and subscribing reinsurers. *  |
| 10.3         | INCR 5th Layer Excess Catastrophe Reinsurance Contract, effective July 1, 2012, between Federated National Insurance Company and subscribing reinsurers. * |
| 10.4         | 2012 Stock Incentive Plan (incorporated herein by reference to the Company's Definitive Schedule 14A Proxy Statement filed on July 10, 2012)               |
| 31.1         | Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act.*   |
| 31.2         | Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act.*   |
| 32.1         | Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act.*   |
| 32.2         | Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act. *  |
|              | 101.INS-XBRL Instance Document. **   |
| 101.SCH-XBRL | Taxonomy Extension Schema Document. **   |
| 101.CAL-XBRL | Taxonomy Extension Calculation Linkbase Document. **   |
| 101.LAB-XBRL | Taxonomy Extension Label Linkbase Document. **   |
| 101.PRE-XBRL | Taxonomy Extension Presentation Linkbase Document. **  |

\* filed herewith

\*\* In accordance with Rule 406T of Regulation S-T, these interactive data files are deemed not filed for purposes of Section 18 of the Exchange Act, or otherwise subject to the liability of that section, and shall not be part of any registration statement or other document filed under the Securities Act or the Exchange Act, except as shall be expressly set forth by specific reference in such filing.

Federated National Holding Company

Signatures

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 hereunto duly authorized.

FEDERATED NATIONAL HOLDING COMPANY

By: /s/ Michael H. Braun  
Michael H. Braun, Chief Executive Officer  
(Principal Executive Officer)

/s/ Peter J. Prygelski, III  
Peter J. Prygelski, III, Chief Financial  
Officer  
(Principal Financial and Accounting Officer)

Date: November 14, 2012



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Federated National Holding Company

EXHIBIT INDEX

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